AMERICAN BANKRUPTCY INSTITUTE

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Cryptocurrency and Blockchain: What Is It? How Does It Apply to Restructurings and Bankruptcy?

Darren Azman
McDermott Will & Emery; New York

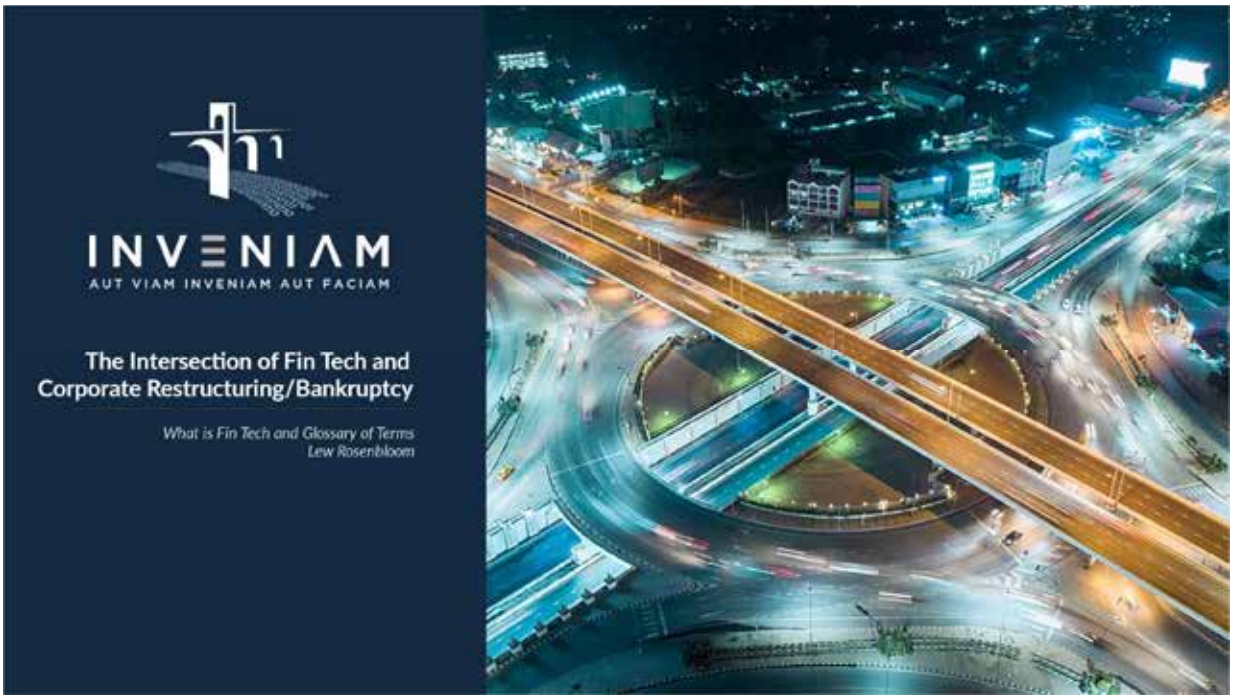
Richard A. Chesley
DLA Piper; Chicago

Ori Katz
Sheppard, Mullin, Richter & Hampton LLP; San Francisco

Lewis S. Rosenbloom
Inveniam; Chicago

CONCURRENT SESSION

2021



INVENIAM
AUT VIAM INVENIAM AUT FACIAM
1 (212) 220-6681
One World Trade Center, Suite 8500
New York, NY 10007
114 East Main Street, Suite 300
Northville, MI 48167

What Is Fin Tech?

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AUT VIAM INVENIAM AUT FACIAM

1 (212) 220-6681
One World Trade Center, Suite 8500
New York, NY 10007

114 East Main Street, Suite 300
Northville, MI 48167

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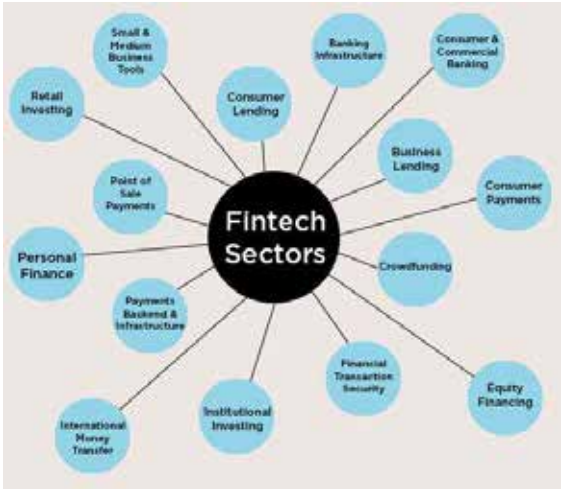
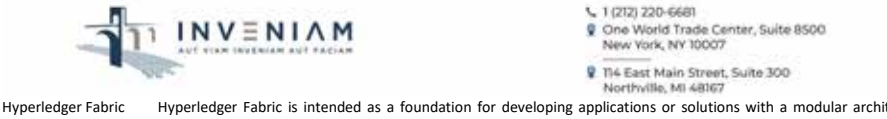
Northville, MI 48167



Bitcoin	Bitcoin is a digital currency created in January 2009 following the housing market crash. It follows the ideas set out in a whitepaper by the mysterious and pseudonymous Satoshi Nakamoto.1 The identity of the person or persons who created the technology is still a mystery. Bitcoin offers the promise of lower transaction fees than traditional online payment mechanisms and is operated by a decentralized authority, unlike government-issued currencies. There are no physical bitcoins, only balances kept on a public ledger that everyone has transparent access to, that – along with all Bitcoin transactions – is verified by a massive amount of computing power. Bitcoins are not issued or backed by any banks or governments, nor are individual bitcoins valuable as a commodity. Despite it not being legal tender, Bitcoin charts high on popularity, and has triggered the launch of hundreds of other virtual currencies collectively referred to as Altcoins.
Bitcoin Cash	Bitcoin cash is a cryptocurrency created in August 2017, from a fork of Bitcoin. Bitcoin Cash increases the size of blocks, allowing more transactions to be processed. The cryptocurrency underwent another fork in November 2018 and split into Bitcoin Cash ABC and Bitcoin Cash SV (Satoshi Vision).2 Bitcoin Cash is referred to as Bitcoin Cash because it uses the original Bitcoin Cash client.
Blockchain	NEED DEFINITION????
DAO's	NEED DEFINITION????
DEFI	Decentralized Finance: a set of technologies that allow a distributed set of peers to organize and conduct transactions; Bitcoin is cited as the first such tech, but it has been augmented by more flexible, purpose-specific standards.
Digital Financial Instrument (DFI)	A digital evidence of ownership.

Distribution of Tokens	The process of transferring some tokens from the main deal wallet to the wallets of selected users.
DLT	Distributed Ledger Technology (DLT)
DLT Transaction	This is a transaction recorded into block-chain. Typically, this would be some signed documents belonging to the deal burned into its smart contract. A third-party service that provides the tools for electronically signing legal documents A deal can have several stages that collect due diligence information (internal and external). Due Diligence has to do with collecting KYC and AML documents, credit, tax and insurance documents and any other documents that are required by law for performing the deal. It also is responsible for the audit and approval of these documents by the qualified people. A type of deal. Equity deal type is designed to sell shareholder equity. Selling equity is basically selling bits of ownership in a company.
ESG	Environmental, social, and governance (ESG) criteria are a group of standards used by socially conscious investors to screen investments.
Ether	Ether is the integral element of the Ethereum blockchain network that acts as the network's fuel, keeping it agile and functional. While many believe that ether is the native digital currency of Ethereum, it acts as a medium of incentive or form of payment for the network participants to execute their requested operations on the network.
Ethereum	Ethereum is open access to digital money and data-friendly services for everyone – no matter your background or location. It's a community-built technology behind the cryptocurrency ether (ETH) and thousands of applications you can use today.

Etherscan	A sort of "browser" for the Ethereum blockchain, used for inspecting transactions. We've only written a pointer (URL) and a hash (fingerprint) to the payload on a block. The document itself is off-chain and its access is privately controlled.
GAS	Gas refers to the fee, or pricing value, required to successfully conduct a transaction or execute a contract on the Ethereum blockchain platform. Priced in small fractions of the cryptocurrency ether, commonly referred to as gwei or sometimes nanoeth, the gas is used to allocate resources of the ethereum virtual machine (EVM) so that decentralized applications such as smart contracts can self-execute is a secured fashion. The exact price of the gas is determined by the network's miners, who can decline to process a transaction if the gas price does not meet their threshold.
Hash	A cryptographic "fingerprint" of a piece of data.
HLT	Hyperledger technology (HLT) is just such an adapted and adaptable modular blockchain technology platform for the business sector, based on Linux open-source software. HLT enables interested companies to quickly create their own frameworks as the foundation for the business use of blockchain.
HUB	Multichain wallet hosted on a platform for the user.
Hyperledger	Hyperledger is an open-source community focused on developing a suite of stable frameworks, tools and libraries for enterprise-grade blockchain deployments. It serves as a neutral home for various distributed ledger frameworks including Hyperledger Fabric, Sawtooth, Indy, as well as tools like Hyperledger Caliper and libraries like Hyperledger Ursa.



Hyperledger Fabric	Hyperledger Fabric is intended as a foundation for developing applications or solutions with a modular architecture. Hyperledger Fabric allows components, such as consensus and membership services, to be plug-and-play. Its modular and versatile design satisfies a broad range of industry use cases. It offers a unique approach to consensus that enables performance at scale while preserving privacy.
Metamask	A browser plug-in that "custodies" the user's keys (and thereby controls crypto transactions).
Merkle Tree	Merkle tree is a fundamental part of blockchain technology. It is a mathematical data structure composed of hashes of different blocks of data, and which serves as a summary of all the transactions in a block. It also allows for efficient and secure verification of content in a large body of data. It also helps to verify the consistency and content of the data. Both Bitcoin and Ethereum use Merkle Trees structure. Merkle Tree is also known as Hash Tree.
Private Network	A private blockchain is an invitation-only network governed by a single entity. Entrants to the network require permission to read, write or audit the blockchain. There can be different levels of access and information can be encrypted to protect commercial confidentiality.
Public Network	A public blockchain is an open network. Anyone can download the protocol and read, write or participate in the network. A public blockchain is distributed and decentralized. Transactions are recorded as blocks and linked together to form a chain.
Smart Contract	An unbreakable contract based on events observable on-chain.
Tokenization	The process of issuing a token for a deal and deploying its Smart Contract to block chain.

INSOL International

Cryptocurrency and its impact on insolvency and restructuring

May 2019

INSOL SPECIAL REPORT

Cryptocurrency and its impact on insolvency and restructuring

Contents

INSOL International, 6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

May 2019

Acknowledgement

Following on from the very successful sessions on cryptocurrency at the INSOL Singapore annual conference at the beginning of April 2019, we are pleased to provide our members with a Special Report titled “Cryptocurrency and its impact on insolvency and restructuring”, by Rick Chesley and Malithi Fernando of DLA Piper.

In this Special Report the authors look at a variety of issues relating to cryptocurrencies, starting with the most basic description of cryptocurrency, blockchain and initial coin offerings (ICOs). This is followed by a discussion of the legal characterisation of cryptocurrencies (also from the point of view of various jurisdictions) and a discussion on whether or not security rights may be taken over cryptocurrencies. The report then looks at cryptocurrencies in the context of insolvency and restructuring, concluding with a forward-looking discussion on the regulation of cryptocurrencies.

INSOL International would like to thank Rick Chesley, Malithi Fernando and the whole DLA Piper team for this very timely and interesting paper on cryptocurrency and its impact on insolvency and restructuring.

May 2019

Contributors

The authors would like to thank the DLA Piper team listed below for their contribution to this Special Report:

Country	DLA Piper Contributor(s)
England	Michael Fiddy Martin Bartlam Neil Riley Michael McKee Christopher Whittaker
Denmark	Dennis Højslet
Italy	Alberto Angeloni Raffaele Buono
Netherlands	Marc Molhuysen Jian-Cheng Ku Frank van de Wakker Bram Vlaanderen Aline Kiers Rhys Bane Guy Verbon
Russia	Alexei Kolesnikov
Sweden	Erik Selander Kent Hägglund Mikaela Reinhammar Adam Tideman
US	Deborah R Meshulam Benjamin Klein Tara Nair Alana Friedberg

Cryptocurrency and its impact on insolvency and restructuring

By Richard Chesley[1] and Malithi Fernando,[2] DLA Piper

1. Introduction

The UK government recently released certain papers under the Official Secrets Act 1989, where the 1994 government advisors during John Major's premiership confidently commented that e-mail would never catch on. As our inboxes fill up while we are on holiday, and smartphones presage new technologies, we may wish that they had been right but history will judge their greatest prophetic moment. History has been littered with intelligent predictions about how innovations will either change our very essence or become a white elephant. In 1920, The New York Times dismissed the possibility of space travel by claiming that "a rocket will never be able to leave the Earth's atmosphere." In 1969, the paper issued a retraction of its original article as the Apollo 11 headed to the moon. Undoubtedly, cryptocurrency has inspired numerous predictions on both sides and in time we may be able to judge which were accurate but at the moment it remains to be seen whether cryptocurrencies will remain the successes of the internet and space travel, or disappear like Google glasses.

The world is changing in such a way that the lines between the "virtual" and the "real" world are becoming less distinct. Banks and traditional financial institutions have moved to online platforms and physical cash is becoming obsolete. Modern payment systems are computerised and money exists mostly as digital records on a bank's account ledger.

1.1 Where do cryptocurrencies fit into our world?

Digital currencies are currencies stored and transferred electronically; cryptocurrencies are a form of digital currency. On 3 January 2009, the cryptocurrency revolution commenced with the launch of the first cryptocurrency in the form of the Bitcoin network. However, digital currencies have been around for some time. For example E-gold was a digital gold currency operated by Gold & Silver Reserve Inc., founded in 1996. It allowed users to open an account denominated in grams of gold (or other precious metals) on their website and make an instant transfer of value to other E-gold accounts. Certain digital currencies can be held and used only in the context of a virtual world, for example, video games like World of Warcraft allow users to purchase certain virtual products within the game using virtual currencies. These virtual currencies are those that are not intended for use in real life or for the purchase of real assets. On the other hand, cryptocurrencies are mathematical and cryptographical constructs designed with the intention of acting as a substitute for traditional payment platforms. Cryptocurrencies originated from the shadows of the financial crisis, as a direct contender against the traditional system of currency and central banks. The new generation of consumers are disillusioned by the traditional financial system, the cost associated with transactions and the role that banks and financial institutions played in the recent financial crisis. This has led to the growing interest in a decentralised financial system which is inclusive of all consumers irrespective of credit history and a system which has the ability to give the consumer greater control.

[1] Richard Chesley is a Partner and Global Co-Chair of Restructuring at DLA Piper LLP (US).
[2] Malithi Fernando is an Associate in the London Restructuring Practice at DLA Piper UK LLP.

The growth in popularity of digital currencies with consumers over the years has forced markets, legislators and regulators to pay attention. How things will be litigated can be postulated but no one really knows whether something will continue to grow or whether it will fail. Cryptocurrencies exemplify this notion. What we do know is that all innovations will need the benefit of the insolvency and restructuring profession at some point through their development journey. As crypto-transactions infiltrate the mainstream markets and become part of the bankruptcy estate of individuals and corporations alike, insolvency professionals will be asked to answer questions that have not yet been made clear through legislative guidance and regulation. We also know that only through the lens of insolvency will the real nature of the legal relations of cryptocurrency be tested. Insolvency professionals will need to adopt new and innovative methods to tackle the issues arising from the unchartered legal complexities of cryptoassets and the difficulties of consolidating a legal black hole.

The purpose of this paper is to provide an overview of cryptocurrencies, particularly looking at Bitcoin. The paper commences with an analysis of what cryptocurrencies are and how they function within the current economic environment. We then continue to consider the legal characterisation of cryptocurrencies, or the lack thereof, and the implications of this for those participating in the cryptocurrency markets. We also consider what security interests are capable of existing in a cryptoasset. We analyse the challenges that insolvency professionals face when confronted with an insolvency estate that contains various cryptoassets. We then conclude by providing an overview of the current regulatory position of cryptocurrencies in a number of jurisdictions to get a sense of the issues that they are confronting. It is not surprising to learn that there is little universalism. It soon becomes clear that the issues surrounding cryptocurrencies and blockchain have outpaced legislation and regulation.

2. Cryptocurrency and blockchain

2.1 What is cryptocurrency?

2019 is the tenth anniversary of the world's first cryptocurrency, Bitcoin. Cryptocurrencies emerged as a bi-product of digital cash and within a few years would be worth more than USD 10 billion, peaking at above USD 300 billon. Despite the overwhelming success of cryptocurrencies over the years, the technology appears to still linger on the fringes. In this part of the paper the essential characteristics of cryptocurrency and blockchain are considered, particularly looking at Bitcoin (considered to be the first and most important cryptocurrency in play at present) as our case study and its journey so far.

A paper on cryptocurrencies would be incomplete without a brief history of the development of cryptocurrency and paying particular homage to the legendary Satoshi Nakamoto, the enigmatic inventor of Bitcoin. We know very little about Nakamoto, not even whether the name is a pseudonym for an individual or a group of likeminded individuals.[3] We do know that in 2008 Nakamoto developed a paper titled "Bitcoin: A Peer-to-Peer Electronic Cash System" which was posted to an obscure list of "cypherpunks"[4] looking to incite social, economic

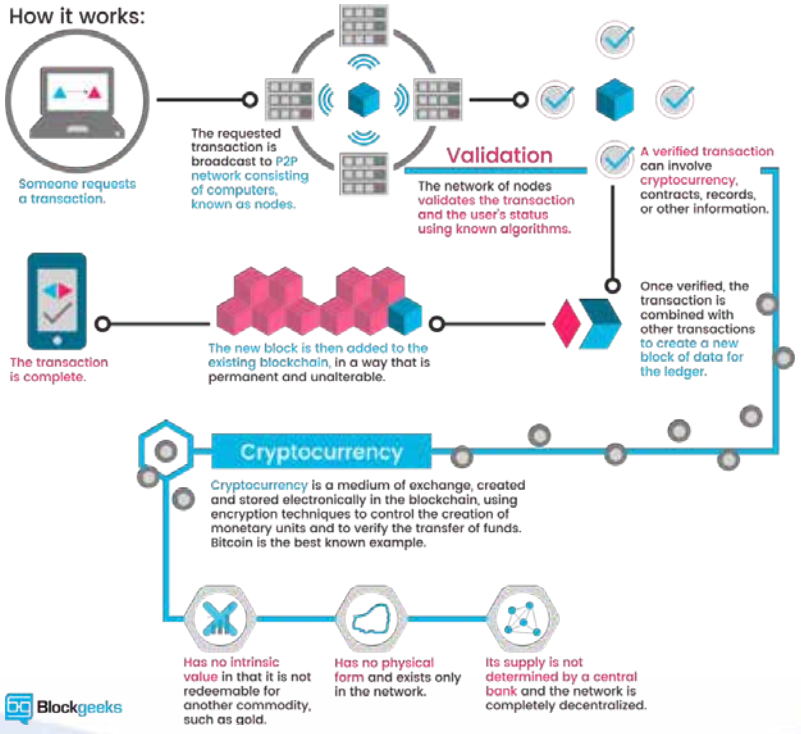
[3] As this paper goes to print, the unveiling of the actual invention of Bitcoin is gathering substantial media attention.

[4] A "cypherpunk" is an activist advocating the widespread use of strong cryptography and privacy-enhancing technologies as a route to social and political change.

and political change through cryptography and computer science. The idea emerged from the ashes of one of the worst financial crises the world had ever seen; Nakamoto idealised a society which is independent and capable of performing basic functions of life without the need for bankers, accountants and government (seen by some to be the instigators of the financial crises). The paper set out the blueprints for Bitcoin, which intended to prevent double spending and to create a completely decentralised digital cash system. The basic idea is to allow money to be transferred between individuals in the online community in a transparent environment without restrictions and extra fees being paid to a third party. This is in contrast to the traditional payment system that requires a central server (charging fees) that maintains a record of the balances.

Bitcoin consists of a network of peers and every peer has a record of the history of all transactions, including the balance of every account. When a transaction is requested, it enters the peer-to-peer network consisting of computers known as nodes. Using algorithms, the network of nodes validate the transaction including the user's status. When the transaction is verified by the network it is combined with other transactions to create a new block of data for the ledger. The new block is added to the existing blockchain in a way that is permanent and unalterable. The transaction is known almost immediately by the entire network. Miners alone can confirm transactions in the cryptocurrency network and they are rewarded with a token of cryptocurrency for fulfilling this role.

The diagram below demonstrates how Bitcoin transactions work:[5]



[5] https://blockgeeks.com/guides/what-is-cryptocurrency/.

The essential characteristics of Bitcoin are:

- transactions confirmed by the network are irreversible;
- transactions and the accounts are not connected to the actual identities of users. The accounts consist of a random chain of thirty characters. It is possible to analyse the transactions that have been made using the account address as these are available on the decentralised network for anyone to view. However, it is difficult to connect to a real world identity without co-operation from the user or an exchange platform;
- transactions made using the network are near instantaneous and can be confirmed within a few minutes. The system consists of a global network of computers and it is not affected by geographical location, business hours or public holidays;
- cryptocurrency funds are stored in a public key cryptography system which can only be accessed by the holder of the private key;
- due to the decentralised nature of the network, cryptocurrency transactions are reviewable by anyone on the platform without restriction. It only requires an individual to download the software which is free of charge.

Bitcoins are created by "mining", which is the processing of transactions by adding to the record of past transactions. Anyone in the cryptocurrency community can be a miner since the decentralised system does not have an authority to delegate the role. In order to prevent fraud, Nakamoto created the rule that miners will need to solve a cryptologic puzzle in order to qualify to perform the role of a miner. With the solution to the puzzle, the miner can proceed to build a block and add to the blockchain. A finite number of Bitcoins can be mined by this process; 21 million according to Nakamoto's design. This determines the market value of Bitcoins. Ethereum is the second largest alternative cryptocurrency to the Bitcoin. Ethereum, unlike Bitcoin, has automated transaction functionality.

