

THE CRYPTO CONTAGION



AN OVERVIEW OF RECENT CASES

Authored by: Paul Madden (Partner) - Harneys Luxembourg

The digital assets world has seen a number of collapses of some of the market's key players, the most recent and notable being FTX, Three Arrows Capital, and Celsius which have all resulted in cross-border insolvency proceedings.

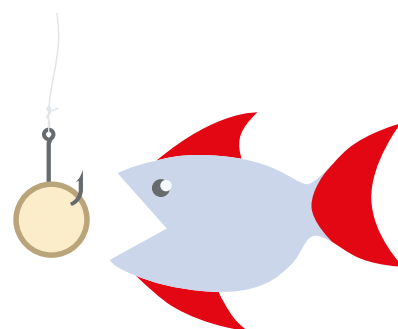
The domino effect of one collapse leading to another is no coincidence.

It has transpired that these failed entities were heavily investing in each other, either through equity investments, or buying each other's proprietary digital assets. This investment strategy had a number of effects to variously include the boosting of business volume and a potential increase in the book value of their assets and/or the value of their own proprietary cryptocurrencies (if they had any). It also meant investors were more likely to continue to make deposits. It also ensured investment practices of this nature created financial circles that initially led to exponential

growth across the market but has resulted in similarly exponential collapse of some potential bad actors, the true extent of which we are learning in real time at pace.

These investment practices have resulted in insolvency proceedings for a number of digital asset funds, centralised lenders and centralised exchanges. It is anticipated that separate actions will be taken by law enforcement and regulators across the globe and there can be no doubt that the bad actors in this space have helped to create a distrust of centralised digital assets participants and platforms. It remains to be considered whether individual investors or groups of investors will seek to bring direct claims against participants, likely in the form of mis-selling, fraud or price manipulation, and how such claims could sit beside any related insolvency proceedings.

In this article we examine the fallout of three household crypto names and the legal proceedings that have ensued.



FTX

The lack of regulation or effective regulation in the industry has been felt most recently by the FTX fallout and allegations of a long-running scheme to misuse investor funds. As this scandal involved an exchange that was promoted and relied on by many participants as being among the safest in the market, it caused a strong ripple effect across the industry following FTX's bankruptcy filing and subsequent claims against its founder for fraudulent conduct. We have most recently seen

guilty pleas from FTX's top level of management in the Southern District of New York.

FTX was founded in 2019 and became the third-largest crypto exchange in the world by volume. Through the FTX exchange platform, investors could buy and sell a wide range of cryptocurrencies. FTX also created its own token (FTT), which facilitated lower trading fees on the FTX platform, insurance protection for leveraged transactions, and staking for validation transaction and various rewards. The FTX exchange was advertised as being a safe and easy option for investors; it was marketed by well-known celebrities and had received capital from high-profile investment firms. However, the success of FTX was short-lived and it filed for bankruptcy on 11 November 2022 in the US Bankruptcy Court for the District of Delaware.¹

The founder of FTX, Sam Bankman-Fried (SBF), has since been accused of engineering "one of the biggest financial frauds in American history" and now faces criminal charges.² The allegations include misappropriation of customer funds. As part of the conspiracy, it is alleged that funds were also diverted to make undisclosed investments, real estate purchases, and even political donations.

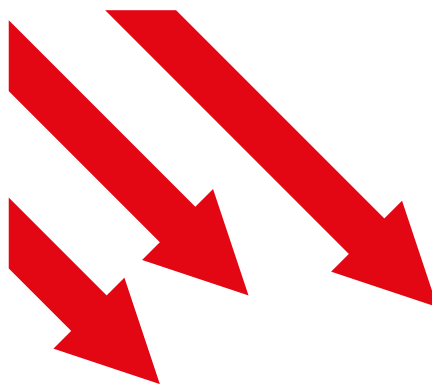
The Supreme Court of the Bahamas (Bahamas being where FTX's non-US operation was headquartered and therefore its centre of main interests (COMI)) has appointed provisional liquidators (JPLs) to oversee the exchange's assets pursuant to the Companies (Winding Up Amendment) Act 2011. One of the steps taken since the appointment of liquidators has been to transfer FTX's crypto wallets to Bahamian government-controlled wallets in order to preserve assets.

The JPLs, appointed over FTX, filed a Chapter 15³ suit in the Southern District of New York for FTX Digital Markets⁴, one of the companies under

the FTX umbrella and the name of the entity located in the Bahamas. These proceedings have since been transferred to Delaware, where FTX had already filed for bankruptcy protection. The Chapter 15 proceedings seek, amongst other relief, recognition of the Bahamian liquidation as a foreign main proceeding under Chapter 11 and appointment of the Bahamian appointed JPLs as FTX Digital's foreign representatives.

Chapter 15 promotes the interests of comity and cooperation between foreign courts by empowering the US court to recognise foreign insolvency proceedings, assist foreign appointed liquidators, and regulate ancillary US proceedings.

Where a company has assets, liabilities and claims in multiple countries including the US, Chapter 15 is a powerful tool for both the debtor (seeking to protect assets in the US) and for creditors (by maximising the value of the debtor's assets and regulating the claims process).