A study by the European Financial and Administrative Authority in 2015 set out the types of cryptocurrency payment arrangements in existence, taking into account the interaction between cryptocurrency and traditional currency:

- **closed arrangements** have no connection between the global economy and cryptocurrencies. Cryptocurrencies are only exchanged with other cryptocurrencies, that is, in computer games using in-game currency. This type of cryptocurrency is not yet considered to require regulation or legislation;
- **unidirectional flow arrangements** are where the cryptocurrency can be transformed into fiat currency (currency that has been declared by a government as legal tender). However, the opposite cannot occur (for example, Facebook Credits sold by Facebook in 2009, whereby fiat currency could be used to purchase the Facebook Credit, but the Facebook Credit could not be converted back to fiat currency). This would also not require a great deal of regulation as long as users do not oversubscribe to it; and
- **bidirectional flow arrangements** are where cryptocurrency could be converted freely into cash and *vice versa*. Therefore, cryptocurrency can be used to buy and sell goods and services. This type of payment arrangement will be of particular interest to lawmakers and regulators.

2.2 What is blockchain?

As described above, blockchain provides a new approach to holding and authenticating data. It is a database operating through distributed ledger technology (DLT) in which data is recorded on computers, by way of a peer-to-peer mechanism, based on pre-agreed consensus algorithms in the applicable participating network. It is a form of database where data is stored in the chain in either fixed structures called “blocks” or algorithm functions called “hashes”.

Each block includes unique features, such as its unique block reference number, the time the block was created and a link back to the previous block. Each block is reviewed by a number of nodes and the block is only added to the database if the node reaches consensus that the block only contains valid transactions. Content includes digital assets and instructions that reflect the transactions and parties to those transactions. The ability to track previous blocks in the chain makes it possible to identify transactions back to the first ever transaction completed, enabling parties to verify and establish the authenticity of the assets in the latest block. This makes blockchain exceptionally accurate and secure.

Specialist users on the system apply advanced computing software to identify time-stamped blocks, verify the accuracy of the blocks using sophisticated algorithms and add the verified blocks to the chain. As the number of participants increases, the replication of the data over a wider base makes it harder for any person to alter the data in the chain. Any attempted addition or modification to the information on a block needs to be approved by all users in the network and verification of any block can only happen through a “proof of work” process. This process requires vast amounts of computing power, making it practically impossible to insert fake transactions into a block.

As a result, the data is identified and authenticated in near real-time, providing a permanent and incorruptible database sufficiently robust to operate as a store of value (for example, in the case of Bitcoin) or providing an indisputable record, for example, relating to securities transfer.

Blockchain may be public and open (also known as “permissionless” or “unpermissioned”) or structured within a private group (also known as “permissioned”). Permissionless blockchains include Bitcoin and Ethereum, in which anyone can set up a node that, once authorised, can validate, observe and submit transactions. The identities of the participants are not known (other than the unique and random identities known as an address). Permissioned ledgers restrict participation in the network and only the specific participants are given access and are known within the network. The network is private and only organisations that have been authorised can participate and view transactions. The technology supporting a distributed ledger could be used for recording ownership and transfer of property, potentially replacing organisations such as a land registry. However, adapting blockchain technology for public ledgers, such as land registries, will require the real life identities of the individuals to be easily accessible.

Due to the cost efficiency of blockchain, many financial institutions have been investing in several blockchain-based services and smart settlement systems. Accenture has estimated that the largest investment banks could save USD 10 billion annually by using blockchain technology to improve the efficiency of

clearing and settlement.[6] Major financial institutions (including JP Morgan Chase and Citigroup) have been exploring blockchain technology for tracking derivative trades. In 2015, New York fintech firm R3 created a consortium with a number of financial institutions including Barclays, BBVA, Commonwealth Bank of Australia, Credit Suisse, JP Morgan, State Street, Royal Bank of Scotland and UBS. The consortium seeks to investigate blockchain use in securities settlement payments.

The Financial Conduct Authority (FCA), the financial regulator in the UK, is currently considering a number of applications from blockchain firms that could lead the way for UK consumers using products underpinned by blockchain technology.

2.3 What is an initial coin offering (ICO)?

ICOs are a form of digital currency or token using blockchain technology. ICOs are often a means by which funds are raised for a new blockchain or cryptocurrency venture (the market for ICOs was booming in early 2018). ICOs come in a wide variety of forms and may be used for a wide range of purposes. Some forms of ICOs may be directed at customers or suppliers as a form of loyalty programme, or a form of access or purchasing power (preferential or otherwise) in respect of assets of the issuer's business. Other forms may be more focused on raising initial funding. It is essential to examine the legal and regulatory basis of any ICO. An unauthorised offering of securities is illegal and may result in criminal sanctions in a number of jurisdictions. Legal analysis of the underlying token will determine whether it should be treated as a specified investment or as a form of regulated security, or is more appropriately a form of asset that is not itself subject to the regulatory regime.

Typical attributes provided by tokens will include:

- access to the assets or features of a particular project;
- the ability to earn rewards for various forms of participation on the platform; and
- prospective return on the investment.

Key aspects to consider will include the:

- availability and limitations on the total number of the tokens;
- decision-making process in relation to the rules or ability to change the rules of the scheme;
- nature of the project to which the tokens relate;
- technical milestones applicable to the project;
- basis and security of the underlying technology;
- amount of coins or tokens that are reserved or available to the issuer and its sponsors and the basis of existing rights;
- quality and experience of management; and
- compliance with law and all regulatory requirements.

[6] https://www.accenture.com/t20170120T074124Z_w_/us-en/_acnmedia/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Consulting/Accenture-Banking-on-Blockchain.pdf#zoom=50, at p 6.

The nature of the business and the purpose and structure of the token offering will typically be set out in a white paper available to potential purchasers.

Set out below is a list of some of the largest ICOs to date:

1) Cayman Islands-based Block.one raised USD 4 billion through an ICO selling a proprietary token, EOS. Block.one did not have a live product at the time it collected investments, thereby raising capital on investor confidence alone. The investments were used to fund a decentralised alternative to current cloud-hosting services;
2) Filecoin is a decentralised storage network that was converted to a cloud storage company which runs on blockchain, with Filecoin tokens earned by miners who provide storage to clients (similar to the Bitcoin miners who are rewarded with Bitcoins for validating the blockchain). Filecoin raised USD 257 million to develop and unlock unused storage in data centres;
3) Telegram provides an encrypted messaging and blockchain ecosystem and raised USD 1.7 billion. The company used the ICO funding to develop the Telegram Open Network, which can be likened to the Ethereum ecosystem with apps, services and a store for digital and physical goods;
4) Venezuela's cryptocurrency, the Petro, was reported to have raised USD 5 billion, which is considered to be the most successful ICO of all time.

In September 2017 the UK's FCA issued a statement warning the public that "ICOs are very high-risk, speculative investments" and outlining the potential risks associated with investing in unregulated parts of the financial sector. The FCA stated that it will consider whether ICOs fall within the FCA's regulatory boundaries on a case by case basis. This is due to the fact that some ICO's may involve regulated investments and regulated firms; consequently, it may fall within the definition of a regulated activity. The FCA gave the following warning:

> "Businesses involved in an ICO should carefully consider if their activities could mean they are arranging, dealing or advising on regulated financial investments. Each promoter needs to consider whether their activities amount to regulated activities under the relevant law. In addition, digital currency exchanges that facilitate the exchange of certain tokens should consider if they need to be authorised by the FCA to be able to deliver their services."[7]

Now that we have a better understanding of what cryptocurrencies are and the environment in which they developed, why should we care about them? Is it just another bubble that will grow exponentially in the short run and die a quick and painful death? Are all of the investors in tokens just throwing their money away, is it just another form of gambling, or are they onto something that is likely to continue to develop and grow? Today, it is difficult to provide an answer to any of these questions. One thing that everyone can agree on is that the crypto-market is volatile and uncertain. However, if cryptocurrencies are able to achieve the principles idealised by their inventors in a safe and effective way, it could be a serious competitor to the financial *status quo*. Clearly cryptocurrencies have slowly infiltrated into the financial markets in the form of ICOs and as an alternate payment system and the insolvency and restructuring profession should pay attention. As more consumers and corporations engage in transactions involving cryptocurrencies, the greater the likelihood of

[7] FCA - Consumer warning about the risks of Initial Coin Offerings (ICOs), published 12 Sep 2017.

insolvencies and bankruptcies involving cryptoassets. This is particularly evident from the insolvency cases that have arisen in jurisdictions such as Russia and the US, which are considered in greater detail later in this paper. The pertinent question remains: is it likely to emerge from the fringes as a serious alternate currency or payment system? This will depend on a number of factors, both commercial and legal. The rest of this paper will consider some of these legal factors in greater detail.

3. Legal characterisation of cryptocurrencies

How does the law deal with cryptocurrencies and cryptoassets, what is the legal characterisation of cryptocurrencies and why is it necessary to consider these questions? At around the time of the finalisation of this paper, one Bitcoin was equivalent to GBP 4,114.75. If individuals were looking to spend a substantial price to purchase one Bitcoin, they would want to understand their legal rights over the Bitcoin. On purchasing the Bitcoin from an exchange or another individual, does one "own" the Bitcoin? If so, how can this ownership right be demonstrated? Bitcoin is intangible; at its core it is merely cryptographic code held on a digital system in a virtual account under a pseudonym, which might not have any connection to someone's real world identity.

Why does this matter to the insolvency and restructuring profession? It matters because insolvency professionals are already having to address these issues when dealing with insolvent estates that include some form of cryptoassets, and they come in various forms. The difficulty arises where there is no clear legal characterisation of the cryptoasset; is it a currency due to the fact that it has been coined as one, or is it a financial instrument or a commodity? It is important for an insolvency professional to understand how to treat a cryptoasset within an insolvent estate, as the primary duty of an insolvency professional is to maximise the value of the assets in that estate. In order to do this, the insolvency professional needs to decide the characterisation of cryptocurrencies within the context of the relevant insolvency regime and the security interests attached to such assets. To date, there is little guidance in bankruptcy case law as to how Bitcoin and other cryptocurrencies should be valued. This will in turn permit creditors to call into question the actions of an insolvency professional dealing with cryptoassets. This is more clearly demonstrated in the case study dealing with MtGox later in this paper.

Before considering what rights reside over cryptocurrencies, the legal status of cryptocurrency needs to be understood. In this part of the paper the categories that cryptocurrencies can fall within, are considered.

3.1 Cryptocurrency as currency

Currency is a medium of exchange and fiat money is currency that has been declared by a government as legal tender. In *California Bankers Association v Schultz*[8] the US Supreme Court set out the test to determine currency: "currency is defined in the Secretary's regulations as the "coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued." The European Central Bank (ECB) has defined virtual currencies as a "type of unregulated, digital money which is issued and usually controlled by its

[8] 416 US 21 (1974).

developers and used and accepted among the members of a specific virtual community".[9] Whilst Bitcoin would not likely be considered a currency as it is not issued or sanctioned by a government, the ruling of the European Court of Justice (ECJ) in *Skatteverket v David Hedqvist*[10] supported the position that cryptocurrency may be regarded as currency. The ECJ ruled that the services of a Bitcoin exchange were exempt from VAT on the basis of the "currency" exemption in Article 135(1)(e) of the VAT Directive.[11] The decision confirmed that the exchange of Bitcoin for fiat currency is a supply of services equivalent to a transaction concerning currency, bank notes and coins used as legal tender.

Legal tender is a medium of payment recognised by a legal system to be valid to meet a financial obligation. Fiat currency is legal tender in many countries. In order for cryptocurrencies to truly be accepted as a form of currency, they must be accepted as legal tender within the relevant jurisdiction.

In Russia, cryptocurrencies, or in fact any type of virtual currency, do not constitute legal tender or money. The Federal Law "On the Central Bank of Russia" and the Russian Civil Code state that the rouble (the monetary unit of the Russian Federation) is the only legal tender in Russia. That means there is no obligation in Russia to accept payments made in cryptocurrencies.

As is determined in articles 10 and 11 of Council Regulation (EC) No 974/98 on the introduction of the Euro, the Euro is the only lawful currency within the Eurozone. This rules out the possibility of cryptocurrencies being a currency in the legal sense. The Dutch civil code determines that an obligation to pay under a contract can be legally fulfilled by paying with a currency that is "accepted". Although this seems to open the door to the ability to pay dues with cryptocurrencies, this is not the case. "Accepted" currencies in this sense must be seen as currencies that are tolerated by the government or that are accepted from a societal point of view. At the moment cryptocurrencies are not generally accepted in the Netherlands.

In the US, cryptocurrencies are not authorised or adopted by the US government; on the face of it, cryptocurrencies do not meet the Uniform Commercial Code definition of "money" under article 1-201(b)(24). However, in the criminal and civil sector, courts have treated Bitcoin in a manner more similar to currency. For example, in *United States v Murgio*,[12] in which the defendants were charged with operating an unlicensed Bitcoin exchange business in violation of 18 USC § 1960, the court reasoned that when a term goes undefined in a statute, courts should give it "its ordinary meaning." Utilising this line of reasoning, the court concluded that the ordinary meaning used by numerous courts of "funds" is "available pecuniary resources" or "money, often money for a specific purpose" and in turn, "money" is defined as "something generally accepted as a medium of exchange, a measure of value, or a means of payment." In applying these definitions, the court held that Bitcoins qualify as "funds" or "money" within the plain meaning of the term and can be accepted as a payment for goods and services or bought directly from an exchange with a bank account. Bitcoin clearly qualifies as "money" or "funds" under these plain meaning definitions. The court reasoned that Bitcoins are "funds" because they

9 "Virtual Currency Schemes" by the European Central Bank (October 2012) - https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf
10 C-264/14.
11 Directive 2006/112/EC.
12 No. 15-CR-769 (AJN) (SDNY April 21, 2016).

"can be either used directly to pay for certain things or can act as a medium of exchange and be converted into a currency which can pay for things."

In addition, in *Securities Exchange Commission v Shavers*,[13] the court held that "Bitcoin is a currency or a form of money…". Further, the court in *United States v Ulbricht*[14] found that "Bitcoins carry value - that is their purpose and function - and act as a medium of exchange" and Bitcoins may be exchanged for legal tender, be it US dollars, euros, or some other currency.

3.2 Cryptocurrency as electronic money (E-money)

Could cryptocurrencies fall within the remit of E-money? In Europe, E-money is defined by the ECB as "an electronic store of monetary value on a technical device that may be widely used for making payments to entities other than the E-money issuer. The device acts as a prepaid bearer instrument which does not necessarily involve bank accounts in transactions."[15] The meaning of E-money can differ between jurisdictions. In Russia, the Federal Law "On the National Payment System" recognises the notion of E-money, which is defined as "monetary funds which are advanced by one person (provider of funds) to another person that records the information on the amount of advanced funds without opening a bank account for the purpose of discharging payment obligations of the provider of funds to third parties and in respect of which the provider of funds is entitled to give instructions only with the use of electronic means of payments." However, it is likely that cryptocurrencies in most cases will not fall within the framework of E-money as it is decentralised, based on blockchain technology and, as a general rule, the payment is made in other cryptocurrencies.

Similarly, in Europe, cryptocurrency cannot be classified as E-money under the Electronic Money Directive.[16] The Electronic Money Directive uses three criteria to define E-money: it should be stored electronically, issued on receipt of funds of an amount not less in value than the monetary value issued and accepted as a means of payment by undertakings other than the issuer. A cryptocurrency such as Bitcoin probably complies with the first and the third criteria, but not with the second. Since it cannot be defined as E-money, the Electronic Money Directive would not be applicable. Interestingly, on 14 March 2018 the digital currency exchange, Coinbase, received an Electronic-Money authorisation from the FCA. Coinbase is a San Francisco-based digital currency exchange that offers users the ability to trade Bitcoin, Bitcoin Cash, Ethereum and Litecoin. The authorisation of Coinbase by the FCA is highly significant as it makes Coinbase the first cryptocurrency exchange to be authorised as an E-Money Institution. It marks a significant development in the interaction between the cryptocurrency sector and traditional financial regulation.

3.3 Cryptocurrency as a financial instrument

There are some jurisdictions that claim that cryptocurrencies do not appear to be financial instruments. For example, pursuant to Swedish legislation, a financial instrument must be considered a transferable security. Under Swedish law, cryptoassets are not considered a transferable security and are therefore

[13] 4:13-CV-416, United States District Court, Eastern District of Texas, Sherman Division (6 August 2013).
[14] No. 15-1815, US Court of Appeals for the Second Circuit (31 May 2017).
[15] https://www.ecb.europa.eu/stats/money_credit_banking/electronic_money/html/index.en.html.
[16] 2009/110/EC.

unlikely to be a financial instrument. Therefore, it is unlikely that Bitcoin and other cryptocurrencies will be classified as securities (that is, as a derivative, shares or bonds). On the other hand, in a recent case *Banca Dati S.r.l. - Univest* the Court of Verona considered the offer of cryptocurrency as a financial services transaction.[17]

A recent EU legislative discussion has considered including cryptocurrency within the list of financial instruments under existing financial regulation. This was first considered by the European Parliament and secondly in the context of making an amendment to the Markets in Financial Instruments Directive[18] (MiFID II) to extend the list of financial instruments in MiFID II. The reasoning behind this is that investors treat cryptocurrency as a substitute for financial instruments. The definition would reflect the terms defined in the anti-money laundering (AML) regulation which contains a broad scope covering all and any cryptoasset. Classifying a wide range of cryptoassets within the financial instrument definition, means that a lot of the activities currently undertaken by those trading in cryptoassets could become a regulated activity (that is, mining, arranging ICOs and advising on transactions related to cryptocurrency transactions).

According to the European Securities and Markets Authority (ESMA), the aim is to classify certain cryptocurrencies as financial instruments, in particular those assets that are created in the course of an ICO seeking to raise funding. A recent report by the Commission of the European Banking Authority stated:

> "[t]ypically crypto-assets fall outside the scope of EU financial services regulation. Moreover, divergent approaches to the regulation of these activities are emerging across the EU. These factors give rise to potential issues, including regarding consumer protection, operational resilience, and the level playing field."[19]

3.4 Cryptocurrency as money

The legal characterisation of cryptocurrencies is a fairly new concept and it may therefore be necessary to consider whether cryptocurrencies satisfy the economic functions of money. Adam Smith defined money by the roles it plays in society, in particular how it serves as a store of value with which to transfer purchasing power from today to some future time; a medium of exchange with which to make payments for goods and services and a unit of account with which to measure the value of a particular good, service or loan.[20] Money as a token of value and exchange has been regarded as property under English law.[21] There is no clear consensus as to whether Bitcoin fulfils the economic functions of money.

Mark Carney, the Governor of the Bank of England, is of the opinion that cryptocurrencies perform poorly under the three criteria. He is of the opinion that cryptocurrencies do not function well as a store of value. Even the more stable cryptocurrencies, such as Bitcoin, experience very high volatility in price which,

[17] Judgment n 195/17, Court of Verona.
[18] 2004/39/EC.
[19] Report with advice for the European Commission on crypto-assets, dated 9 Jan 2019.
[20] Adam Smith, *The Wealth of Nations* (W Strahan and T Cadell, London, 1776).
[21] David Fox, *Property Rights in Money* (Oxford University Press, 2008).

according to him, disqualify them as a store of value. Furthermore, the volatility is an effect of a lack of intrinsic value and external backing.

As a means of payment, cryptocurrencies do not currently offer a great deal. Even Bitcoin can only be used to pay in a very small proportion of businesses. The speed and the cost of transacting in Bitcoin compete very unfavourably with the established payment methods. There is very little evidence of cryptocurrencies being used as a unit of account. Even the businesses that accept cryptocurrencies as payment frequently update the price to reflect a constant fiat value of goods or services. The Bank of England is also "not aware of any business that accepts Bitcoins in payments that also maintains its accounts in Bitcoin". As a result, Mark Carney stated that "cryptocurrencies act as money, at best, only for some people and to a limited extent, and even then only in parallel with the traditional currencies of the users".[22] The Bank of England further remarked that "how far an asset serves these roles can differ, both from person to person and over time. And meeting these economic definitions does not necessarily imply that an asset will be regarded as money for legal or regulatory purposes."[23]

The Bank of England reviewed the nature of fraud risk and unreliability of cryptocurrencies. It was noted that in a decentralised system, there is no requirement for users to share personal information, thus removing the risk of data breaches. However, it was acknowledged that the risk of direct loss of digital currencies is higher than that for deposits held (electronically). For example, a lost password to an online bank account is recoverable or can be reset by the bank. On the other hand, if the private key granting access to the cryptocurrency wallet is lost then it would be unrecoverable as there is no central server to provide a reset. However, in these terms, it was apparent that "a digital wallet is more analogous to a physical wallet containing physical currency".[24] Therefore, a robust cryptocurrency scheme would not be less reliable as a store of value than "real world" currencies in their physical form.

The Swedish National Bank has stated that cryptocurrency is under no circumstances to be seen as cash, but has not provided any further definition. The main reasons that it should not be seen as cash are that cryptocurrencies lack official publishers and do not have the potential to form well-functioning means of payment. Cryptocurrencies are only a mode of handling payments between those within the network, excluding the possibility for it to be a financial instrument or regular cash / currency. It is also difficult to obtain a stable value of the asset and there is no underlying asset of intrinsic value.

There is a clear debate as to whether cryptocurrencies fulfil the functions of money. However, as highlighted by the Bank of England, compliance with the economic theory of money would not definitively conclude that cryptocurrencies will be regarded as money for legal and regulatory purposes.

22 "The Future of Money"; speech given by Mark Carney, Governor of the Bank of England on 2 March 2018.
23 Bank of England 2014 Quarterly Bulletin Q3. published on 16 Sep 2014.
24 *Ibid*.

3.5 Cryptocurrency as a commodity

On the other hand, it has been argued that cryptocurrency is a commodity. A commodity is a good that is used in commerce that is interchangeable with other goods. On 6 March 2018, Judge Weinstein of the US District Court for the Eastern District of New York ruled that virtual currencies are commodities subject to US Commodity Futures Trading Commission (CFTC) regulation. The ruling was issued in response to a *pro se* motion to dismiss in *CFTC v McDonnell*[25] and is the first judicial endorsement of the CFTC's long-held position that the Commodities Exchange Act (CEA) authorises it to regulate virtual currencies. The CFTC asserted that the CEA's "definition of commodity is expansive in scope" and extends to "intangible commodities" ranging from "renewable energy credits and emissions allowances" to virtual currencies. As explained by the CFTC, "virtual currencies . . . fall within the [CEA's] category of all other goods and articles" and "the rights and interests that inhere to each unit of virtual currency constitute rights [or] interests . . . in which contracts for future delivery are presently . . . dealt in." In his 6 March 2018 order, Judge Weinstein explained, "[v]irtual currencies can be regulated by CFTC as a commodity" because they "are goods exchanged in a market for a uniform quality and value" and "fall within the CEA's definition of commodities as all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in."[26]

Bitcoin has some similarities to gold:

1. Bitcoin and gold are not overseen by a government;
2. there is a finite supply of Bitcoin (the total number of Bitcoins that can be mined is 21 million) and it is estimated that there are only 171,000 metric tons of gold in the world;
3. Bitcoin is theoretically free of political interference in the same way as gold (supply of currency can be increased by government monetary policy); and
4. the value of gold fluctuates in correlation to demand and it is evident that the price of Bitcoin is connected to the demand in the market.

Evidently, there are inherent flaws in this comparison whereby there is an intrinsic value in gold whereas the same cannot be said about Bitcoin.

From a legal perspective, pursuant to US case law, Bitcoin can fall within the definition of a commodity pursuant to US law under "useful articles of commerce", as Bitcoin may be traded online for goods and services or even exchanged for fiat currency. Bitcoin is capable of possession as the holder of the private key has control over the transfer of the Bitcoin-holding in the digital wallet. Furthermore, control of this nature over the Bitcoin-holdings could be interpreted as constructive possession where the holders of the Bitcoin have the ability to guide the destiny of the Bitcoin.[27] If cryptocurrencies were classified as a commodity, then the Bankruptcy Code would not automatically afford the same protections. To qualify for protections as a commodity, any agreement related to the transfer of Bitcoins would have to constitute a "forward contract"

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25 *Commodity Futures Trading Comm'n v. McDonnell*, No. 1:18-cv-00361-JBW-RLM, slip op. (EDNY Mar 6, 2018).

26 https://www.dlapiper.com/en/us/insights/publications/2018/05/how-one-new-york-court-is-shaping-the-future-of-cryptocurrency-regulation/.

27 Tara Mandjee, "Bitcoin, its Legal Classification and its Regulatory Framework", 15 *J Bus & Sec L* 157 (2016).

as defined in the Bankruptcy Code, providing for the commodity's delivery days in advance of the contract's maturity date. Forward contracts provide numerous protections, including immunity from the automatic stay, prohibition against bankruptcy defaults and the ability to continue "business as usual".

3.6 Tax treatment of cryptocurrencies

3.6.1 Italy

In Italy, under Article 1 of Legislative Decree No 90/2017, cryptocurrencies are defined as "digital exchange methods representing value, which are not issued by any Central Bank or public Authority and which are not related to any currency". Pursuant to Resolution No 72/2016, the Italian Tax Authority (*Agenzia delle Entrate*) equated cryptocurrencies to foreign currencies. Certain Italian scholars deem that encompassing the cryptocurrencies within the foreign currencies scope might be erroneous. The volatility of the cryptocurrency market, for instance, is not comparable with the volatility of material currencies. Note that the resolutions of the Italian Tax Authority do not have the value and authority of the law but only express guidelines for the interpretation of the relevant specific cases and circumstances.

3.6.2 Denmark

According to the Danish tax authorities, the Bitcoin system is "nothing more than a payment system facilitating payment of digital currency not regulated by a central bank and where the rate is set on the basis of supply and demand of Bitcoin."[28] The Danish tax authorities classified the digital currency Bookcoin as being a structured claim, that is, a claim regarding a semi-generic purchase of the underlying asset at a future point in time.[29] The digital currency in question was very closely tied to the price of silver and the issuer of Bookcoin backed the coin with actual silver bars. Owners of Bookcoins could exchange the digital currency for silver at a fixed exchange rate of one Bookcoin to one gram of silver. Due to these ties to an actual commodity's price, Bookcoin is now subject to a different taxation regulation than Bitcoin.

Under Danish law a business must present its annual report in either Danish kroner (DKK) or in another foreign currency. Seeing as Bitcoin is not regulated by a foreign central bank, it does not meet this "foreign currency" requirement. Likewise, considering that invoices are required to be issued in DKK or in another foreign currency due to the requirement to explicitly list the VAT amount on each invoice, Danish businesses are not permitted to issue invoices solely in digital currencies. The Danish tax authorities have taken the stance that any purchase or sale of Bitcoin will be an act of speculation and, therefore, taxable, irrespective of whether the purchase was made many years before digital currencies came to the public's attention.

3.6.3 Sweden

Cryptocurrencies are not acknowledged as a currency under Swedish tax legislation. Instead, transactions involving cryptocurrencies are seen as individual transactions involving assets. In each case, the acquisition price of the

[28] Taxation and Duties Gazette, 2014.466
[29] Taxation and Duties Gazette, 2017.592

specific asset / cryptocurrency (for example, Bitcoin) should be calculated. The asset is taxed upon divestment on the difference between the acquisition price and the remuneration. For example:

a) if someone bought their cryptocurrency, the acquisition price is the amount they paid for the cryptocurrency converted to Swedish krona;
b) if someone mined their own cryptocurrency, the acquisition price is the market value converted to Swedish krona upon the allocation of cryptocurrency in the mining process;
c) if someone has received cryptocurrency as a means of payment in an individual business transaction, the acquisition price is the value they report as revenue, including VAT; and
d) if someone has received cryptocurrency as salary, the acquisition price is the value that they report as income from employment.

Mining of cryptocurrency is not subject to VAT and transactions involving exchange of fiat currency against cryptocurrency are also exempt from VAT. The Swedish Tax Agency has issued specific accounting guidelines for when a company receives cryptocurrencies as means of payment in its business and stipulates that the subsequent change in value should be taxed as income of capital. Bitcoin has been used to make online purchases and the Swedish Tax Agency has defined Bitcoins as other assets that are subject to capital gains on disposal.

3.6.4 The Netherlands

If a person conducts business activities and the profits (or losses) related to the cryptocurrencies are attributable to the business activities, this profit or loss falls within the scope of the taxable profits from business activities. In the case of cryptocurrency mining, depending on the size of the mining operation, it may be considered to constitute business activities (by virtue of the mining activities qualifying as a material business enterprise). In that case, any profits attributable to these activities would constitute taxable profits from business activities. If a person is employed and receives his or her wages in cryptocurrencies, the value of the cryptocurrency at the moment the employee receives the wage constitutes the amount of employment income enjoyed by an employee. If a person performs work (that does not qualify as a business activity or employment income), income from cryptocurrencies may constitute results from other activities if the work performed could be considered to be more substantial than the active (normal) management of funds (as may be the case for individual portfolio investors). The taxable base attributable to cryptocurrencies would be their market value (as it may be derived from cryptocurrency exchanges) at the reference date, being 1 January of each calendar year.

3.6.5 England and Wales

In England and Wales all forms of assets, including incorporeal property generally and any currency other than sterling, are considered an asset under tax legislation.[30] Accordingly, in order for cryptocurrencies to be an asset for tax purposes it will need to have the following characteristics:

[30] Taxation of Chargeable Gains Act 1992, s 21(1).

- it must be something that is capable of being owned; and
- its value must be capable of being realised.[31]

The UK tax authorities recognise cryptocurrencies as an asset falling within this definition. Cryptocurrency is not a recognised sovereign currency; therefore, any transactions that use cryptocurrencies as consideration (given or received) will be regarded as "barter transactions". The UK tax manual defines a barter transaction as "a transaction in which an asset is disposed of for some consideration which is not sterling cash, but which takes the form of some other asset."[32] This means that where the transaction is at arm's length, the cryptocurrency consideration is measured as the sterling worth at the date of the acquisition or disposal of what is given or received. This is the case where the other asset is a foreign currency. The UK tax authorities will treat each cryptocurrency according to the pre-defined agreed rules and so each case will be dealt with on its individual facts.

On 3 March 2014, the UK tax authorities considered the position of the tax treatment of income received from and charges made in connection with activities involving Bitcoin and other similar cryptocurrencies. A summary of the VAT position is set out in the table below:[33]

Type of income	Is VAT payable?
Bitcoin mining activities	Outside scope and does not constitute an economic activity
Received by miners for activities (that is, services with verification of transactions)	Exempt[34]
Bitcoin is exchanged for Sterling or for foreign currencies	No VAT due on value of Bitcoins
Arranging or carrying out a transaction in Bitcoin	Exempt[35]
Payments in cryptocurrency for supply of goods and services	Yes - sterling value of the cryptocurrency at point of transaction

This Revenue and Customs brief only outlined the provisional position of the UK tax authorities pending further developments and confirmed that taxpayers could rely on the treatment outlined unless the UK tax authorities announce any changes. Any changes would not apply retrospectively.

3.7 Miscellaneous

The final category to consider is particularly varied. Considering the diverse features of cryptocurrency, it may be possible to align it to a range of characterisations.

31 "Chargeable assets: intangible assets: rights", HMRC Internal Manual CG12010.
32 "Foreign currency: assets acquired or sold for currency", HMRC Internal Manual CG78310.
33 Revenue and Customs Brief 9 (2014): Bitcoin and other cryptocurrencies on 3 March 2014 (Policy Paper).
34 EU VAT Directive, art 135(1)(d).
35 *Ibid*.

3.7.1 Surrogates

The Central Bank of the Russian Federation (CBR) compared cryptocurrencies to monetary surrogates, which indicated the risk of prospective prohibition and penalties for issuers and owners. However, these concerns were alleviated by the Federal Tax Service in 2016 which emphasised that the current legislation does not provide definitions or rules for monetary surrogates, cryptocurrencies or tokens and does not therefore restrict the circulation of the respective instruments. In its latest circular of 2017 the CBR, still sceptical about cryptocurrencies and ICOs, questioned the practicability of their admission to the public trading infrastructure, but no longer called for a general ban. Any definitive answer in regard to the position of tokens in Russia would require the adoption of special legislation, preparation of which is currently on hold due to the legislator's intention to look at the further development of the market and regulation in other jurisdictions before taking any regulatory steps.

3.7.2 Claim

In Sweden, it has been argued that cryptocurrency could be classified as a claim.[36] In order for a claim to arise there must be an established creditor and debtor relationship. The fact that a claim can be seen as a means of payment is quite obvious and the value of the claim is based on a combination of the size of the claim and the risk that the receiver of the claim takes, which depends on the debtor. It may not be very well known that money was legally defined as a claim for quite some time. Historically, currencies based on a natural asset such as gold has been seen as a claim against the state. The Swedish National Bank has historically taken a debtor position and had to make sure there was a gold reserve that guaranteed the holders of the currency (Swedish krona) that their claim corresponded to a certain amount of gold which guaranteed the value of the currency. There have been discussions as to whether cryptoassets could be seen as a claim in a similar way. However, it is likely that the idea is too far-fetched since there is no one to take the debtor position nor is there any underlying instrument to ensure the value of the claim.

3.7.3 Tangible asset

It would seem that cryptocurrencies cannot qualify as tangible assets since they are in essence not tangible, which is, rather unsurprisingly, one of the prerequisites for something to be a tangible asset. There are, however, cases of criminal law in the Netherlands where the court decided that information could qualify as a tangible asset and that it can therefore be stolen.[37] Unfortunately, this only applies to criminal law and thus does not apply to civil law cases. In the Netherlands, there are some that claim that cryptocurrencies do not fall within any of the given categories. Cryptocurrencies would then be treated in the same way as goodwill. While it is apparent that a cryptocurrency can be of value, they do not fall within the scope of Dutch civil law. As such, they cannot be transferred in a legal sense, nor is it possible to secure repossession through a legal action (for example, by using the *rei vindicatio*). Therefore, it appears that a clear legal characterisation of cryptocurrencies in the Netherlands does not yet exist.

[36] *Crypto currencies: a special legal effect on holdings of Bitcoins and other similar means of payments, Emil Elgebrant, 2016*

[37] The "Runescape-arrest", ECLI:NL:HR:2012:BQ9251.

3.8 Is there a legal characterisation of cryptocurrencies?

It is evident that cryptocurrencies could fall within a range of categories due to their unique features. Without legislative interference, it is unlikely that this uncertainty will be clarified. It is essential that any guidance from the legislators and regulators shows that assets derived from cryptocurrency are not all alike, even tokens (such as Ethereum) encompass different features when compared to Bitcoin. It is therefore unlikely that an unsophisticated legislative regime would suffice. Jackson Palmer, an Australian entrepreneur, launched a token named Dogecoin in late 2013 as a parody of the numerous cryptocurrencies flooding the market at the time. However, Dogecoin soon became an educational starting point for new investors in cryptocurrency (due to its low price) and it grew through social media to value at USD 2 billion market capitalisation in 2018. Dogecoin is a good example of how easy it is for anyone to enter the cryptocurrency market where there is no regulatory or legislative guidance in place. In the absence of an appropriate legal characterisation, we tend to primarily rely on the name of something when characterising something as a cryptocurrency or cryptoasset. An asset named or referred to as a cryptocurrency or cryptoasset should not by default mean it is a cryptocurrency. However, with no legislative guidance on the legal status of cryptocurrency we dangerously tend to rely on something being named or called a cryptocurrency or token. Until clear legislative guidance has been provided, insolvency practitioners will need to keep themselves informed of reliable sources in order to ensure that they are fulfilling their duties and to avoid their actions being called into question.

3.9 What proprietary rights exist over cryptocurrencies?

3.9.1 Introduction

This part of the paper considers the crucial question of what ownership rights exist over an intangible asset that is yet to be legally categorised. As explained in paragraph 2.1 of this paper, cryptocurrency at its core is cryptographic code. The relevant underlying asset appears to be knowledge of the private access key which bestows the holder with control over the cryptocurrency in the wallet (including transfers). Cryptocurrencies do not have a physical existence in the same way as fiat currencies; therefore, how can proprietary rights exist over cryptoassets? What follows is an analysis of the proprietary rights that might exist over cryptocurrencies in the jurisdictions mentioned below.

3.9.2 Russia

The Russian doctrine presents a wide range of opinions on the definition of the legal nature of cryptocurrency. In particular, some authors support the illegitimacy of cryptocurrency as a whole with the imposition of punishment (administrative or criminal) for the use or release of cryptocurrency. However, most researchers consider it appropriate to introduce a special term in legislation which would serve as a reference point for the subsequent development of the corresponding legal regime of cryptocurrencies. In Russia, the discussion focuses on determining the place of cryptocurrency in the system of objects of civil rights and attempts to define it. There are generally quite a few systematised and generalised works on cryptocurrency and other crypto-technologies.

At present, the concept of tokens or cryptocurrencies is not recognised in Russian legislation; likewise, the question of proprietary rights attached to cryptocurrencies has not yet been resolved. However, it is indicated in Article 2 of the draft law "On Digital Financial Assets" that a digital financial asset (the term that was provided for use when referring to cryptocurrency and other tokens) is electronic property created using encryption (cryptography). Ownership of this property is verified by making digital entries in the register of digital transactions. Thus, the draft law proposes to extend the proprietary regime to cover cryptocurrency.

Furthermore, a recent case heard in the Commercial Court of Moscow[38] noted that the objects of property rights are not exhaustively listed in Russian Law, in particular the reference to "other assets" under Article 128 of the Russian Card Code which is open to interpretation. The court emphasised that considering the current economic realities the "broadest interpretation [of other assets] is justified". It was further noted by the court that any property of the debtor having economic value, including cryptocurrency, shall not be arbitrarily excluded from the insolvency estate.

3.9.3 Sweden

Swedish academics agree that cryptocurrencies are to be defined as non-physical property; however, it has not been further defined under Swedish law.[39] Since it is difficult to determine what sort of property cryptocurrency constitutes, it is difficult to determine whether there are any proprietary rights attached to it. There are those who argue that there are proprietary rights attached to cryptoassets in general, but it has not been defined in what way or tested in court yet.[40]

3.9.4 The Netherlands

Academics in the Netherlands favour the idea of proprietary rights existing over cryptoassets.[41] Although most seem to agree that cryptocurrencies fulfil most of the criteria of a proprietary right, they also note that it is problematic to qualify a cryptocurrency as a "right". After all, a right under Dutch law implies consideration has been provided. When one lends money to someone, the claim he has pursuant to the loan qualifies as a proprietary right since it gives the claimant the right to consideration, namely repayment under the conditions of the loan. The ownership of a cryptocurrency does not give a right to such consideration as there is no clear counterparty due to the inherent decentralised nature of cryptocurrencies.

A recent case heard by the Dutch courts on 17 January 2018, considered whether the obligation to transfer Bitcoins was verifiable for the purpose of opening insolvency proceedings. The court affirmed that it was, on the basis that "Bitcoin represents a value and is transferable. […] it thus shows characteristics

[38] *Tsarkov* (case number: A40-124668/2017 dated 5 March 2015).
[39] Emil Elgebrant, *Kryptovalutor: särskild rättsverkan vid innehav av bitcoins och andra liknande betalningsmedel* (Eng: "Crypto currencies: special legal effect on the holding of Bitcoins and other similar means of payments"), Wolters Kluwer, 2016.
[40] *Ibid*; Gabriel Söderberg, "Are Bitcoin and other crypto-assets money?", article published by Sveriges Riksbank in *Economic Commentaries* (No 5, 2018) – see: https://www.riksbank.se/globalassets/media/rapporter/ekonomiska-kommentarer/engelska/2018/are-bitcoin-and-other-crypto-assets-money.pdf.
[41] Valérie Tweehuysen, "Goederenrechtelijk pusselen met bitcoins", *Ars Aequi* AA20180602.

of a property right. A claim for payment in Bitcoin is therefore to be regarded as a claim that qualifies for verification."[42] The court considered the obligation to transfer the Bitcoin as legally valid and capable of commencing insolvency proceedings if it was not transferred. However, the Dutch courts did not fully characterise the legal nature of Bitcoin in its judgment.

3.9.5 Denmark

Under Danish law, similar intangible assets such as shares or intellectual property rights are afforded certain proprietary rights, for example voting rights in the case of shares. Cryptoassets are, however, not covered by any legislation affording such statutory proprietary rights. Therefore, cryptoassets only carry the inherently technical based proprietary rights that the blockchain itself affords it, that being digital proof of ownership and the right to sell the asset.

3.9.6 England and Wales

Property under English common law "must be definable, identifiable by third parties, capable in its nature of assumption by third parties and have some degree of permanence or stability."[43] Furthermore, under English law property is categorised as real or personal property. Real property is any interest in land, real estate, growing plants or the improvements on the property. Personal property is everything else that is the subject of ownership that does not come under the definition of real property. This can be divided into tangible personal property (which includes animals, merchandise, etcetera) and intangible personal property (which includes rights over stocks, bonds, patents and copyrights). Intangible personal property can be a chose in action or another form of intangible. Sovereign currency can be categorised as tangible property as it can be in the physical form of coins and notes which can be possessed by a user; therefore, these are choses in possession. On the other hand, a chose in action can exist over a bank account containing a deposit of fiat currency that does not entail physical possession of the money but can be claimed through legal action.

Evidently, English law does not clearly set out the proprietary rights that may exist over a cryptoasset. It is unlikely that legislators contemplated the concept of a cryptoasset at the time such legislation was determined. Therefore, in the absence of new legislation that clearly tackles the issues of proprietary rights over cryptoassets, common law precedents will need to be considered in order to answer these questions.

For instance, it could be argued that cryptocurrencies may be classified as intangible property and categorised in the same class as that of a chose in action. A chose in action is "a thing recoverable by action, as contrasted with a chose in possession, which is a thing of which a person may have physical possession. The meaning ... has expanded over time, and is now used to describe all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession."[44] However, there are some characteristics of cryptocurrencies that overlap with the rights under a chose in possession. Certain cryptocurrencies can be transferred from one wallet to another, stored in a wallet and lost when the private access key to the wallet is

[42] *Koinz Trading BV*, 20 March 2018 (case ECLI:NL:RBAMS:2018:869).
[43] *National Provincial Bank v Ainsworth* [1965] 1 AC 1175 at 1247–8, by Lord Wilberforce.
[44] Halsbury's Laws of England (5th ed) Vol 13 para 1.

lost. Therefore, it could be argued that some forms of cryptocurrencies could be possessed in the same way as physical coins and notes in an actual wallet.

Under English law, a record of the private key could be capable of being property. On the other hand, the private key itself would only be considered as confidential information which can be protected by enforcing a duty of confidence, or awarding damages for breach of confidence. However, the information itself cannot be regarded as a form of property[45] except in reference to patents and trademarks (unless extended by legislation). Therefore, it would appear useful to review the proprietary interests over certain assets such as intellectual property and bearer shares, which appear to have features similar to those of cryptocurrencies.

It is accepted that proprietary rights exist over intellectual property even though intellectual property refers to creations of the mind such as goodwill, brand recognition, patents and trademarks – all of which are intangible. Intellectual property is divided into industrial property (which includes patents for inventions and trademarks) and copyright (which covers literary works, films and artistic works). Intellectual property rights allow the creator to protect their work and benefit from the creation and can be protected in England to prevent theft and plagiarism. In England, copyright and design rights exist automatically by law whereas an application will need to be made in relation to protection by trade mark, patents and registered designs. Since intellectual property rights are territorial, they give the owner exclusive rights only within the territory in which the application is granted. The UK Intellectual Property Office (IPO) is the official government body responsible for intellectual property rights in the UK and maintains a record of intellectual property rights. Evidently, an intangible asset such as intellectual property has been brought within the remit of property through legislative intervention and can be identified easily on the IPO register. Certain parallels can be drawn between intellectual property and cryptocurrencies where both are intangible assets of value to the holder. Evidently, cryptocurrency transactions are publicly reviewable through the blockchain; however, the issue relates to the anonymity of the wallet holders which means that a cryptocurrency register in the same form as the IPO register would be impractical. It is clear that legislative guidance clarifying the position as to whether there are proprietary rights over cryptocurrencies is necessary in order to provide greater certainty.