Three Arrows Capital (3AC)

3AC was the first major crypto firm to go into bankruptcy in 2022 albeit the collapse was triggered by the prior collapse of Terra Luna, which was the victim of a complex hack. The resulting difficulties caused a ripple effect and lead to the first major casualty being 3AC. This BVI incorporated investment firm filed bankruptcy proceedings in the BVI on 27 June 2022⁵ followed by parallel New York proceedings pursuant to Chapter 15 in order to protect US assets⁶. Liquidators were appointed by the BVI Court⁷ and continue to wind down the operations of the collapsed crypto fund and liquidate its assets.

While no mismanagement claims have been filed against the founders of 3AC thus far, they have been accused of failing to co-operate with the insolvency process.

The liquidators of 3AC have sought assistance from the courts, recently applying to the US Bankruptcy Court to authorise the service of subpoenas on the founders and investment managers of 3AC for provision of discovery necessary to preserve assets.⁸

One of the related casualties in the 3AC collapse is Voyager Digital, which filed for Chapter 11 bankruptcy protection after 3AC was unable to pay back funds totalling approximately US\$670 million.

The most recent filing in the 3AC Chapter 15 proceedings gives notice of the assignment of the Honourable Chief Justice Margaret Ramsay-Hale in voluntary liquidation proceedings currently pending in the Cayman Islands for Much Wow Limited,⁹ a Cayman Islands incorporated Company indebted to 3AC for approximately US\$25.2m.¹⁰

1 FTX Trading Ltd., a company incorporated in Antigua and Barbuda, that filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code on 11 November 2022: In re FTX Trading Ltd., Case No. 22-11068

2 US prosecutors filed criminal charges against Bankman-Fried in December 2022

3 11 US Code Chapter 15 - Ancillary and Other Cross-Border Cases

4 In the Matter of FTX Digital Markets LTD. Case 22-11217-JTD

5 In re Three Arrows Capital Limited, Case No. BVIHCOM2022/0119

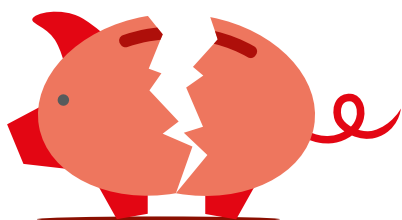
6 In re Three Arrows Capital Limited, Case No. 22-10920-(mg)

7 Eastern Caribbean Supreme Court in the High Court of Justice Virgin Islands (Commercial Division)

8 Case No. 22-10920-(mg), document 75 at page 12

9 FSD 278 of 2022

10 Petition filed on 29 November 2022 at [14].



Celsius

In July 2022, Celsius Network, a crypto lender described as “one of the largest and most sophisticated cryptocurrency based finance platforms in the world”,¹¹ filed for Chapter 11 bankruptcy protection due to a liquidity crisis. Celsius suspended withdrawals, swaps and transfers on its platform in June 2022 and hired a restructuring advisor before commencing the Chapter 11 process the following month.¹²

Chapter 11 of the Bankruptcy Code¹³ facilitates the resolution of financial distress. Once proceedings are instigated, an automatic stay comes into effect which precludes creditors from

taking action against the debtor or its property, such as enforcing pre-petition judgments or terminating contracts on account of pre-petition defaults.

This provides breathing room for the debtor to remedy operational problems and implement a reorganisation plan.

Similar to the FTX allegations, Celsius has been accused of misusing customer funds and effectively running “a Ponzi Scheme”¹⁴. A complaint was filed against Celsius by Jason Stone, the CEO and founder of KeyFi, Inc., which managed billions of dollars in digital asset investments for Celsius. In addition to allegations of disorganisation, mismanagement, and fraud,¹⁵ Stone asserts that the lending platform was using customer funds to manipulate crypto-asset markets to their benefit.¹⁶ Celsius responded by filing a claim against Stone and KeyFi, Inc in August alleging that it was in fact Stone

who was misusing customer funds by stealing millions of dollars in coins from Celsius “wallets”.¹⁷ A motion by Stone and KeyFi to dismiss the causes of action brought by Celsius has recently been denied¹⁸ and therefore both lawsuits continue to run alongside the Chapter 11 proceedings.

Conclusion

There is an expanding web of legal proceedings resulting from the current contagion in the digital assets sector, and while many of these proceedings are currently in the early stages, the far-reaching effects are already evident. As the above digital assets cross-border insolvencies run their courses, we expect that they will tackle some of the novel issues relating to the nature and location of assets, discovery and identification of relevant parties and we anticipate many more digital assets-related filings in the Cayman courts.

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¹¹ In legal documents filed in 1:2022bk10964

¹² The Chapter 11 proceedings for all Celsius Network entities are now being jointly administrated under the case of Celsius Network LLC 1:2022bk10964

¹³ 11 U.S. Code Chapter 11 - Reorganization

¹⁴ KeyFi Inc. v. Celsius Network Ltd. et al: Complaint dated 7 July 2022 at [4]

¹⁵ KeyFi Inc. v. Celsius Network Ltd. et al: Complaint dated 7 July 2022 at [13]

¹⁶ KeyFi Inc. v. Celsius Network Ltd. et al: Complaint dated 7 July 2022 at [7]

¹⁷ Celsius Network Limited et al v. Stone et al 22-01139-mg at [3].

¹⁸ Memorandum and Order dated 8 December 2022 (Doc 47)