Bearer shares are equity securities wholly owned by whoever holds the physical stock certificate, as the issuing company does not register the owner of the stock or track transfers of ownership. Bearer shares clearly differ from registered issued shares which are required to be certificated and documented on an internal stock register and, in jurisdictions such as England, disclosed publicly. Similar to cryptoassets, the evident benefit of bearer shares is anonymity in ownership. Many jurisdictions have enacted legislation that restricts the use of bearer shares in order to deter illicit nefarious corporate activities. Cryptocurrencies appear to have similar characteristics to a bearer instrument, whereby control over the object could entitle the holder the rights of ownership or title to the underlying property. As with bearer shares, cryptoassets can be lost or stolen. Losing a cryptoasset could be as simple as misplacing or forgetting the private key which provides access to the digital wallet. This has been illustrated to devastating effect by the Quadriga cryptocurrency exchange

[45] *OBG v Allan (2008)* 1 AC 1.

which filed for protection from creditors in January after the CEO died suddenly without disclosing the private key to a number of crypto wallets. Consequently, the cryptocurrency held in the wallets, valued at approximately USD 135 million, was inaccessible. In this sense, cryptoassets could be categorised as a bearer asset and proprietary rights considered to be held by those who have the private key.

The issues relating to cryptocurrency have been dealt with by the Court of England and Wales in a criminal case at the Kingston Crown Court,[46] involving the Proceeds of Crime Act 2002 (POCA). In this case, the police had discovered the private access key of a digital wallet held by the defendant who was subsequently convicted of drug and money-laundering offences. The digital wallet contained 295 Bitcoins worth GBP 975,000. The police applied to the Court for a restraint order over the defendant's assets, including permission to convert the cryptocurrency held by the defendant into sterling. The Court was satisfied to make the order. In order to make such an order, the Court had to be satisfied that seizure (undefined in the POCA) could apply to cryptocurrencies in the same way as seizing a car or valuable items (cash is subject to a separate seizure regime which the police did not utilise). The definition of realisable property under the POCA includes incorporeal property. If we consider the definition of "seize" in the New Oxford Dictionary, it is to "take possession of (contraband, assets, documents, etc) by warrant or legal right". Therefore, in this case the Court determined that cryptocurrency was realisable property under POCA and could be seized by the police.[47]

It is important to note that recent judicial decisions in England have tended to support the categorisation of a proprietary right wherever they have acquired economic value and shown themselves susceptible to transfer and trade. The hypothesis, therefore, is that units of cryptocurrency convincingly shown to have economic value and transferability among market participants and robustly engineered enough to trade freely, are likely to be categorised as a type of property in common law.[48] The nature of this proprietary right in England is yet to be clarified.

3.9.7 China

The Shenzhen Court of International Arbitration recently published a case analysis[49] which dealt with the issue of proprietary rights over cryptoassets. The cryptocurrencies in dispute were valued at around USD 493,158. The claimant had entered into a contract with the defendant, who permitted the latter to trade and manage the cryptoassets on the claimant's behalf and to return the assets on a specified date. The defendant failed to return the assets on the agreed date and the claimant sought the return of the assets with accrued interest. Chinese law does not explicitly govern cryptocurrencies and the arbitrator's analysis of the proprietary rights over the cryptoassets provided an insight into the application of Chinese law in these circumstances. The defendant argued that the ban on cryptocurrencies and ICOs in China resulted in the invalidation of the contract. However, the arbitrator determined that the claim relied on the contractual obligations of returning the cryptoassets, which does not fall within

46 *R v Teresko (Sergejs)* – unreported, 11 October 2017.
47 Interestingly, the way in which the police seized and confiscated the cryptocurrency was by transferring the Bitcoin from the digital wallet held by the defendant into a digital wallet held by the police.
48 Joanna Perkins and Jennifer Enwezor, "The Legal Aspects of Virtual Currencies", [2016] 10 *JIBFL* 569.
49 Shen Guozhong Case Selection https://mp.weixin.qq.com/s/U_qDgQN9hceLBbpQ13eEdQ.

the cryptocurrency ban. It was further noted that there is no prohibition on the possession of Bitcoins and transactions between individuals. It was concluded that the uncertainty as to the status of Bitcoin as legal tender does not impact the fact that ownership rights over Bitcoin should be protected under the law of contract in China. The Court further noted that "Bitcoin has the nature of a property, which can be owned and controlled by parties, and is able to provide economic values and benefits." Although the Court did not consider the legal status of cryptocurrencies in this case, it is clear from this decision that proprietary rights over cryptocurrencies will be protected in China.

3.9.8 United States

The growth of cryptocurrencies will impact the determination of issues concerning whether cryptocurrencies of a debtor constitute property of such debtor's estate. The commencement of a bankruptcy proceeding "creates [the bankruptcy] estate."[50] Section 541(a) of the Bankruptcy Code provides that property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held." Property interests under the Bankruptcy Code are thus defined broadly. Therefore, subject to certain exceptions, cryptocurrencies are considered property of a debtor's estate if owned on the petition date or date of the filing of the bankruptcy case.

The US Bankruptcy Court for the Northern District of California considered whether there are proprietary rights over cryptocurrencies in *Re Hashfast Technologies LLC*.[51] This case involved an attempt by a bankruptcy trustee to set aside a transfer of 3,000 Bitcoins, equating to USD 360,000 at the time of the transaction, which had by then appreciated to a value of USD 1.2 million. The trustee argued that the Bitcoins were property that could be recovered by the estate at present day value (the higher rate), while the defendant transferee argued that the Bitcoins were the equivalent of US dollars and thus retained the transfer date value. In accordance with the US Bankruptcy Code, the judge ruled "it is sufficient to determine that, despite the defendant's arguments to the contrary, Bitcoins are not United States dollars." Judge Montali further ruled that the Bitcoin should be categorised as "intangible personal property", which is defined in the Bankruptcy Code as something of value that cannot be touched or held (that is, trademark or copyright). However, the judge emphasised that this categorisation should be limited to actions for fraudulent transfers under section 550 of the Bankruptcy Code. The case at hand dealt with a motion to dismiss and did not rule on the application made by the trustee to set aside the Bitcoin transfer.

3.9.9 Conclusion

Clearly then, cryptocurrencies are too complex for a simple categorisation and there are several arguments as to the type of proprietary right that could exist over a cryptoasset. On review of the various jurisdictions, there does not appear to be a definitive position. Thus, some level of statutory interference will be necessary to bring cryptocurrencies within the parameters of the existing legal framework.

[50] US Bankruptcy Code, s 541(a).
[51] Bankruptcy case no 14-30725DM, 19 Feb 2016.

3.10 Characteristics of security in the context of cryptocurrencies

Ideally, security should have the following characteristics:

1) it should be enforceable by a secured creditor with limited recourse to the courts;
2) the claim should be enforceable in priority to other unsecured claims against a secured asset;
3) there should be certain mechanisms to prevent or control dealings with the secured asset which might be detrimental to the value or enforcement of the security.

It is evident from a review of cryptoassets that the above characteristics are unlikely to be fulfilled without an actual transfer of the cryptoasset to the creditor, or disclosure of the private key. Cryptoassets are intangible and it is likely that an uncooperative debtor will need to be coerced by an order of the court to provide the private key in order to access the crypto wallet. Unlike the situation with proprietary rights over other intangible assets, such as intellectual property, there is no central registration system that provides notice to third parties who may seek security over the same cryptoasset. It appears that without a system for registering a security interest over the cryptoasset which can be reviewed by the public, it is the responsibility of the debtor to inform the parties involved that a security interest already exists over the cryptoasset. This could be avoided altogether if the creditor was to obtain "possession" of the cryptoasset which would ensure that their claim is enforceable in priority to any other claims. This would also prevent the debtor from dealing with the cryptoasset in a way that might be prejudicial to the security interest granted over it. The meaning of "possession" in these terms is the transfer of the cryptoasset to a wallet controlled solely by the creditor in order to prevent the debtor dealing with the secured asset in a way that is detrimental to the enforcement of the security.

However, outright transfer of the cryptoasset to the creditor could lead to concerns about the solvency of the creditor, in particular how the debtor would recover a cryptoasset from the insolvency estate of a creditor. It has been suggested[52] that if this is a preferred method, the parties could utilise a third party escrow agent to hold the cryptoasset under the terms of a security agreement. The escrow agent would transfer the cryptoasset to the appropriate party based on the performance of the obligations under the security agreement. Clearly the parties would have to be satisfied that the escrow agent is reliable and also be aware that, although there are several escrow agents offering cryptoasset related escrow services, this is an area that is not regulated.

There are clearly several legal concerns associated with the creation of a security interest over a cryptoasset. There are also commercial difficulties that might deter a creditor from accepting a cryptoasset as security for debt. The most prominent obstacle appears to be that cryptocurrencies are not backed or regulated by central governments. Cryptocurrencies may be popular in the current market and have grown exponentially in the past few years, but they are still not easily exchangeable for assets of real value. Creditors should be particularly cautious about accepting large quantities of cryptocurrency as security for debt. Similarly, the value of cryptocurrency is volatile and valuing a

[52] David Quest, "Taking security over bitcoins and other virtual currency", (2015) 7 JIBFL 401.

cryptoasset can be a very speculative exercise. A secured creditor might at the start of the life of the lending agreement be in a strong position should the value of the cryptocurrency be high and may even lead to the creditor's claim being over-secured. However, the situation could easily reverse as a sharp drop in the value of the cryptoasset may result in the creditor being under-secured. Consequently, the secured creditor cannot be certain that there will be adequate value in the cryptoasset given as security to cover the debt. The cautious approach would be to avoid such a volatile asset being used as security. However, if it is necessary or desired that cryptoassets be used as security, it seems sensible not to rely solely on these types of assets as security and to instead obtain a security package with a mix of cryptoassets and other traditional assets.

3.11 What security interests exist over cryptocurrencies?

3.11.1 Introduction

A brief review of various jurisdictions shows that there is no clear legal characterisation of cryptocurrencies and, consequently, there is a lack of guidance as to what proprietary rights may exist over a cryptoasset. From our analysis, it seems likely that the courts will recognise some form of proprietary right over cryptoassets. In this part of the report we will consider whether security interests can exist over cryptocurrencies by looking at the situation in various jurisdictions. This is relevant to the insolvency professional, since the primary duty of such a person is to maximise the value of assets in the insolvency estate to ensure that creditors can maximise returns. In order to do this, it is important for an insolvency professional to be able to determine which assets are part of the insolvency estate and, of these assets, which contain a security interest held by a third-party creditor. It is crucial that an insolvency professional completes this exercise so that they have taken reasonable steps to ensure that the secured creditors can realise their security interests and that the sale of any other assets in the insolvency estate are free from encumbrances such as security rights. As we have already discussed, there are various difficulties associated with identifying cryptoassets that form part of an insolvency estate and consequently this is not an easy task to undertake.

There is always some form of risk present when lending money to a third party and a creditor would usually require some degree of comfort in the knowledge that there will be recourse to something of value in the event that the debtor fails to repay the outstanding debt. Indeed, this is the whole purpose of providing security. With the benefit of a valid security interest, a creditor will be able to realise the value of the secured asset and apply it to the payment of the outstanding debt. Security is also important when a debtor is no longer able to make the payments that are due to creditors and enters into an insolvency process. Security therefore provides the creditor with a proprietary interest in an asset of value until the outstanding liability is discharged.

The questions that arise here are:

- Can the traditional methods of granting security be applied to a cryptoasset?; and
- Can a cryptoasset be used as a commercially viable form of security?

3.11.2 England and Wales

It is evident from the previous discussion on the legal characterisation of cryptocurrencies, that it is unclear how cryptoassets will be legally categorised. If they are held to be currency, it may be possible to utilise the traditional methods of granting security over currency in the form of a deposit of the currency in a bank account or in the form of a debt due to the party giving the security. Under English law, the deposit account and the debt would be classified as intangible property, thus creating a chose in action that represents the account holder's right to be paid the balance if the obligation owed is not discharged. The debtor may be able to grant a charge by way of a legal or equitable assignment. In principle, a bank could do the same for cryptoassets where the cryptocurrency would be transferred to the bank on certain terms. Accordingly, if a bank was to offer a deposit account denominated in cryptocurrency and the debtor's cryptocurrency is deposited in that bank account, the debtor could grant a charge or assignment over the bank account to the creditor. Thereby, the creditor would have the right of a chose in action over the cryptocurrency bank account pursuant to the terms of the security documentation. In reality, banks do not offer cryptocurrency denominated bank accounts in the UK. As a result, the cryptoasset will be held directly by the grantor of the security and there will be no third party involved.

The difficulty in considering whether a security interest can exist in a cryptoasset relates to the issue that the "owner" of a cryptoasset is whoever has control over it; this would be the holder of the private key. It is unclear whether cryptoassets confer any legal rights against third parties and it only appears to have value to the extent that there is a demand for it.

It would be unlikely that, under English law, a creditor will be able to take a lien over a cryptoasset. This is because, according to case law, "rights properly classified in English law as a general lien were incapable of application to anything other than tangibles and old fashioned certificated securities".[53] This was further reiterated in a case where the Court of Appeal ruled that a lien could not be granted over an electronic database.[54] Based on this judgment, the English Courts are unlikely to accept that a lien exists over an asset which is fundamentally cryptographic code. At paragraph 3.9.6 of this paper, we reviewed the proprietary rights that exist over bearer shares and made comparisons to cryptoassets. It is possible to grant a pledge over bearer shares because ownership of the bearer instruments can be transferred by delivery of possession. Similarly, it may be possible to do the same for a cryptoasset, whereby the debtor transfers the cryptocurrency from their digital wallet to that of the creditor's digital wallet, or transfers the private key to the creditor. This transfer should be documented in a memorandum stating that the intention is to create a pledge whereby the cryptocurrency is deposited with the creditor for safekeeping until the payment of the debt, thereby purportedly creating a security. If a valid security is created, the creditor would have an implied common law right under English law to sell the pledged asset if the debtor does not comply with the terms of the underlying transaction. It is then important to set out the terms of the contractual right of sale in the memorandum. Therefore, it appears that it may be possible, under English law, to grant a pledge over the cryptoasset. There are, however, several practical issues that may arise from

[53] *Re Lehman Brothers international (Europe) (in administration)* 2012 EWHC 2997 (Ch).
[54] *Your Response Ltd v Datateam Business Media Ltd* (2014) EWCA Civ 281.

this type of transfer. Sharing the private key does not prevent the debtor from using the private key himself and transferring the cryptoasset to a separate wallet held by the creditor. Furthermore, a transfer would result in the debtor losing the economic benefit and risk associated with the cryptoasset.

3.11.3 Sweden

There are three types of security that can be created under Swedish law; pledge, charge (mortgage) and separation rights.

The debtor may grant a pledge that can be perfected by handing over all control of the pledged object to the creditor (pledgee), that is, handing over possession of a physical object to the creditor. In order to perfect a pledge containing an intangible asset such as shares or other financial instruments registered at a bank, it may be assigned and notice given to the bank. Where the asset is a right to intellectual property, the pledge agreement must be registered at the Swedish Patent and Trademark Office. Since there are no official registers in relation to cryptocurrencies, a pledge securing a cryptoasset cannot be perfected by registration similar to cases dealing with intellectual property and, since there are no trusted third party banks or central securities depository, there is no one to give notice of the assignment. In order for a pledge of cryptocurrencies to be complete, the cryptocurrency must be in the possession of the creditor. There are those who argue that this could be done by a transaction in the blockchain, provided the transaction is transferred to a new e-wallet where the key to the transferred asset is left in the old e-wallet and a new key is issued within the new e-wallet.[55] Otherwise the pledgor may still have possession over the asset by copying the existing key. Whether or not a cryptocurrency can be transferred and secured by a pledge is still highly speculative as it has never been tested in court.

Academics argue that cryptocurrencies should be excluded from assets that are included in a floating charge certificate and draw parallels to the exceptions of cash and the similarities to financial instruments.[56] There are also those who argue that an agreement on a purchase of cryptocurrencies should be included in a floating charge certificate as a claim connected to a specific performance, that is, to sell the cryptocurrencies. The same argument applies to a claim on the purchase price for sold cryptocurrencies. Cryptocurrencies should be exempted from floating charge certificates pursuant to the preparatory work in the Swedish Limited Floating Charges Act,[57] where it is argued that cash in a bank account and financial instruments should be exempt since they are to be considered funds that are immediately available for lifting and are usually included in what a debtor considers to be liquid assets. Whether or not cryptocurrencies really are immediately available for lifting and thereby constitute liquid assets, is debatable.

If a legal entity is declared bankrupt it could hold assets that belong to someone else; for example, if the entity has sold goods to a buyer but has not yet transferred them, or if the entity holds assets that someone else has the ownership of. The rightful owner of the asset can in certain situations retrieve

[55] Emil Elgebrant, *Kryptovalutor: särskild rättsverkan vid innehav av bitcoins och andra liknande betalningsmedel* ("Crypto currencies: special legal effect on the holding of Bitcoins and other similar means of payments"), Wolters Kluwer, 2016.
[56] *Ibid.*
[57] Limited Floating Charges Act (SFS 2008:990).

the property when the entity is declared bankrupt by pleading the right of separation. In order to separate an asset in a bankruptcy, the asset must be identified and ownership proved. If a legal entity holds cryptocurrencies that belong to someone else, one could ask whether that cryptocurrency could be separated in a bankruptcy. Cryptocurrency is a fungible asset similar to money in a bank account. Fungible assets are difficult to identify and the ownership of one part of the fungible asset is hard to distinguish from another part of the fungible asset that belongs to the bankrupt entity. For example, if a bankrupt entity holds cryptocurrencies in an e-wallet that do not belong to the entity, together with cryptocurrencies that do belong to the entity, they are hard to separate and distinguish from one another. In addition, it is uncertain how the ownership of a cryptocurrency is transferred since there is no third party or trusted intermediary that holds the asset (for example, a bank). There are those who argue[58] that the ownership of a cryptocurrency has shifted if and when an identified transaction in the blockchain has been completed. Since this has never been tested in court, it cannot be ruled out that the buyer of a cryptocurrency lacks the capacity of pleading separation of rights and would therefore lack the protection of its asset against other creditors.

In Sweden, there is uncertainty in ascertaining when possession and the proprietary rights of a cryptoasset have been transferred. In order for a creditor to take security over a cryptoasset, the creditor should obtain details of the cryptoasset and the e-wallet together with the private key. Generally speaking, it is almost impossible to enforce security over a cryptocurrency without the consent and co-operation of the debtor.

3.11.4 Denmark

Danish law allows for the creation of two types of security rights over assets, namely pledges and mortgages. The form of the security right is essentially dependant on what type of asset is subject to such a right. Security over cryptocurrencies could be created as a pledge, that is, the pledgee taking possession of the digital wallet containing the digital assets. Alternatively, a floating mortgage could conceivably cover digital currencies provided they constitute inventory for the pledgor (that is, the pledgee would need to be trading with the digital assets). The practical enforcement of these security rights is, however, an open question and the value of such security is therefore quite uncertain.

3.11.5 The Netherlands

It is currently unclear whether a security interest can exist over a cryptocurrency as it is not yet apparent how a cryptocurrency is to be classified. It is therefore not yet possible to definitively determine in what manner an (undisclosed) right of pledge can or ought to be vested. Currently it may be best to seek another (conventional) contractual type of security, for example a bank guarantee or a guarantee. Such security would not be vested directly “on” the cryptocurrency itself but would provide a form of enforceable surety.

[58] Emil Elgebrant, *Kryptovalutor: särskild rättsverkan vid innehav av bitcoins och andra liknande betalningsmedel* (“Crypto currencies: special legal effect on the holding of Bitcoins and other similar means of payments”), Wolters Kluwer, 2016.

3.11.6 Italy

Similarly, in Italy, it would appear that the Italian legal framework does not provide for the creation of traditional security interests over a cryptoasset. According to the recent case *Seven Business Srl - One Coin*,[59] it would not be possible to create a pledge or foreclose cryptocurrencies. Consequently, the co-operation of the debtor is crucial in order to enforce a secured cryptoasset and the security interests could be documented through a private agreement between the debtor and the creditor.

3.11.7 Conclusions to be drawn

There does not appear to be a clear answer as to whether security interests can be created over cryptoassets. Where a purported security has been created by transferring the cryptocurrency from the debtor's wallet to that of a creditor, an insolvency professional would face the difficulty of determining who the cryptoasset has been transferred to. As already discussed, the value of cryptocurrencies can fluctuate over time and the transferred cryptocurrency may be valued at a greater value than that of the debt owed to the creditor. In such a scenario, it is essential that an insolvency professional has the ability to recover the remaining value of the cryptoasset for the rest of the creditors.

4. Cryptocurrency and insolvency

4.1 What are the challenges facing insolvency professionals?

Where an estate comprises of cryptoassets, it is clear an appointed insolvency professional would need to take into consideration the applicable law, cross border recognition and apply modified identification (due to the anonymity of cryptocurrency holders) and realisation methods. Given the relatively recent rise of cryptocurrencies and their use as a form of payment and storage as an asset, it is vital for bankruptcy courts to identify whether cryptocurrency is an asset that falls under the property of a debtor's estate and is capable of being recovered by an appointed insolvency professional or creditors. The growth in the use of cryptocurrencies has and will continue to create difficulties for the administration of bankruptcy cases. The unique nature of cryptocurrencies will require bankruptcy courts to consider creative interpretations of the existing insolvency regime to protect the interests of both the debtor and its creditors in a liquidation/insolvency scenario. Certain key issues are considered in further detail below.

Where it is determined that a cryptoasset falls within an insolvency estate, the first issue is that of control. The individual in possession of the private key can be regarded as the controller of the cryptocurrency held in the digital wallet. Therefore, in order to realise any of the cryptoassets held in the digital wallet the insolvency professional will require the co-operation of the debtor in obtaining the private key; otherwise the insolvency professional will not have sufficient control over, or access to, the cryptoassets in order to realise their value. It is therefore likely that an insolvency professional will struggle to identify whether an insolvent individual or entity holds cryptoassets if the holder of the digital wallet does not disclose this information.

[59] Judgment 18/07/2018, Court of Brescia.

In the evolving market of cryptocurrency, bankruptcy trustees in the US, for example, face the challenge of identifying both the owner and / or location of a debtor's cryptocurrency, which may prove even more difficult if the debtor attempts to hide such assets during the bankruptcy proceedings. Fortunately, the Bankruptcy Code in the US provides an incentive for a debtor to reveal its cryptoasset. In the US, the bankruptcy courts can release an individual debtor from personal liability for most debts in a chapter 7 bankruptcy by making a discharge order. After a discharge order has been granted the creditors of the bankruptcy cannot bring an action against the debtor. Unless there is an objection or a motion to extend the time to object, the bankruptcy court will issue a discharge order. Section 727 of the US Bankruptcy Code sets out the grounds for denying a chapter 7 discharge, including such cases where the debtor transfers, removes, destroys, mutilates, or conceals Bitcoin or any associated records. On the request of a trustee, creditor or the US trustee the bankruptcy court may revoke a chapter 7 discharge if the debtor fraudulently failed to report an asset or surrender it to the trustee.[60] Consequently, a debtor will likely be motivated to disclose the cryptoasset in order to avoid being denied a discharge or the revocation of a discharge. This is of course relevant only in relation to an individual debtor rather than a corporate debtor. Nevertheless, bankruptcy trustees still face significant challenges in identifying other account holders or transfer recipients that the debtor may be unaware of and in compelling the handover of Bitcoin held overseas. However, there is hope as the fintech sector continues to develop new technology and innovative methods to trace and identify cryptocurrency transactions.

Where an insolvency professional is able to gain sufficient control over the cryptocurrency holding, the next issue is whether the distribution of the payments should be made in cryptocurrency or converted to fiat currency. This might not be an issue if the relevant security arrangements with creditors set out the specific amount of cryptocurrency that is attributable to discharging the debt of the creditor. However, where this is not the case the distribution process becomes difficult. Due to the volatile nature of the value of cryptocurrency, the point of valuation will be critical as the value is capable of drastically rising or falling. It may be the case that creditors may want their entitled portion of the cryptoasset to be converted to fiat money. In this scenario, the question of conversion arises. As with most things in life, cryptocurrencies are valuable to the extent that other participants are willing to accept them as payment, or will purchase them. Therefore, the insolvency professional needs to be aware of the impact a large disposal of cryptocurrency will have on the value of the asset. Without a credible strategy in the disposal of the cryptocurrency, the insolvency professional's actions could devalue the cryptoasset and this would be a breach of duty of the part of the insolvency professional who has a duty to consider the interests of the creditors as a whole. In order to avoid a situation where the actions of the insolvency professional are called into question by the creditors, it is advisable that any disposal or the decision to hold the cryptoasset is validated by an order of a Court with relevant jurisdiction.

A good example of this is the insolvency of the cryptocurrency exchange MtGox (this case is analysed in more detail below in paragraph 4.6.1). On 25 September 2018, the trustee, in consultation with the Court and the examiner, made a disposal of Bitcoin. The decision to implement a sale was heavily criticised as it resulted in the sale of roughly 35,841 Bitcoins for approximately

[60] https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics.

USD 360 million. The sell-off was perceived as driving down the price of Bitcoin and it was claimed this was contrary to the trustee's duty to maximise and protect the value of the assets on behalf of the creditors. Had the trustee not consulted the Court prior to making this decision, it is likely that the criticism would have accelerated into litigation against the trustee.

Volatility of the cryptocurrency market is an important factor which an insolvency professional must take into consideration for a liquidation plan over an estate which comprises of a significant holding of cryptoassets. As seen in MtGox, the trustee followed the Japanese bankruptcy rules which state that the claims are to be valued at the April 2014 Bitcoin market price; consequently, the trustee had priced the Bitcoins at their 2014 value of USD 483. The creditors, dissatisfied with this, petitioned the Court to reinstate civil rehabilitation proceedings (from bankruptcy proceedings) so that they could reclaim the cryptocurrencies at the value of the cryptocurrency in 2016, which had accelerated to USD 1.3 billion. Due to the increase in value of the Bitcoin, the Court reinstated the civil rehabilitation.

The question of conversion of cryptocurrencies into fiat currency arose in a recent unreported criminal case in England, in the context of a seizure of Bitcoins from an individual who was convicted of drugs and money-laundering offences (details of this case is set out at section 3.9.6 of this paper).[61] The police applied to the Courts for an order permitting them to convert the cryptocurrency into sterling due to the volatility of the value of Bitcoin and its susceptibility to theft. The police submitted evidence in relation to two methods of conversion of the cryptocurrency: public auction (which has been successfully used in the US) and a Bitcoin exchange (which has been used by the Dutch police for over five years). The court held that the appropriate means of conversion was the approved Bitcoin exchange, as the fees for this method of conversion was lower and its effectiveness had been established. While what is stated above took place in relation to a criminal case, it is possible that an insolvency professional could present options to the Court in order to obtain directions as to the best method of conversion.

4.2 Antecedent transactions

In most jurisdictions, including the ones under review in this paper, an insolvency professional is provided with a set of clawback tools in order to challenge a reviewable transaction made within a certain period of time. Where a challenge is successful, the court will make an appropriate order to reverse the effect of the transaction, for example by setting aside a transfer and ordering the return of the assets. The returned assets or proceeds of such transaction would form part of the assets of the insolvent company and would be available for distribution to the creditors. In most jurisdictions it is yet to be tested whether the clawback powers available to an insolvency professional will apply also in the context of a cryptoasset. However, it is likely that clawback powers would be applicable to crypto-transactions in most jurisdictions, unless there is a clear exclusion contained in legislation.

[61] *R v Teresko (Sergejs)* – unreported, 11 October 2017.

4.2.1 United States

There has been one particular case in the US where a bankruptcy trustee has sought to utilise claw-back powers to recover cryptoassets for the insolvent estate. In *In re Hashfast Techs LLC*, the trustee moved for partial summary judgment (Motion) seeking two determinations from the court.[62] First, he sought a determination that Bitcoin constitute commodities, not currency, for the purpose of recovery under section 550(a) of the US Bankruptcy Code.[63] Section 550(a) of the Bankruptcy Code provides that once a trustee has avoided a transfer, the trustee may recover, for the bankruptcy estate's benefit, either the transferred property or, if the court orders, the value of the property.[64] Second, he sought a determination that the bankruptcy estate was "entitled to [recover] either the Bitcoin or the value of the Bitcoin as of the transfer date or time of recovery, whichever is greater."[65] In support of the latter, the trustee argued that the purpose of section 550(a) of the Bankruptcy Code was to restore the bankruptcy estate to the financial condition it would have been in had the transfers not occurred.[66] In opposition, the defendants argued that the bankruptcy estate was only entitled to recover the value of the Bitcoin as of the transfer date.[67] The defendant further argued that restoring the bankruptcy estate to the financial condition it would have been in had the transfers not occurred, "would involve paying the dollar value for services rendered, not the windfall sought here."[68] In addition, the Defendant argued that the Bitcoin transfers he received do not constitute fraudulent transfers because the transfers satisfied an antecedent debt and, therefore, the debtors received value for the Bitcoin transfers to the defendant.[69]

In February 2016, the Court entered an order granting in part the trustee's Motion.[70] As noted above, the Court determined that "Bitcoin are not United States dollars," rejecting the defendant's argument.[71] The Court stated that it need not determine "whether Bitcoin are currency or commodities for purposes of the [Bankruptcy Code] fraudulent transfer provisions."[72] The Court also stated that if the Trustee ultimately prevailed in the action, then it would determine "whether . . . he may recover the Bitcoin (property) transferred or their value, and if the latter, valued as of what date."[73] Ultimately, however, the Court did not have the opportunity to determine this, as the parties stipulated to dismiss the action with prejudice.[74]

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62 See Pl's Mot for Partial Summ J at 2, *Kasolas v Lowe* (*In re Hashfast Techs. LLC*), No 15-03011 (Bankr ND Cal Jan 22, 2016), ECF No 42; see also Pl's Mem of Points and Authorities in Supp of Mot for Partial Summ J, *supra* note 53, at 3 ("[T]he Motion is not directed to avoidance of the Bitcoin transfers, but rather to the discrete legal issue of whether, once avoided, the Bitcoin constitute mere currency – the equivalency of dollars – or a commodity which can rise or fall in value based upon changing market conditions.").

63 See Pl's Mot for Partial Summ J, *supra* note 56, at 2.

64 See 11 USC, § 550(a).

65 See Pl's Mot for Partial Summ J, *supra* note 56, at 2.

66 See Pl's Mem of Points and Authorities in Supp of Mot for Partial Summ J, at 2, 3, 6, 8, *Kasolas v Lowe* (*In re Hashfast Techs. LLC*), No.15-03011 (Bankr ND Cal, Jan 22, 2016), ECF No 42-1.

67 *Idem,* at 3, 14.

68 *Idem,* at 12.

69 *Idem,* at 13.

70 *See* Order on Motion For Partial Summary Judgment, *Kasolas v Lowe* (*In re Hashfast Techs LLC*), No 15-03011 (Bankr ND Cal, Feb 22, 2016), ECF No 49.

71 *Idem* at 1.

72 *Ibid.*

73 *Idem,* at 1–2.

74 *See* Order Approving Stipulation to Dismiss Adversary Proceeding with Prejudice, *Kasolas v Lowe* (*In re Hashfast Techs LLC*) (2016) (No 15-03011).

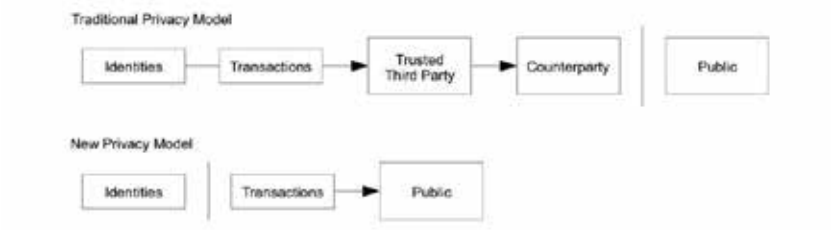
It can be argued that if virtual currencies were classified as money or currency, Bitcoin transactions would receive greater protection under the Bankruptcy Code. Specifically, cryptocurrency transfers or contracts in which individuals exchanged it for dollars or other currencies, may be classified as "swap" agreements (swap agreements) and receive beneficial protections under sections 362, 546 and 560 of the Bankruptcy Code. Under sections 362 and 546 of the Bankruptcy Code, swap agreements would be protected from avoidance as constructive fraudulent transfers. Under section 548 of the Bankruptcy Code, a transfer made by a debtor within two years of filing for bankruptcy can be reversed if it is deemed constructively fraudulent. Specifically, under section 548 of the Bankruptcy Code, transfers can be reversed within two years of the filing of a bankruptcy case if the debtor: (i) transferred an interest in its property; (ii) was insolvent at the time of the transfer or was rendered insolvent thereby; and (iii) received less than reasonably equivalent value in exchange for such transfer." Section 546(g) of the Bankruptcy Code may offer protections to swap agreements by prohibiting a bankruptcy trustee from avoiding preferential transfers made before the filing of a bankruptcy case, unless the transferor intended to hinder, delay, or defraud creditors. Lastly, section 560 of the Bankruptcy Code provides swap agreements broad protection from the automatic stay, in that swap participants would not be prohibited by the automatic stay to liquidate, terminate, or accelerate a swap agreement. Therefore, Bitcoin holders would have the ability to sell Bitcoin in exchange for US dollars without the fear that such transfers would be deemed constructively fraudulent, receiving the same protection under the Bankruptcy Code as if they were exchanging US dollars.

4.3 Tracing transactions

When it comes to cryptoassets, there may be an added difficulty for insolvency professionals when seeking to trace the cryptoasset. One of the compelling bases of cryptocurrencies is that they allow anonymity and that transactions are untraceable. Although there are certain types of cryptocurrencies, such as Moreno and Zcash, designed to avoid tracking, there are methods to trace transactions by studying the relevant distributed ledger technology. For example, Bitcoin provides for a level of anonymity in the sense that the users use pseudonymous identities through a public key to secure transactions and the public key does not contain any identifiable information about the user. All of the transactions made using this public key are publicly available to the entire Bitcoin network through the blockchain. Blockchain contains detailed information about the nature and the context of every transaction ever made, including time, values, recipients and user public keys. This allows data scientists and statisticians to identify links between exchanges and certain transactions which can be traced back to a digital wallet with a unique identifier. The user remains anonymous unless the Bitcoin address can be linked to the real-world identity of the user.

The diagram[75] below sets out the differences in the traditional privacy model against the new Bitcoin privacy model. The traditional banking model achieves a level of privacy by limiting access to information to the parties involved and trusted third parties. The transactions are generally not transparent. However, Bitcoin transactions are available for review but without linking the transaction to a particular individual / entity.

[75] Bitcoin: A Peer-to-Peer Electronic Cash System (https://bitcoin.org/bitcoin.pdf).



Cryptocurrency exchanges are websites where users can buy, sell or exchange cryptocurrencies for other digital currency or fiat currency. Certain exchanges maintain a database of identities of their users and the co-operation of the exchange platform will therefore be required in order to identify the individual who controls the digital wallet. This is only possible where the exchange platform has obtained the necessary information from the digital wallet holder. Sophisticated exchange platforms would normally require users to verify their identity; the majority of Bitcoin trading platforms both in the US and the UK require some form of identity verification. However, there are other platforms that do not require a user to create an account and consequently no personal information in relation to the user will be stored by the exchange platform. At present there is no regulatory or legal requirement for exchange platforms to maintain the identities of their users. Another shortcoming of the tracing process is that the companies that provide these services have to set up an intricate tracing system for each type of cryptocurrency. There are 2,143[76] different types of cryptocurrencies that exist in the world today with a total market cap of USD 177,151,636,370. Realistically, these tracing companies are probably only in a position to track the high profile cryptocurrencies.

Due to the nature of cryptocurrencies, an insolvency professional will most likely need the expertise of a tracing company to track any reviewable transactions. With the help of experts it is not impossible to create a roadmap of the transactions. Therefore, an important consideration for an insolvency professional is whether the costs associated with tracing are reasonable in relation to the ability to realise value from the cryptocurrency holdings. If the cost of tracing cryptocurrency transactions is greater than the amount that could be realised from the asset, then this is obviously not a worthwhile exercise. This might not be a simple decision to make, as an insolvency professional may not have a clear understanding of the value of the cryptocurrency holding without further investigation, which in itself may be costly without the co-operation of the insolvent entity or bankrupt individual. It is also important to note that the analytics companies that have assisted with the tracing of cryptocurrency transactions, have done so in the context of detecting fraud. They do not therefore specialise in identifying transactions within the context of insolvency. It does not seem unrealistic that tracing companies could apply similar forensic techniques for the purpose of tracing transactions in the context of insolvency.

4.4 Choice of law and jurisdiction

Cross-border issues are common in corporate restructurings and insolvencies as most large corporates have operations or assets in several locations. It is

[76] https://coinmarketcap.com/all/views/all/.

therefore important to understand that there is a disparity between the insolvency regimes of different jurisdictions. The distributed nature of cryptocurrency and Blockchain technology raises significant jurisdictional questions that will need to be considered. Due to the complexities of jurisdiction and choice of law in relation to cryptocurrencies, one could produce an entire paper on this topic alone. It is for this reason that the paper only deals with this topic at a very high level.

The two key issues that arise in matters with a multi-jurisdictional aspect are where the principal proceedings should be opened and which law will govern the process. Answering the first question helps in answering the second.

In the context of the European Union (EU), the European Insolvency Regulation[77] (EIR) seeks to co-ordinate insolvency proceedings through the concept of a centre of main interest (COMI) in order to determine which member state of the EU (other than Denmark) has jurisdiction to open insolvency proceedings and which state's laws take precedence if competing insolvency procedures are commenced in different member states. Although the term COMI is not defined, there is a rebuttable presumption that the debtor's registered office (or place of residence in relation to an individual) is the centre of the debtor's main interest. Additionally, proceedings can be brought in a state in which the debtor does not have its COMI but has an "establishment." This is defined as any place of operation where the debtor carries out an economic activity with human means and goods, which is not of a temporary nature. In addition, the UNCITRAL Model Law on Cross-Border Insolvency (Model Law) provides a legal framework that sets out when and how a court can recognise insolvency proceedings opened in another jurisdiction. The Model Law has no legal or binding status but serves as a framework that can be adopted by jurisdictions around the world. Some concepts contained in the Model Law are similar to the EIR where it categorises foreign insolvency proceedings into main proceedings and foreign non-main proceedings. Commencing proceedings in one jurisdiction may be just one of many proceedings in various jurisdictions that are necessary to resolve a debtor's financial difficulties. It is therefore essential that courts of other jurisdictions can be enabled to recognise and give effect to the proceedings commenced in the first jurisdiction and to co-ordinate an effective realisation of the assets.

Many jurisdictions rely (in part) on the *lex rei sitae* in order to establish jurisdiction over assets; in other words, the physical location of the asset determines who has jurisdiction over that asset. This raises the issue of where cryptoassets are located:

a) Is it the location of the digital wallet, which could be online, on a local machine or on a backup storage system?
b) Is it the location of the Blockchain itself?
c) Is it the location of the exchange used by the person in question?

Where the insolvency relates to an exchange platform that has been incorporated in a particular location, it is likely that the governing law and jurisdiction would be that of the country where the exchange platform has been incorporated. On the other hand, the location of the Blockchain is akin to a

[77] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

circular determination of jurisdiction due to the distributed nature of the technology, whereby it has no single fixed location. It must, however, be noted that the value of the cryptoasset is dependent on the ledger contained in the Blockchain reflecting the existence / ownership of the assets in question. In this regard it shares some similarities with shares in non-listed companies, where the *lex rei situs* over the shares would point to the law of the registered office of the company.

The physical location of the wallet would be the natural starting point, that is, the local machine that contains the wallet or the location of the online wallet. But considering that any number of backups of the wallet could exist elsewhere, any one of these could conceivably establish jurisdiction. The wallet itself is, however, just digital proof of ownership of part of the Blockchain. It could therefore be argued that the wallet is merely the key to accessing the actual asset, the Blockchain, and not the asset itself. The keys to a house would not constitute an asset and would not in itself establish jurisdiction over the house.

Furthermore, exchange platforms and companies that provide digital wallets operate through software that is globally accessible. These companies may not follow a traditional corporate structure, hold physical assets or occupy office space but will engage with customers worldwide. As evidenced by the multiple proceedings that arose from the insolvency of MtGox, the greatest challenge that insolvency professionals will face is that their appointment may not be recognised by other jurisdictions around the world. Even if an insolvency professional was able to overcome the issues surrounding jurisdiction, the issue of which law should govern the proceedings will remain. As has already been established, there does not appear to be clear legislative guidance in any jurisdiction as to how cryptocurrencies should be characterised.

In terms of governing law, every modern country provides guidance on how to deal with a dispute. Where there is a difference in the result achieved through the application of the rules in one jurisdiction compared to another, the question of governing law becomes a pertinent one. This is particularly relevant where one jurisdiction might have structured legislative guidance on dealing with cryptocurrencies compared to another. However, as has already been shown in this paper, there is little legislative guidance regarding cryptocurrencies in most countries around the world. This brings us to the second issue; if the governing law has been agreed, which category of law will apply to cryptocurrencies? Which juridical concepts can be applied to cryptocurrencies when they cannot be legally categorised as something? Unfortunately, at this point one can only raise these issues as the answers have yet to be discovered.

4.5 Cryptocurrency exchanges

As already mentioned, users in the cryptocurrency community engage with cryptocurrency exchanges in order to invest in cryptoassets. The exchange platform will usually hold cryptocurrency deposits in an account pursuant to the terms of engagement. For example, if a comparison is made to the traditional banking system involving cash deposits, under English law where a customer deposits cash with a bank the customer has a debt claim for the amount of the cash deposit against the bank in the event the bank enters an insolvency procedure. Furthermore, in order to mitigate the risk to customers, there are banking regulations that require financial institutions holding cash deposit accounts to maintain certain levels of capital reserves to cover the deposits. In

addition to this, the government provides further protection through government bank deposit protection schemes, such as the Financial Services Compensation Scheme in the UK. There appears to be very little protection provided to customers who invest by using cryptocurrency exchange platforms. The EU's Fifth Anti-Money Laundering Directive[78] seeks to bring exchange platforms and custodians within its regulatory remit. However, it contains no equivalent capital reserve requirement or any form of compensation scheme. It would therefore appear that cryptocurrency investors have a mere unsecured claim against an exchange platform that enters a process of insolvency.

The relationship between an investor of cryptocurrency and an exchange platform could also be compared to that of a custodian / broker of traditional securities. With traditional securities investments, the investor will make relevant investments in the securities through a custodian or broker, who will then hold the securities on behalf of the investor. This relationship is usually governed by a custody agreement which requires that the custodian return the securities and interest accrued by the securities back to the investor. In order for investors to retain a proprietary interest over the securities held on their behalf, it is a common occurrence that the custodian will hold the assets on trust for the investor. The assets of the investor should therefore be clearly identifiable. Under English law, for example, assets that are combined with the assets of another investor would still be capable of being held on trust for the relevant investors. However, where the investor assets are mixed with the assets of the exchange platform, it would be challenging to establish a trust relationship. Ordinarily, regulation dictates that assets of clients should not be mixed with the assets of the custodian; however, such regulation does not apply to cryptocurrency exchange platforms and it is therefore unlikely that this is a common practice by exchanges. In any event, this is based on the premise that proprietary rights are capable of existing over cryptocurrencies, which is presently unclear.

4.6 Case studies

4.6.1 Exchange platform - MtGox

MtGox was founded by Jed McCaleb in 2010 at a time where there were few exchanges for buying and selling Bitcoin. It grew exponentially and was sold to Mark Karpelès who resided in Japan. At its peak, MtGox was reportedly engaged in an estimated 70% of all global Bitcoin transactions. Throughout the life of the exchange it had suffered cyber hacks, technical issues and dealings with the US Government. In 2013, federal agents seized a total of more than USD 5 million after a judge ruled that there was probable cause to suspect that MtGox was engaged in money transmitting without a licence. This seizure set a precedent for Bitcoin exchanges seeking to operate in the US. In 2014, the exchange restricted all withdrawals as it came to light that a cyber-hack was syphoning Bitcoins out of MtGox.

MtGox was reportedly the largest cryptocurrency exchange in the world until it went into a process of insolvency after a cyber-hack, which resulted in the theft of nearly all of its own Bitcoins and that of its 750,000 customers at the time. The value of the loss equated to around 7% of all available Bitcoins and was

[78] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU.

worth around USD 473 million at the time. In the absence of regulation, the exchange apparently did not back up its Bitcoin deposits with capital.

MtGox filed for civil rehabilitation proceedings in the Tokyo District Court on 28 February 2014, as an attempt to recover from the losses it was making. Civil rehabilitation proceedings in Japan are intended to enable the debtor to reconstruct the business in accordance with a rehabilitation plan approved by a certain majority of creditors. The distribution to creditors under these proceedings should not be less than that in a bankruptcy. The process was dismissed by the court soon after on the basis that there was no prospect of recovery and so an order for provisional administration was made. Within eight days of the order, the company was placed into bankruptcy proceedings. Soon after commencing the Japanese bankruptcy proceedings a petition was filed in the US Bankruptcy Court for the Northern District of Texas, requesting that the civil rehabilitation procedure be recognised pursuant to Chapter 15 of the US Bankruptcy Code. The US Bankruptcy Court recognised the Japanese bankruptcy proceedings as a foreign main proceeding. Similarly, the MtGox trustee successfully obtained an order from the Ontario Superior Court of Justice in Canada, recognising the Japanese bankruptcy proceedings. This was in opposition to a class action petition commenced by Canadian investors alleging negligence, fraud and breach of contract. The recognition of the bankruptcy proceedings in Japan resulted in a stay of all actions brought against the exchange in Canada. This was achieved due to the fact that the trustee was able to demonstrate that the bankruptcy proceeding in Japan was a “foreign main proceeding”.

On 25 May 2016, the trustee completed a review of the assets and claims from customers and creditors; 24,750 claims had been proved, totalling USD 432 million. According to Japanese bankruptcy rules, the claims had to be valued at the April 2014 Bitcoin market price. The trustee proceeded to value the Bitcoins at their value in 2014 (the date on which the insolvency proceedings had commenced), at which time the value equated to USD 483 per Bitcoin. Valuing the Bitcoin at the time the insolvency proceedings were commenced was a contentious issue, as the value of Bitcoin had increased significantly since 2014. It is a rare occurrence indeed to find a company undergoing a bankruptcy procedure becoming solvent as a result of the appreciation in the value of its assets, but this is exactly what transpired in the MtGox case.

On 25 September 2018, the trustee announced that in consultation with the Court and the examiner based on the examination report dated 28 February 2018, the trustee had secured a certain amount of money for the bankruptcy estate through the sale of assets. The quantities sold and the amounts paid into the bankruptcy estate are set out in the table below:[79]

[79] https://www.mtgox.com/img/pdf/20180925_announcement_en.pdf.

Type of cryptocurrencies	Quantity sold	Amounts paid into bankruptcy trustee's account
BTC	24,658.00762 BTC	JPY 22,561,004,011
BCH	25,331.00761 BCH	JPY 3,414,698,341
	Total amount	JPY 25,975,702,352

As a result of the sale, the balance of the bankrupt trustee's account was approximately JPY 70,059 million.[80]

The decision to implement a sale was heavily criticised as it resulted in the sale of roughly 35,841 Bitcoins for approximately USD 360 million. The sell-off was perceived as driving down the price of Bitcoin and it was claimed this was contrary to the trustee's duty to maximise and protect the value of the assets on behalf of the creditors. The trustee's response to the criticism was that the decision was made to secure fiat value for the Bitcoins while the price was relatively high and that the sale was structured through a private offering to minimise the impact on the market price. Obtaining court approval for the plan to sell-off certain cryptoassets provided the trustee's actions with some legitimacy.

The value of Bitcoin continued to rise through to 2017 and the trustee announced that any assets in excess of the claims against MtGox would be distributed back to the shareholders, including Karpelès. Consequently, on 24 November 2017 the creditors petitioned the court to convert the proceedings to a civil rehabilitation proceeding. On 22 June 2018, the Tokyo District Court complied and issued an order to commence civil rehabilitation proceedings for MtGox. As a result, the ongoing bankruptcy proceedings were stayed and a Civil Rehabilitation Trustee (CRT) was appointed. The stay on the bankruptcy proceedings meant that the mass Bitcoin sell-off that had caused controversy, had also ended. The bankruptcy trustee, Nobuaki Kobayashi, was appointed as the CRT who has the power and authority to administer and dispose of the MtGox assets and implement the civil rehabilitation proceeding, including the administration of assets and investigation of claims subject to the supervision of the Tokyo District Court. Civil rehabilitation proceedings in Japan do not require non-monetary claims (claims in relation to Bitcoin) to be converted into fiat currency value and permits flexibility in the method of distribution to creditors in accordance with a rehabilitation plan.

Pursuant to this order, the CRT launched an online claims submission process which gave creditors until 22 October 2018 to submit a filing. According to the CRT, "if [a] proof of claim is not filed by the deadline, then disenfranchisement (that is, loss of the right to claim) might apply". This process allowed creditors who did not submit claims prior to the bankruptcy proceedings to submit their filings in the rehabilitation proceedings.

The CRT recently announced that the balance of the funds held by him in relation to MtGox is JPY 69,553,086,521 (USD 629,594,540) in cash and BTC 141,686.35 and BCH 142,846.35 cryptocurrency valued at over USD 593

[80] https://www.mtgox.com/img/pdf/20180925_announcement_en.pdf.

million.[81] The CRT continues to investigate and locate further funds said to have been hacked and / or lost by the exchange. This includes retrieving money owed to MtGox by other parties, such as the former CEO Mark Karpelès and majority owner Tibanne Co.

On 19 March 2019, the trustee announced that he had concluded the processing of creditors' rehabilitation claims and submitted to the Tokyo District Court a statement of approval or disapproval. The claims were submitted via two forms:

- online filing system; and
- supplementary online method or offline method.

On 3 April 2019, the CRT announced that all creditors who had filed rehabilitation claims had received decisions regarding their claims. Creditors can appeal whatever decision was made by making an application for the assessment of the claim with the court. The timing and method of payment had not yet been determined at the time this paper was written but the details will be set out in a rehabilitation plan in due course.

4.6.2 Individual bankruptcy

The status of cryptocurrency in Russia is unclear and, therefore, from a practical standpoint, it is debatable whether cryptocurrency can be included in a bankruptcy estate. In a recent case of individual insolvency in the Moscow *Arbitrazh* Court,[82] a financial administrator proposed that the debtor's crypto-wallet be included in the bankruptcy estate. According to the documents on file, the financial administrator considered cryptocurrency to have a high pecuniary value and that the exclusion of the debtor's crypto-wallet would therefore violate creditors' rights by reducing the size of the insolvency estate. The trial court dismissed the financial administrator's claim.

The trial court found it difficult to determine whether the cryptocurrency was an asset, or information on decentralised servers. As a result, transactions involving cryptocurrencies were found by the court to be unenforceable. The court justified the decision on the basis that, due to the anonymity of cryptocurrency holders, it would be difficult to identify the owner of the cryptocurrency. This was evidently not relevant to the case at hand as the debtor confirmed that he was the holder of the cryptoasset and provided the relevant information. Furthermore, the court considered the decentralised features of cryptocurrency whereby there was no entity to guarantee the value of the cryptocurrency. It appeared that none of the features mentioned by the trial court affected the ability to recognise cryptocurrency as an asset. Instead, it appears that the court was unwilling to rule on the legal status of cryptocurrencies on the eve of the amendments to the Civil Code of the Russian Federation and the draft law "On Digital Financial Assets."

On 15 May 2018,[83] the court of appeal set aside the ruling of the trial court and included the crypto-wallet in the bankruptcy estate. The appellate court obliged the debtor to provide the financial administrator with the relevant access key

[81] https://www.coindesk.com/mt-gox-creditors-warn-mass-sale-could-put-bitcoin-fork-prices-at-risk.
[82] *Tsarkov case* (Case number: A40 - 124668/17 - 71-160).
[83] *Tsarkov* (Case number: A40 - 124668/2017).

(password). According to the resolution of the appellate court, cryptocurrency should be regulated as an object of civil rights on the grounds of the broad interpretation of the Civil Code of Russia and should, therefore, be considered a pecuniary asset. The appellate court stated that as far as the debtor himself was able to freely use, possess and dispose of the crypto-wallet, his status should be similar to an owner. Notably, the appellate court stressed the fact that any asset of certain economic merit should be included in the bankruptcy estate unless otherwise directly provided for by the bankruptcy law. In this context, the appellate court concluded that the approach taken by the trial court deprived bankruptcy creditors of the right to have their claims satisfied in full.

5. Regulation of cryptocurrency

The debate in relation to the legal categorisation of cryptocurrencies and their regulation has increased dramatically in recent years. This part of the paper considers how regulation applies to cryptocurrencies and other cryptoassets in various jurisdictions, and discusses its impact.

Whether and to what extent cryptoassets should be regulated, is an open question. Just like conventional assets, cryptocurrencies are vulnerable to being exploited for money laundering, terrorist financing and other criminal activities. In some cases, buying cryptocurrency is akin to investment in traditional financial assets and is vulnerable to the same types of abusive behaviour such as market manipulation, fraud and ponzi schemes. Some cryptocurrencies provide anonymity and are difficult, if not impossible, to trace, making them particularly susceptible to certain nefarious activities.

Challenges arise when considering what level of regulation is appropriate. Cryptocurrency enthusiasts and cypherpunks would say that regulation is a direct contradiction to the basic premise of cryptocurrency, a decentralised digital cash system. Casting an overarching regulatory shadow over cryptocurrencies might result in the suppression of their inherent benefits and value. However, a regulatory framework with requirements for authorisation, personal accountability, mandatory disclosure and other similar rules generally guarantee a certain level of propriety, as well as dramatically reducing due diligence and transaction costs. Cryptoassets are increasingly being experimented with by mainstream financial institutions and being made available to their clients. Although the present cumulative market capitalisation of all cryptocurrencies is relatively small, if linked to the key parts of the financial system they could introduce significant risks to global financial stability. Regulators around the world have expressed a particular interest in asset tokens, which may closely resemble the financial instruments that are currently regulated and may be captured under the existing legislative framework.

There are various types and levels of regulation that can be applied to this relatively new industry / asset class. The application of one type of regulation will not necessarily preclude the use of other types of regulation. Instead, different types of regulation may be used in concert - for example, industry codes of good conduct alongside legal licencing frameworks. Broadly, regulation may come in the form of top-down legislative rules or bottom-up initiatives. The top-down implementation approach is where the government sets out a clear-cut system of command and control, including a clear hierarchy of authority. Bottom-up initiatives begin with implementation strategy formation with the target groups and service deliverers, because the target groups are the actual implementers of

policy. Discretion by the local implementers is the underlying premise of this approach. Some jurisdictions have chosen not to regulate cryptocurrency at all but instead to prohibit it entirely. Evidently, an outright ban fails to recognise the advantages of cryptocurrency but does provide a clear and simple method to handle this new asset class which has the potential to have severe consequences if not managed carefully.

On a broad review of the treatment of cryptocurrencies in a range of jurisdictions, it is evident that there is no clear and consistent approach. As is the case with legal characterisation of cryptocurrencies, the adopted regulatory methods vary between jurisdictions. The map below shows a broad overview of how various jurisdictions are dealing with the regulation of cryptocurrencies.[84]

The light-to-tight regulation scale is based on the following criteria:

Are cryptocurrency exchanges and ICOs banned, regulated or operating in a grey area?	Legal Tender?	Is there any plan to increase crypto-regulation?
Grey area = 1 point	Yes = 1 point	Yes = 1 point
Regulated = 2 points	No = 0 points	No = 0 point
Ban = 3 points		

[84] Data has been collected and produced by Comply Advantage and should be used as guidance only: https://complyadvantage.com/blog/cryptocurrency-regulations-around-world/.

5.1 European Union

The European Union (EU) is a supranational entity with 28 sovereign member states that delegate a portion of authority and sovereignty to the Union to achieve common goals. In the EU, steps have been taken to establish regulation over cryptocurrencies, including the creation of the FinTech Task Force which seeks to harmonise the existing national laws regulating virtual currencies. On the other hand, the member states have also initiated separate strategies in accordance with their local practices. Firstly, this part will review the guidance of the EU and the practices of the following member states of the EU: the UK,[85] The Netherlands, Sweden and Denmark.

A recent paper produced by Policy Department A of the European Parliament[86] emphasised concerns about criminals taking advantage of the unregulated cryptocurrency market for criminal activities, such as money laundering, terrorist financing and tax evasion. It stated that the scale of misuse is as yet unknown but has been estimated to exceed EUR 7 billion worldwide. The paper reiterated the point that the existing European legal framework fails to address the intrinsic difficulties in cryptocurrency, in particular the issue of anonymity. For example, anonymity inhibits the activation of certain tax laws, as an individual cannot be taxed for cryptocurrency transactions if the transaction is not easily attributable to the real world identity of the user. Therefore, it is in the hands of cryptocurrency holders to declare their transactions.

The European Parliament believes that introducing mechanisms of accountability into the crypto-market should prevent the misuse of cryptoassets. The European Parliament acknowledges that “legislative action should always be proportionate so that it addresses illicit behaviours while at the same time not strangling technological innovation at birth.”

One area where the European Commission is taking direct top-down regulatory action, is in regard to laws on anti-money laundering and counter-terrorist financing. The EU’s Fifth Anti-Money Laundering Directive[87] will apply a new legal definition of cryptocurrency as a “digital representation of value that can be digitally transferred, stored or traded and is accepted…as a medium of exchange.” The Directive provides that cryptocurrency firms and exchanges must comply with the same AML / counter terrorism financing regulations applied to financial institutions. Practically, this involves requirements to undertake customer due diligence and submit suspicious activity reports. The Directive requires providers of cryptocurrency exchanges and wallets – the gatekeepers of the industry – to obtain registration with their local regulator. Member states are required to implement these new rules under national legislation before 10 January 2020. The European Commission believes that the reduction in anonymity surrounding cryptocurrencies will increase the trust of their good faith users. It is likely that certain advocates of cryptocurrencies will disagree, particularly those that believe there should be less, not more, government oversight.

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85 At the time this paper was written, the UK was in the process of exiting the EU but for the purposes of this paper has been referred to as a member state of the EU.

86 http://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20-and%20blockchain.pdf.

87 Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU .

5.2 England and Wales

The Governor of the Bank of England, Mark Carney, acknowledged in an important speech that cryptocurrencies are of growing interest to policymakers.[88] In his view, cryptocurrencies do not yet meet the various tests in order to be a viable alternative means of exchange to Pound Sterling. The Governor also stated that cryptocurrencies do not, at this stage, pose a material risk to the financial stability of the UK due to their small size relative to the financial system. Currently, systemically important UK financial institutions only have minimal exposure to cryptocurrencies.

The UK's Financial Conduct Authority (FCA) does not directly regulate cryptocurrencies. Instead, it has classified derivatives using cryptocurrencies as the underlying financial instruments, subject to its supervision. For the trading of cryptocurrencies only, there are no formal mechanisms of redress for any consumer, nor any mechanism to facilitate investor compensation for trading losses due to market abuse. ICOs, on the other hand, are reviewed by the FCA on a case-by-case basis to ascertain whether they involve issuing regulated financial instruments or not.

The UK Parliament's Treasury Committee launched an enquiry into cryptocurrencies on 22 February 2018. This enquiry was designed to investigate the use of cryptocurrencies and their potential impact on systemically important institutions and the UK's regulatory environment.

In the FCA's written submission on digital currencies to the Treasury Committee, the FCA reaffirmed that:

> "Cryptoassets themselves (i.e. those designed primarily as a means of payment / exchange) are generally not within the scope of FCA regulation. Transferring, buying and selling of cryptoassets, including the commercial operation of cryptoasset exchanges, will also typically fall outside the FCA's regulatory perimeter."[89]

The Treasury Committee published its final report on 19 September 2018. The report called for the regulation of the cryptocurrency market and stated that the ambiguity of both the UK government and regulators' positions on cryptocurrencies, is not sustainable. The Treasury Committee noted that regulation would improve customer outcomes, enable sustainable growth and reduce risks.

In addition, the FCA is currently working with the UK Treasury and Bank of England as part of the UK's Cryptoassets Taskforce (Taskforce). In October 2018, the Taskforce released its final report, which included submissions by the FCA, Bank of England and other market experts.[90] The Taskforce concluded that due to the potential significant benefits of distributed ledger technology, the FCA, Bank of England and the UK Treasury will continue to support the development of cryptocurrencies and DLT. The three authorities

88 https://www.bankofengland.co.uk/speech/2018/mark-carney-speech-to-the-inaugural-scottish-economics-conference.

89 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/digital-currencies/written/81677.html.

90 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/-752070/cryptoassets_taskforce_final_report_final_web.pdf.

promised to take action to mitigate risks to consumers and market integrity, prevent illicit activity and guard against threats to financial stability. The authorities have agreed to consult on:

a) implementing one of the most comprehensive responses globally to the use of cryptoassets for illicit activity;
b) a potential prohibition of sale to retail consumers of derivatives where the underlying asset is cryptocurrency;
c) guidance on how cryptoassets are treated within the existing regulatory framework; and
d) whether new regulation or an extension of the regulatory perimeters would be required.

In January 2019, the FCA published a consultation paper on cryptocurrencies. The FCA is seeking industry and public feedback on proposals on FCA guidance on cryptocurrencies and the regulatory perimeter.

The table below, provided by the FCA to the Treasury Committee, helpfully sets out the different forms of cryptoassets and products that may relate to the underlying cryptoasset and whether these would fall within the regulatory parameters.[91]

Product area	Within perimeter?	Typical use case
Cryptoassets as a medium of exchange	N	Peer-to-peer payments, and investment assets, for example, Bitcoin and Ethereum
Regulated payments services that use cryptoassets	Y	Intermediary in cross-border transactions, for example, GBP – Bitcoin – USD transactions
Derivative instruments referencing cryptoassets	Y	Financial instrument to bet on price developments (Contracts for difference (CfD)) or to hedge a position (futures), for example CfD providers IG, Crypto Facilities and Plus500
Investment assets in cryptoassets	Y	Direct investments in cryptoassets, for example, Swedish registered exchange traded notes

[91] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/-treasury-committee/digital-currencies/written/81677.html.

Product area	Within perimeter?	Typical use case
Tokens representing transferable security	Y (security token)	Distribution infrastructure for regulated products such as shares and bonds, for example, issue of traditional shares on public blockchain. Also in the context of ICOs, when tokens amount to a transferable security, more akin to regulated equity-based crowdfunding
Tokens representing a claim on prospective services or products	N ("utility token")	Tokens that do not amount to transferable securities or other regulated products and only allow access to a network or product. Can also be used as a fundraising mechanism akin to unregulated donation and rewards-based crowd funding, also in the context of ICOs

As part of the FCA's Project Innovate initiative, the regulator has granted access to its regulatory sandbox to various fintechs experimenting with cryptoassets. The regulatory sandbox is a way for firms to test new products in a live environment with real customers, by relying on temporary FCA waivers from obtaining authorisation to conduct regulated business. It has existed for a few years and in 2018 40% of the 29 firms granted access were using DLT.[92]

For issuers and their advisors engaging in ICOs in the UK, the FCA's acknowledgement that it does not consider cryptocurrencies themselves as currencies, commodities or other financial instruments under MiFID II,[93] is good news. However, it does serve as a timely reminder for firms considering making offerings of futures or options based on cryptocurrencies, that FCA authorisation and supervision will be a mandatory requirement. The ICO market had tapered off sharply at the end of 2018 as issuers consider the changing regulatory environment and investors pull away from ICOs.

The FCA was investigating 24 businesses that deal with cryptocurrencies in the UK and has opened seven whistleblower reports during 2018 that consider whether the businesses in question might be carrying on regulated activities that require FCA authorisation. The FCA confirmed that it is focusing on "identifying and determining the most serious matters which pose the greatest risk to consumers" and if regulatory breaches are found they will take enforcement action. The FCA noted in April that "it is likely that dealing in, arranging transactions in, advising on or providing other services that amount to regulated activities in relation to derivatives that reference either cryptocurrencies or

92 https://www.paymentscardsandmobile.com/fca-approval-are-cryptocurrencies-going-mainstream/.

93 Markets in Financial Instruments Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance.

tokens issued through an ICO will require authorisation by the FCA." Penalties for breach include fines and may potentially involve imprisonment.

The Bank of England has confirmed that it will not be issuing any digital currency. Central bank digital currency is the digital form of fiat money established as money by government regulation and law. Central bank digital currency differs from that of other digital currency as it will be issued and backed by the state.

A report prepared for the European Parliament's Economic and Monetary Affairs Committee, acknowledges that providing central bank backed digital coins could avoid recurrent instability of the banking system as the fractional reserve character of the current banking system can be a major source of instability. This was contrary to the guidance issued by the Bank for International Settlements, which argued that central banks should not develop their own digital currencies as there may be potentially serious implications for monetary policy and financial stability. The Bank of England has noted these reports but concluded that it will not be issuing central bank digital currency in the medium term.

5.3 Sweden

Trading using cryptocurrencies is not closely regulated under Swedish law. Under Swedish law, trading cryptocurrency is a regulated activity that requires permission from the Swedish Financial Supervisory Authority (Swedish FSA). The Swedish FSA and the Swedish National Bank have agreed that cryptocurrency is not currency or cash. However, the Swedish FSA has stated that a company that allows individuals to purchase cryptocurrencies must be registered under the Swedish Currency Exchange and Other Financial Activities Act.[94]

Cryptocurrencies have not been defined as financial instruments under Swedish regulation. However, it is likely that the purchase of and offering advice on investments in cryptocurrencies will most likely be regulated by the Swedish FSA. It is also likely that cryptocurrencies may be regulated by other Swedish authorities, depending on the type of cryptoasset in question. For example, blockchain technology may fall within the remit of the Swedish Data Protection Authority. If the cryptoasset is associated with medical records or other similar assets, it could be regulated by the Swedish Health Care Authority. However this is highly speculative and as of today the only regulation that exists is that of the Swedish Currency Exchange and Other Financial Activities Act and the Swedish Tax Agency in relation to the sale and purchase of cryptocurrencies.

There remains continued debate over how trades involving cryptocurrencies will be regulated and how to ensure consumer protection. The first concern relates to the financial risks attached to investing in cryptoassets. The Swedish FSA states that it is of high importance that companies offering cryptocurrency investment services in the market ensure that consumers are informed of the novel characteristics of the cryptoasset and the risks involved in trading in it. This is particularly pertinent considering that regulation lags far behind the development of this market and at present consumers are engaging in activities that ought to be regulated but are not. Another concern is the manner in which

[94] 1996:1006. https://www.fi.se/sv/bank/sok-tillstand/valutavaxlare-och-annan-finansiell-verksamhet/.

the cryptocurrency market may be subject to money laundering and the financing of terrorism.[95]

5.4 The Netherlands

The Netherlands Central Bank (DNB) and the Dutch Authority for Financial Markets (AFM) do not categorise Bitcoin and other cryptocurrencies as money. Cryptocurrencies are also not considered e-money under the EU E-Money Directive.[96] It appears that the centralised system cannot be identified as an issuer and any amount held in, for example, Bitcoin does not represent a claim against an issuer. Accordingly, in the Netherlands cryptocurrencies are not subject to robust regulatory supervision.

As cryptocurrencies do not qualify as e-money, related services do not, for example, fall under the scope of the EU Payments Directive.[97] Despite the use of the words "currency" and "coin", holders of cryptocurrencies do not, generally, intend to purchase goods and / or services using the cryptocurrency and cryptocurrencies are not a widely accepted means of payment. Given the high volatility of cryptocurrencies, this is unlikely to change. For most purchasers of cryptocurrencies the purpose is (high-risk) investment. Cryptocurrencies are held with the intention to sell at a higher price. In this respect the Dutch supervisory authorities do not consider cryptocurrencies to be a "financial instrument", a (tangible) "investment object" or other "financial product" as defined in the Dutch Financial Supervision Act (DFSA). Intermediaries in cryptocurrencies do not therefore require an intermediary license. However, an investment fund (manager) that offers participation rights in, for example, fund holding cryptocurrencies, is subject to financial regulatory supervision. Further, trade in derivatives linked to the value of a cryptocurrency is subject to regulation. Although the DNB and AFM have warned the public in respect of cryptocurrencies and expressed concerns related to financial crime, the prohibition of cryptocurrencies is not currently on the table.

5.5 Denmark

Denmark has not seen a significant demand for the regulation of cryptocurrencies. The Danish National Bank has, however, been quite vocal in its warnings against cryptocurrencies, essentially labelling them as nothing more than highly volatile investment items. The Chairman of the Board of Governors of the Danish National Bank has warned that "its lethal. It's an effective form of gambling." and he has compared the 2017 / 2018 digital gold rush to the 17th century tulip mania, where tulip bulbs went from being collector's items to being speculative items, thereby skyrocketing their market price for the duration of the bubble, after which the price crashed.

95 https://www.fi.se/sv/publicerat/nyheter/2013/eba-varnar-for-virtuella-valutor/.

96 Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

97 Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

5.6 Russia

There has been a dramatic shift in the rhetoric used by Russian officials in relation to cryptocurrencies and blockchain assets in recent years. In a little under a year, officials have gone from proposing that cryptocurrencies be banned and users imprisoned, to suggesting legalisation as a potential solution. In January 2014, the Central Bank of the Russian Federation issued its first statement about cryptocurrencies. They referred to them as speculative, high-risk and not backed by state entities. Then, a few years later, in September 2016, the Russian Central Bank issued a statement warning the public about investing in cryptocurrencies. It mentioned that it would be monitoring cryptocurrencies and developing, together with the state, a legal framework to regulate cryptocurrencies. In October 2017, Russian President Vladimir Putin ordered the government to create legislation for cryptocurrencies, including determining their status and creating a legal framework for crypto mining and ICOs.

At the end of March 2018, the first versions of the draft laws "On Digital Financial Assets", "On Attracting Investment Using Investment Platforms" and "On the Introduction of Amendments to Parts One, Two and Four of the Civil Code of the Russian Federation", were presented by Russia's Ministry of Finance (MinFin) and the government of the Russian Federation. The initial objectives of the documents are to minimise the existing risks of using digital objects for transferring assets into an unregulated digital environment for the legalisation of criminal income, bankruptcy fraud or for sponsoring terrorist groups. Russia has been trying to pass cryptocurrency legislation since the beginning of January 2018, with no success so far.

5.7 United States

The Securities and Exchange Commission (SEC) has engaged in enforcement activities, predominantly focusing on cryptocurrency as a security. Notably, the SEC produced its Decentralised Autonomous Organisation (DAO) Report in June 2017,[98] concluding that under the *Howey* Supreme Court test, virtual currencies could be considered security contracts for the purposes of SEC regulation. Since the release of that report, the SEC has vigorously pursued cryptocurrency companies under US securities laws. On 16 November 2018, three divisions of the SEC issued a joint statement on Digital Asset Securities Issuance and Trading. In addition, the SEC has promised new guidance regarding cryptocurrencies in early 2019.[99]

Similarly, the Commodities Futures Trading Commission (CFTC) regulates virtual currencies as commodities. The CFTC has argued that cryptocurrencies, like Bitcoin, are commodities and have succeeded in making these arguments to US courts. On 21 May 2018, the CFTC issued an Advisory with respect to Virtual Currency Derivative Product Listing,[100] offering insight into the CFTC's "enhanced market surveillance" and "risk management" efforts.

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98 Release No 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, July 25, 2017; https://www.sec.gov/litigation/investreport/34-81207.pdf.

99 https://news.bloomberglaw.com/securities-law/sec-plans-plain-english-crypto-securities-guide.

100 https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/-2018-05/18-14_0.pdf.

The US Department of Justice has followed suit, supporting both the SEC's and the CFTC's interpretation of cryptocurrencies as investment contracts and as commodities. The Department of Justice's involvement has ranged from actively levying criminal charges concurrent with the SEC, to engaging in joint investigations with the CFTC related to commodity market manipulation.[101]

The Inland Revenue Service (IRS) expects individuals to pay taxes on cryptocurrency, whether mined, traded, or otherwise accumulated. According to its 25 March 2014 guidance, "[t]axpayers may be subject to penalties for failure to comply with tax laws, [including] underpayments attributable to virtual currency transactions …[or] failure to timely or correctly report virtual currency transactions when required to do so."

The Financial Crime Enforcement Network also seeks to regulate cryptocurrency transactions under the Bank Secrecy Act, including application of Anti-Money Laundering and Combatting Financing of Terrorism rules.[102]

5.8 Other jurisdictions

As mentioned previously, certain jurisdictions have banned cryptocurrencies altogether: Bangladesh, Bolivia, China (use by financial institutions / companies), Ecuador and Morocco. In particular, China had been an active cryptocurrency market until the decision to ban exchanges, financial institutions and payment processors from handling them came into force. Individuals, however, appear to still deal in cryptocurrencies in China.

The decision to ban rather than regulate does not appear to take into consideration the benefits and opportunities to be gained from the development of the technologies. However, a decision to regulate may curtail illicit activities, protect the financial system and take advantage of the technological developments.

6. Conclusion

In 2017 there was a period of growth and increased investment in cryptocurrencies where, at its peak, Bitcoin was valued at USD 20,000. Since 2018, there has been a sharp decline in the value of cryptocurrencies: in December 2018 the value of Bitcoin slumped to USD 3,000. However, it is unlikely that the cryptocurrency bubble has imploded as the value has been steadily rising since then and it appears that the crypto winter may be over.

Over the last few years we have seen a rise in the number of insolvency proceedings that comprise some form of cryptoasset. Notably, the formal proceedings in MtGox demonstrates the issues that the insolvency professional is required to contend with where the estate comprises cryptoassets. The MtGox proceeding has been a long and arduous experience for all stakeholders

[101] See, eg https://www.dlapiper.com/en/us/insights/publications/2018/09/edny-us-securities-laws-can-be-used-to-prosecute-ico-fraud/; https://www.sec.gov/news/press-release/2018-218; https://www.coindesk.com/us-department-of-justice-cftc-probe-crypto-market-manipulation-report; https://www.bloomberg.com/news/articles/2018-05-24/Bitcoin-manipulation-is-said-to-be-focus-of-u-s-criminal-probe.

[102] FinCEN Letter to Senator Ron Wyden (February 13, 2018); https://coincenter.org/files/2018-03/fincen-ico-letter-march-2018-coin-center.pdf.

involved and required guidance from the Japanese Courts to validate the decisions taken by the trustee. It is also relevant that the proceedings have twice changed; from a civil rehabilitation proceeding to a bankruptcy proceeding, finally returning to a civil rehabilitation proceeding as the value of Bitcoin increased.

As discussed in this paper, the current regulatory and legislative frameworks around the world have not yet fully evolved to tackle the issues associated with cryptoassets. This paper seeks to consider the rudimentary questions that arise when a new asset class is created. It is clear from our analysis that the legislative frameworks around the world fail to realise the complexities of cryptocurrencies and the need for a sophisticated legislative regime. As with all things, the uncertainty of an unstructured regulatory regime is likely to cause great hindrance to the growth of the cryptocurrency market. It would appear that regulators and legislators will continue to play a crucial role in determining the future of cryptocurrencies.

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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
CRED INC., *et al.*,[1]	Case No. 20-12836 (JTD)
Debtors.	(Jointly Administered)

REPORT OF ROBERT J. STARK, EXAMINER

BROWN RUDNICK LLP
Andrew M. Carty
Michael W. Reining
Tiffany B. Lietz
Seven Times Square
New York, NY 10036
212-209-4800
acarty@brownrudnick.com
mreining@brownrudnick.com
tlietz@brownrudnick.com

Stephen R. Cook
2211 Michelson Drive, 7th Floor
Irvine, CA 92612
949-752-7100
scook@brownrudnick.com

E. Patrick Gilman
601 Thirteenth Street NW, Suite 600
Washington, DC 20005
202-536-1730
pgilman@brownrudnick.com

ASHBY & GEDDES, P.A.
Gregory A. Taylor (DE Bar No. 4008)
Katharina Earle (DE Bar No. 6348)
500 Delaware Avenue, 8th Floor
P.O. Box 1150
Wilmington, DE 19899
302-654-1888
gtaylor@ashbygeddes.com
kearle@ashbygeddes.com

ANKURA CONSULTING GROUP, LLC
Vikram Kapoor
485 Lexington Avenue, 10th Floor
New York, NY 10017
212-818-1555
vikram.kapoor@ankura.com

Dated: March 8, 2021

[1] The Debtors in these chapter 11 cases, along with the last four digits of each debtor's tax identification number are as follows: Cred Inc. (8268), Cred (US) LLC (5799), Cred Capital, Inc. (4064), Cred Merchant Solutions LLC (3150), and Cred (Puerto Rico) LLC (3566). The Debtors' mailing address is 3 East Third Avenue, Suite 200, San Mateo, California 94401.

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I. EXECUTIVE SUMMARY

A. Scope of the Investigation, In Brief.

On December 23, 2020, the United States Bankruptcy Court for the District of Delaware (the "**Court**") Ordered the appointment of an examiner in the Chapter 11 cases of Cred Inc., *et al.* ("**Cred**" or the "**Debtors**"). On January 7, 2021, the Office of the United States Trustee filed its notice of appointment of Robert J. Stark, as Examiner, and its motion seeking approval of such appointment. On January 8, 2021, the Court entered its Order approving such appointment (the "**Examination Order**"). In the Examination Order, the Court directed the Examiner to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the Debtors of or by current or former management of the Debtors, and otherwise perform the duties of an examiner, as set forth in Bankruptcy Code Sections 1106(a)(3) and 1106(a)(4) (the "**Investigation**").

In organizing his Investigation, the Examiner was mindful that these bankruptcy cases have involved "dueling narratives." 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 Examiner viewed his charge as collecting and analyzing the available evidence, providing an objective view of the facts underlying these cases, and enabling the Court and all stakeholders to better understand why Cred failed and who might be responsible for such failure.

To conduct his Investigation, the Examiner obtained documents from the Debtors, the Official Committee of Unsecured Creditors (the "**Committee**"), and certain customers of the

Debtors.[2] In total, approximately 13,000 documents were delivered and reviewed. The Examiner's professionals interviewed 23 individuals, including Daniel Schatt (founder, co-owner, director, former CEO), Lu Hua (founder, co-owner, director, former CEO), James Alexander (former Chief Capital Officer), Matthew Foster (Chief Restructuring Officer), Scott Wiley (interim Chief Financial Officer), Joseph Podulka (former Chief Financial Officer), Daniel Wheeler (former General Counsel), and Daniyal Inamullah (former Vice President of Capital Markets). Those interviews were conducted over a span of one month, and each lasted for several hours. None of those interviews were conducted under oath, but the Examiner's professionals conducted the interviews in deposition style. In general, the Examiner found the Debtors, Committee members, executives, and other interviewees responsive to the Examiner's information requests, willing to provide/volunteer information and, during the interviews, answer questions largely without interruption by counsel. In sum, even though the Investigation was conducted in a very short time frame (i.e., approximately 8 weeks), the Examiner believes that he was able to conduct a sufficient Investigation[3] to acquit his charge under the Examination Order.[4]

[2] The Examiner wishes to particularly thank the Debtors' and the Committee's professionals for their assistance in connection with the Investigation. The Examiner believes that the various case professionals were attentive to the Examiner's information needs, forthcoming and candid, and that their insights were critically important to the Investigation.

[3] It is important to note that this Investigation was conducted under very tight time constraints, under very pressured circumstances and, given those obstacles, was necessarily reliant on voluntary cooperation of the parties. No assurances can be given that all relevant documents were produced or that no other relevant information/evidence would be revealed in formal discovery bearing on the matters discussed herein.

[4] An earlier draft Report was shared with the Debtors and the Committee, and their feedback was solicited. The Examiner did not make any substantive revisions or modifications to the Report based on commentary from the Debtors or Committee after their review.

B. What Was Cred and What Was It Supposed to Do?

Cred was a cryptocurrency financial services platform that offered holders of cryptocurrencies the option of investing those assets with Cred (through the "CredEarn" program) or borrowing against those cryptocurrencies (through the "CredBorrow" program). Those participating in CredEarn agreed to invest their cryptocurrency with Cred for a finite period of time, during which Cred guaranteed those customers a predetermined rate of return. CredBorrow, on the other hand, allowed customers to deposit their cryptocurrency with Cred and obtain a loan against those assets, usually in an amount not to exceed 50% of the cryptocurrency value at the time of the deposit, for a fixed period and with a fixed interest rate.

Although the loan agreements reviewed by the Examiner (particularly under the CredEarn program) contained terms and conditions as to repayment and yield, they did not dictate precisely how cryptocurrency proceeds would be used or invested by Cred, or include any conditions/constraints with respect to such investments. Based on interviews with certain Cred customers, it appears some believed, based on statements from Cred's website and blog posts (among other things), that Cred's investments were collateralized. For the most part, this was not the case, and certain Cred employees expressed concern that such statements were potentially misleading.

C. Why Did Cred Fail?

The specific causative event was a "flash crash" in cryptocurrency trading value in March 2020, followed by a run-up in April and May 2020 resulting in a liquidity crisis. The Examiner believes, however, that the firm's failure is more aptly attributed to dereliction in corporate responsibility. Swings in cryptocurrency trading value were, after all, a foreseen aspect of the firm's business model. But, Cred's corporate managers did not run the business to effectively

counterbalance such risk, as was promised to customers. This dereliction was grave. Noticeable failures include, among other things: (i) un-systemic, chaotic and, in some instances, non-existent diligence, accounting, and compliance functions; (ii) allowance for currency migration to non-Cred entities operating in mainland China (moKredit), without legal or practical capacity to repatriate capital as and when requested/needed by Cred; and (iii) allocation of important managerial and operating functions to an individual with an extremely worrisome past. Cred, it seems, excelled at its marketing objectives; but, its failures in the most basic of business functions portended its eventual demise.

1. Cred's Corporate Governance and Business Management.

Cred's Board consisted of only two directors (Messrs. Schatt and Hua), one of whom (Hua) was recused on all "big" operations issues, purportedly on advice of his counsel. The Board and senior management seemingly did not adopt clear and effective policies and procedures for virtually any day-to-day functions. There is little evidence that the Board (i.e., Mr. Schatt) ran the business to ensure operative systems/practices, consistent with customer expectations, and to effectively ward off risks inherent in the business.

2. Cred's Business Functions.

For much of its existence, Cred maintained only an informal and "ad hoc" diligence process with respect to material aspects of its business, from the hiring of key officers and employees to the deployment of its assets. Cred did not have formal diligence or oversight policies respecting investment decisions, including the selection of asset managers with whom to invest Cred's assets and customer deposits. Nor did it develop and maintain a standardized, formal process for decision-making pertaining to Cred's investment proposals, investment allocations, risk management strategies, or liquidity. Although certain employees indicated that

they employed informal diligence processes relating to investment decisions, no such processes were formally adopted by the company or implemented consistently.

Cred operated in a similarly undisciplined manner respecting asset management, storage, and transfers. Cred did not maintain records identifying or tracking assets between the CredEarn, CredBorrow, or other programs, and had no discernable method for identifying or tracking specific assets or transfers. Rather, customer assets were comingled and maintained together without a standardized method for distinguishing which assets were deposited by whom and from which program they were derived. Additionally, Cred did not develop and maintain a standardized, comprehensive protocol for tracking customer deposits and for initiating and authorizing transfers. Cred's method for initiating, authorizing, and executing transfers often came through informal channels of communication and all steps were often performed by a single individual without a defined, discernible method of approval or oversight. Moreover, Cred did not maintain reliable records for its trading accounts and did not adopt a regular practice of issuing transaction statements.

These deficiencies extended to the accounting and compliance functions. Cred did not have a centralized, integrated accounting function. Certain accounting information was maintained in offline Excel spreadsheets, but they were not regularly updated. By the time Cred filed for bankruptcy, it had not performed a comprehensive financial reconciliation of accounts in almost a year.

Cred did not implement a formal reporting or compliance policy concerning its investments (either internally, with respect to employees tasked with overseeing investments, or externally, with respect to asset managers overseeing Cred's investments). Again, certain Cred employees indicated that they had developed informal procedures for obtaining investment

information and updates from asset managers, but the Examiner is unaware of any formal Cred policy governing this process.

Given the foregoing, the Examiner endeavored to reconcile Cred's books and records to more accurately appreciate its financial posture and to determine whether funds were properly accounted for or, potentially, improperly diverted from the company. However, given the disorganized and incomplete state of Cred's books and records, as well as the time constraints on the Investigation, the Examiner was not able to complete such reconciliation.

3. The moKredit Relationship.

Throughout its history, Cred was tightly bound to the fortunes of moKredit – a Chinese microlender owned by Lu Hua, Cred's co-founder and 50% equity owner. Cred's business primarily involved converting customer cryptocurrencies into fiat currency for moKredit to lend to its borrowers. Converting cryptocurrencies into fiat currency exposed Cred to fluctuations in cryptocurrency trading prices, a risk that required constant hedging. Even though Cred placed a significant portion of its asset-base with moKredit, it had little visibility as to moKredit's ability to return capital when/if needed to, among other things, maintain an effective hedging position. Cred had, in fact, almost no information respecting moKredit's loan portfolio at any given point in time. When the "flash crash" caused a liquidity crisis for Cred, Cred had to repatriate substantial capital from moKredit, but moKredit was not positioned to return any capital. Cred's hedge positions fell away, rendering it "naked" to future swings in cryptocurrency trading prices. Its fate was thereby sealed.

4. Mr. James Alexander.

Considerable corporate authority was vested in James Alexander, Cred's Chief Capital Officer ("**CCO**"). Neither Cred's CEO, Dan Schatt, nor the Cred Board, nor any other employee

at Cred appears to have conducted any meaningful diligence (e.g., background search, credit check) with respect to Mr. Alexander either prior to his hiring or during his period of employment. It has come to the Examiner's attention that Mr. Alexander was convicted on December 3, 2007 in the United Kingdom for crimes related to illegal money transfers, for which he was sentenced to three years and four months in prison to be served at HMP Ford Prison in West Sussex, England. At the time of his incarceration, there was a prison break at this facility. Mr. Alexander has been identified by the UK government as a fugitive.[5]

Mr. Alexander is an important figure in the story of Cred's demise. Again, the Examiner attributes responsibility for the firm's demise largely to failures in corporate leadership, primarily Messrs. Schatt and Hua. But, Alexander's participation/involvement in poor decision-making is a recurring theme, especially when evaluating particularized errors in business oversight (e.g., undisciplined diligence and asset-allocation functions) and points of loss (e.g., QuantCoin and repayment of the Luxembourg Bonds, both discussed below). At the end of his tenure with the company, and at various times thereafter, Mr. Alexander engaged in behavior that may be charitably described as aberrant. His actions, described herein, only add to the aura of suspicion.

5. Summary of the Events Giving Rise to Cred's Bankruptcy.

Set forth below is a brief synopsis of the circumstances leading to Cred's bankruptcy filings:

[5] MN Form UCF-17-2, Order Granting Name Change, Aug. 18, 1994, (Exhibit 167); *see also* Letter from Andrew Selous MP, Parliamentary Under-Secretary of State for Justice, to Philip Davies MP, House of Commons (Nov. 7, 2014) (Exhibit 168); Rachel Millard, *Exposed: Inmates on the run from Ford Prison*, The Argus (Apr. 7, 2015), https://www.theargus.co.uk/news/12873674.exposed-inmates-on-the-run-from-ford-prison/. All "Exhibit" references in this Report refer to exhibits set forth in the *Compendium of Exhibits to Report of Robert J. Stark, Examiner*, a copy of which is being provided to the Court, the U.S. Trustee, the Debtors, and the Committee.

- Under Cred's initial business model, customers would deposit their cryptocurrency assets with Cred (through the CredEarn program) for a fixed term and return. Cred would convert these assets into other forms of currency (e.g., "USDT," which is a cryptocurrency backed by the U.S. dollar) and use the proceeds to make short-term loans to moKredit. moKredit would convert the assets to Yuan and make short-term, high-interest microloans, typically to Chinese consumers.

- Based on the evidence obtained by the Examiner, Cred's loans to moKredit were unsecured and not backed by any collateral. Cred appears to have performed minimal diligence before entering into the moKredit arrangement, and it does not appear that Cred had considered or developed an effective mechanism to ensure repayment of the loans.

- In an effort to manage the risk and volatility present in the cryptocurrency market, and Cred's exposure to such risk when it converted its cryptocurrency assets to more stable currency, Cred entered into a series of hedge positions (e.g., options, swaps, futures) that were, in theory, structured so as to insulate Cred from fluctuations in cryptocurrency prices. The hedges established under this program did not, however, protect Cred from a significant downturn in the market, and instead exposed Cred to exacerbated losses in such a downturn scenario.

- On March 12, 2020, the price of Bitcoin (Cred's most significant cryptocurrency asset) experienced a quick and precipitous decline (a "flash crash"), after which Cred encountered margin calls in connection with certain of its hedge positions. Cred was unable to satisfy the margin calls and, so, the hedges were terminated. Following the "flash crash," Cred had a cumulative net short position with respect to its hedges of approximately $27 million.

- With approximately 50% of its assets invested with moKredit, Cred did not have in its possession the assets (i.e., $9 million in Bitcoin) necessary to reconstitute its hedges. Failure to reconstitute the hedges left Cred exposed ("naked") to market fluctuations, and, if Bitcoin prices increased, would result in Cred's liabilities (i.e., the market price of the Bitcoin it owed its customers) increasing. In the ensuing weeks and months, the price of Bitcoin steadily rose and, because Cred did not reestablish its hedges (due to a lack of liquidity), so too did Cred's liabilities.

- On or about March 12, 2020, Cred attempted to recall $10 million of the approximately $38 million principal loan amount it had extended to moKredit in order to reconstitute its hedges. Notwithstanding the terms of moKredit's loan agreement, moKredit did not meet that recall request. Despite representations that it would be able to satisfy at least part of the redemption within 10 days, moKredit did not. moKredit's failure to satisfy the request may be attributed, at least in part, to the economic fallout from the COVID-19 pandemic. At this time,

moKredit's loan default rates rose to above 60%, making it difficult (if not impossible) for moKredit to collect on outstanding loans.

- moKredit's situation significantly and adversely impacted Cred's liquidity profile. But, it was not the only cause of Cred's deteriorating liquidity position. Beginning in February 2020, Cred transferred a total of 800 Bitcoin to an entity named QuantCoin, which Cred believed to be an asset management firm. Cred's relationship with QuantCoin seemingly began on the recommendation of James Alexander,[6] as did the execution of an initial 500 Bitcoin transfer. As discussed further herein, Cred ended up losing its entire 800 Bitcoin investment with QuantCoin, valued at approximately $9 million (August 2020). Based on the evidence reviewed by the Examiner, it appears that Cred did minimal diligence on QuantCoin before making its investment.[7]

- As the Chief Capital Officer of Cred, and head of Cred Capital, James Alexander was responsible for raising and deploying capital for Cred. Information delivered to the Examiner indicates that Alexander had "free reign" to choose asset managers and raise and deploy assets in his discretion, with little or no oversight from the Board, Schatt, or other management personnel. When Schatt discovered that Alexander and Dan Wheeler (Cred's former General Counsel) established Cred Capital in a manner contrary to his instructions, Alexander promptly transferred to his personal accounts $200,000 USD and 225 Bitcoin of Cred's assets (Cred Capital) with the assistance, wittingly or not, of Daniyal Inamullah.

- In January 2020, Cred sold $14 million of its moKredit loans through an independent entity in Luxembourg, Income Opportunities (the "**Luxembourg Bonds**"), to two investors. Alexander served as a director of Income Opportunities and was responsible for developing and proposing the investment. The Luxembourg Bonds matured on June 30, 2020, at which time it appears, based on the Examiner's review of relevant documents, only moKredit bore responsibility to Income Opportunities. By June 2020, it was evident that moKredit could not repay the loan balance. Cred purchased the Luxembourg Bonds (i.e., $14 million in exposure to moKredit) from the two investors, notwithstanding its own acute liquidity problems.[8]

[6] According to Alexander, he was introduced to QuantCoin through Schatt. The Examiner was not furnished with any information corroborating this statement.

[7] The Examiner was unable to fully investigate the QuantCoin transaction, given time and information constraints. The Examiner was unable to discern, for example, if anyone at the company (e.g., Alexander) received any payments from those involved with QuantCoin.

[8] The Examiner was unable to fully investigate the Luxembourg Bonds transaction, given time and information constraints. The Examiner was unable to discern, for example, if Alexander separately received any payments in connection with his involvement with Income Opportunities and the Luxembourg Bonds.

In the Examiner's opinion, the cumulative effect of these events, coupled with (and in some cases, a result of) Schatt's and the Board's failure to adequately oversee and manage the day-to-day operations of the company, led to Cred's decline and ultimate Chapter 11 filings.

D. Additional Topics Included within the Investigation and this Report.

The Investigation also included a review of Lu Hua's transfer of 300 Bitcoin to Cred in March 2020, which was prompted after Hua informed Cred that moKredit would not be able to repay $10 million of its principal loan balance as requested by Cred in March 2020. Hua and Schatt characterize the 300 Bitcoin transfer as a loan. Relevant documents indicate, however, that Hua made the transfer as an equity contribution in exchange for 5,000,000 shares of Class B common stock in Cred Capital.

Finally, the Examiner analyzed certain issues implicated by Cred's Chapter 11 plan of liquidation,[9] specifically, the estate release provisions contained therein.[10] Based on his review of the definition of "Released Parties" under the Chapter 11 Plan, and discussions with professionals for the Debtors and Committee, the Examiner understands that the estate releases under the Chapter 11 Plan encompass only those professionals retained by the Debtors and the Committee in the Chapter 11 Cases (and certain related parties).[11] During the course of his

[9] *See First Amended Combined Joint Plan of Liquidation and Disclosure Statement of Cred Inc. and Its Subsidiaries under Chapter 11 of the Bankruptcy Code*, Jan. 21, 2021, ECF No. 380 (as amended, modified, or supplemented, the "**Chapter 11 Plan**") (Exhibit 169).

[10] *See id.* § 18.2.

[11] Under the Chapter 11 Plan, the term "Released Parties" is defined as "Professionals retained by the Debtors, Grant Lyon as the Debtors' independent director, Matthew Foster as the Debtors' chief restructuring officer, any other staff supplied by Sonoran Capital Advisors, LLC, the Professionals retained by the Committee, and the respective agents and representatives of each of the foregoing." *See id.* § 1.113. The term 'Professional" is, in turn, defined as "any professional Person employed in the Chapter 11 Cases pursuant to section 327, 328, 363 or 1103 of the Bankruptcy Code pursuant to an Order of the Bankruptcy Court and to be compensated for services rendered pursuant to sections 327, 328, 329, 330, 331 or 363 of the Bankruptcy Code." *See id.* § 1.106.

Investigation, the Examiner did not become aware of any facts that, in his opinion, would give rise to any viable estate claims or causes of action against any of the Released Parties.

In this respect, the Examiner notes that, following discussions with the U.S. Trustee's Office, the Committee, and the Debtors, the Examiner reviewed work performed by Cred's outside counsel, Paul Hastings LLP ("**Paul Hastings**"), prior to the Petition Date. The Examiner received a list of matters on which Paul Hastings performed work for Cred (including a privilege log of purportedly privileged materials and information) and conducted an interview of a representative of Paul Hastings regarding such matters (and related issues, as deemed appropriate by the Examiner). As with the other Released Parties, the Examiner did not become aware of any facts that would, in his opinion, give rise to any viable estate claims or causes of action against Paul Hastings.

II. KEY ENTITIES AND INDIVIDUALS

A. Debtor Entities.[12]

- **Cred, Inc.:** The parent company of the below subsidiaries. Cred, Inc. handled business with international customers.
- **Cred (US) LLC:** A wholly-owned subsidiary of Cred, Inc. Cred (US) LLC handled borrowing and lending for domestic customers.
- **Cred Capital, Inc.:** A wholly-owned subsidiary of Cred, Inc. Formed in March 2020, its stated purpose was to sell securities products.
- **Cred Merchant Solutions LLC:** A wholly-owned subsidiary of Cred Inc. Formed in October 2019, its stated purpose was to facilitate the purchase of cryptocurrency assets at the physical point of sale. Cred Merchant Solutions had no business and no assets as of the Petition Date.

[12] Unless otherwise specified, the Debtors are collectively referred to herein as "Cred" or the "Debtors".

- **Cred (Puerto Rico) LLC:** A wholly-owned subsidiary of Cred. Inc. Formed in March 2020, its stated purpose was to facilitate transactions for customers in Puerto Rico.[13]

All Debtor entities are organized under Delaware law and have their principal place of business in California, except Cred (Puerto Rico) LLC, which was formed under the laws of Puerto Rico.[14] Cred (US) LLC holds a California Finance Lender license.[15]

B. Involved Entities.

- **100 Acre Ventures ("100AV"):** Formed in Delaware and registered as a foreign LLC in California. A technical investment firm focused on institutional investment and risk management in digital assets.[16] Cred invested with 100AV beginning in April 2020, based on James Alexander's recommendation.[17]

- **Blockfills.com ("Blockfills"):** A DBA of Reliz Limited and registered in the Cayman Islands, is a digital asset liquidity provider. It provides an off-exchange platform for customers to exchange cryptocurrency and fiat currency.[18] Cred Capital initiated a relationship with Blockfills on the recommendation of Daniyal Inamullah, Cred's Vice President of Capital Markets, who oversaw due diligence on Blockfills.[19]

- **CryptoLab Capital LLC ("Cryptolab Capital")**: Based in California, a now-defunct hedge fund that used a data-heavy approach to invest cryptocurrency assets.[20] Cred invested in Cryptolab Capital (also referred to as the "Martingale investment"). Cryptolab lost 100% of its assets

[13] *Decl. of Daniel Schatt in Supp. of Debtors' Chapter 11 Pet. and First Day Mot.* ¶ 12. (ECF No. 12) ("**Schatt Decl.**") (Exhibit 1).

[14] *Id.* ¶ 13.

[15] Base Prospectus, Jan. 30, 2020 at 2 (Exhibit 2); License Search, California Dept. of Fin. Protection and Innovation, https://docqnet.dfpi.ca.gov/LicenseSearch/LicenseDetails/ (last visited Mar. 7, 2021) (search for License No. 60DbO-91480).

[16] 100 Acre Ventures Form ADV, May 15, 2020 (Exhibit 20); 100 Acres Ventures Mission Page, https://www.100acreventures.com/mission (last visited Mar. 4, 2021).

[17] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[18] Blockfills FAQ Page, https://www.blockfills.com/faq/ (last visited Mar. 4, 2021).

[19] Videotaped Dep. of Daniyal Inamullah, Dec. 8, 2020 ("**Inamullah Dep.**") 46:16–47:7 (Exhibit 9).

[20] Laurence Fletcher, *Crypto hedge funds struggle to recover from 'bloodbath'*, Fin. Times, May 20, 2020 (Exhibit 19).

when Bitcoin prices fell in March 2020, resulting in a 14% loss for Cred on its position.[21]

- **Cyber Quantum Pte. Ltd. ("Cyber Quantum"):** Founded by Daniel Schatt, Cyber Quantum is a Singapore entity registered by Hua in January 2018 used to raise funding for Cred through an Initial Coin Offering.[22]

- **JST Capital ("JST"):** Also known as JST Systems, a limited liability company organized under New Jersey law.[23] JST provides financial services to individuals in the digital asset market in two primary areas: trading and asset management, and risk and balance sheet management.[24] In late 2018, Cred hired JST as a consultant to assist Cred with a hedging platform.[25] JST created hedging positions against various cryptocurrencies for Cred, including Bitcoin (BTC), Ripple (XRP), Ethereum (ETH), Bitcoin Cash (BCH), Litecoin (LTC), XLMedia (XLM), OMG Network (OMG) and Cardano (ADA). Cred also used JST as its "paying agent" in connection with interest payments received from moKredit.[26] Under this arrangement, JST received interest payments from moKredit in cryptocurrency and transferred those payments to Cred in the form of USD.[27] In connection with this service, JST invoiced Cred for monthly "profit share" fees.[28]

- **Kingdom Trust:** Kingdom Trust is an escrow agent for and custodian of both fiat and alternative assets, including cryptocurrencies.[29] Cred did not

[21] Inamullah Dep. 104:9–16, 210:11–211:1 (Exhibit 9).

[22] Cyber Quantum Pte. Ltd. Unaudited Financial Statements, 2018 (Exhibit 7); Cyber Quantum Pte. Ltd. Directors' Resolutions, 2018 (Exhibit 8).

[23] Business Name Search, NJ Division of Revenue and Enterprise Services, https://www.njportal.com/DOR/BusinessNameSearch/Search/BusinessName (last visited Mar. 4, 2021) (search for JST Capital).

[24] Services, JST Capital, https://jstcap.com/#services (last visited Mar. 4, 2021).

[25] Inamullah Dep. 105:8–14; 110:4–17 (Exhibit 9) ("[W]e're essentially taking cryptocurrency liabilities in the form of CredEarn participations and translating that into a dollar asset, which is – in moKred. Now, if crypto starts to rise, we will not be able to return the same number of cryptocurrency units back to the customer if we do not hedge the upside exposure."); Emails exchanged between H. Ng, K. Wong, D. Schatt and InnReg representative regarding JST onboarding process, Dec. 7–20, 2018 (Exhibit 10).

[26] Email from J. Alexander to K. Wong, Jan. 22, 2019 (Exhibit 11).

[27] Email from D. Granet to L. Hua, copying in Messrs. J. Alexander, K. Wong, S. Zhang and S. Freeman, Jan. 14, 2019 (Exhibit 12).

[28] Exhibit 11; JST Systems Invoice, Jan. 22, 2019 (Exhibit 13).

[29] Qualified Custodian Executive Summary, Kingdom Trust, https://www.kingdomtrust.com/qualified-custodian/executive-summary (last visited Mar. 4, 2021).

transact with Kingdom Trust, but transferred 800 Bitcoin to a person or entity purporting to be a Kingdom Trust employee between February and April 2020.[30]

- **moKredit Inc. ("moKredit"):** Founded by Cred co-founder Lu Hua in 2012, moKredit Inc.[31] is a Chinese consumer lending platform that provides microcredit loans to Chinese borrowers.[32] moKredit is incorporated in the Cayman Islands and based in Shanghai, China.[33] Beginning in 2018, Cred lent funds obtained through its customers' investments – generally retail customers – to moKredit. Cred received 20% interest return on those loans.[34] Cred passed between 6-10% of that interest on to its customers, depending on the cryptocurrency invested (i.e., Bitcoin, Ethereum, XRP) and the amount of time those customers "locked up" their funds.[35] Cred allocated to itself the remaining 10% of the moKredit interest proceeds as revenue.[36]

- **Sarson Funds Inc. ("Sarson Funds"):** A cryptocurrency "marketing company" that advertises investment products ("sub-funds," organized as separate entities).[37] Cred invested in two Sarson Funds sub-funds in or around March 2020: (a) Fifth Khagan, a small coin/small token fund;[38] and (b) AX Momentum,[39] a "covered call options fund."[40]

- **UpgradeYa Investments, LLC ("UpgradeYa"):** A cryptocurrency investment firm and a customer of Cred's borrowing program,

[30] Inamullah Dep. 155:4–156:16 (Exhibit 9); Cred Inc. Update for the Creditors Committee, Dec. 14, 2020 at 23 (Exhibit 25).

[31] moKredit Inc. Overview Report at 2.1 Corporate History, Aug. 7, 2019 (Exhibit 3). At times, parties also refer to moKredit as "moKred," "mo9," and previously "GamaxPay, Inc."

[32] Videotaped Dep. of Dan Schatt 26:18–24, Dec. 14, 2020 ("**Schatt Dep.**") (Exhibit 4).

[33] Articles of Association of moKredit, Oct. 25, 2017 (Exhibit 170); Note Purchase Escrow Agreement, Jan. 28, 2020 (Exhibit 171).

[34] Schedule of Advances (Exhibit 46).

[35] Loan and Security Agreement between moKredit Inc., and Cred LLC, Dec. 27, 2018 (Exhibit 5).

[36] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[37] Sarson Funds, https://www.sarsonfunds.com/ (last visited Mar. 4, 2021).

[38] Sarson Funds Fact Card: Fifth Khagan (Exhibit 14).

[39] Sarson Funds Fact Card: AX Momentum (Exhibit 15).

[40] Inamullah Dep. 208:24–209:1 (Exhibit 9).

"CredBorrow."[41] On April 20, 2020, UpgradeYa and Cred entered into a Loan and Security Agreement whereby Cred agreed to provide UpgradeYa with a $2 million revolving line of credit secured by Bitcoin pledged by UpgradeYa equal to an initial maximum loan-to-value ratio of 50%.[42] UpgradeYa also participated in the CredEarn plan to earn interest on its cryptocurrency.[43]

- **Uphold:** A cloud-based asset platform that enables users to store, buy, and convert classes of assets.[44] At Cred's founding, Schatt served on Uphold's board of directors and later added Uphold as a partner for Cred in early 2019.[45] For Cred, Uphold assisted with operations and acted as its customer wallet.[46] Throughout 2019, Uphold was also one of Cred's primary sources for customer leads.[47]

C. Relevant Individuals.

- **Daniel ("Dan") Schatt:** Co-founder and former Chief Executive Officer ("**CEO**") of Cred. Schatt has 20 years of experience in the finance and financial technology sectors. Schatt met Cred's other co-founder, Lu Hua, while both worked at PayPal in 2009. When Schatt and Hua founded Cred (then called Libra Credit), Schatt became the company's president and Hua the CEO. Schatt stepped into the CEO role after Hua resigned in mid-to-late-2018. Schatt resigned as CEO in December 2020. Schatt and Hua each own 50% of Cred's equity.[48]

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[41] *Suppl. Decl. of Marc Parrish in Supp. of the Mot. of UpgradeYa Investments, LLC for Relief from Stay under Bankruptcy Code Section 362* ¶ 2 (ECF No. 128) (Exhibit 172); Nathan DiCamillo, *Here's What Happened at Crypto Lender Cred's Latest Bankruptcy Hearing*, CoinDesk, Dec. 18, 2020 (Exhibit 18).

[42] *Mot. of UpgradeYa Investment, LLC for Relief from Stay Under Bankruptcy Code Section 362* ¶ 8 (ECF No. 89) (Exhibit 17); UpgradeYa Loan and Security Agreement, Apr. 20, 2020 (Exhibit 176); Holdings Update, Oct. 11, 2020 (Exhibit 177).

[43] *Decl. of Marc Parrish in Supp. of the Mot. of UpgradeYa Investments, LLC for Relief from Stay under Bankruptcy Code Section 362* ¶ 5 (ECF No. 91) (Exhibit 173); UpgradeYa Tranche 1 Closing Statement (Exhibit 178); Exhibit 177.

[44] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021); Uphold About Page, https://uphold.com/en/resources/about (last visited Mar. 4, 2021).

[45] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[46] *Id.*

[47] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[48] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

- **Lu Hua:** Founder of moKredit in 2012. In 2018, Hua also founded what is now Cred with Dan Schatt, his former PayPal colleague.[49] Hua owns a 50% equity stake in Cred and sat on its Board from its inception until the eve of its bankruptcy filing. Initially, Hua served as Cred's CEO before yielding the role to Schatt in mid-to-late 2018 as Cred shifted its operations from China to the United States.[50]

- **Joseph ("Joe") Podulka:** Cred's Chief Financial Officer from July 2019 to December 2020.[51] In that role, he oversaw Cred's corporate cash management and expenses incurred by Cred Capital.[52] On June 29, 2020, he became a member of Cred Capital's board of directors.[53] Podulka, also a former PayPal employee, was Head of Finance with PayPal Europe from 2010 to 2011 and Head of Finance at PayPal New Ventures from 2011 to 2014.[54]

- **Daniel ("Dan") Wheeler:** Joined Cred as its General Counsel in August 2019. Wheeler previously served as Cred's primary outside counsel while a partner at Bryan Cave Leighton Paisner LLP ("**Bryan Cave**") from May 2012 to August 2019.[55] In 2020, Wheeler oversaw the organization of Cred Capital,[56] and was appointed Cred Capital's Corporate Secretary and General Counsel on or about March 16, 2020.[57]

- **James Alexander:** Hired as Cred's Chief Capital Officer in August 2018.[58] Alexander's primary roles included soliciting cryptocurrency investments and allocating assets.[59] In March 2020, Cred directed

[49] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[50] *Id.*

[51] *Decl. of Joe Podulka in Supp. of Debtors' Obj. to Mot. of James Alexander to Dismiss the Cred Capital, Inc. Case* (Jan. 29, 2021) ¶ 12 ("**Podulka Decl.**") (Exhibit 21).

[52] *Id.* at ¶ 6.

[53] *Id.* at ¶ 9–11.

[54] Podulka Decl. ¶ 2; LinkedIn Profile of Joe Podulka https://www.linkedin.com/in/Podulka/ (last visited Mar. 4, 2021).

[55] *Decl. of Daniel F. Wheeler RE Mot. of James Alexander to Dismiss the Cred Capital, Inc. Case* ¶ 1 (ECF No. 386) ("**Wheeler Decl.**") (Exhibit 24); Schatt Dep. 43:8-14 (Exhibit 4).

[56] Wheeler Decl. ¶¶ 2–3 (Exhibit 24).

[57] *Id.* ¶ 1.

[58] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[59] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

Alexander to establish and manage Cred Capital as a subsidiary of Cred.[60] Instead, Alexander organized Cred Capital as a separate, independent, entity over which he had almost complete control.[61] On June 24, 2020, two days before Cred terminated him, Alexander directed Daniyal Inamullah to transfer 225 Bitcoin from a Cred Capital account to a blockchain address provided by Alexander.[62]

- **Daniyal Inamullah:** Served as Cred's Vice President of Capital Markets from January 2020 to April 2020.[63] In that role, Inamullah reported to James Alexander and was responsible for seeking investment opportunities, conducting due diligence, and proposing investments to Cred's "investment committee."[64] From April 2020 to July 2020, Inamullah served as Cred Capital's Vice President of Capital Markets, where he was responsible for underwriting and selling debt products and marketing bonds.[65] Amid a corporate shuffle, Cred Capital terminated Inamullah in July 2020 and Cred immediately re-hired him as Vice President of Capital Markets, where he reported to Schatt.[66] Inamullah left Cred in November 2020 and is now the Chief Investment Officer at Sarson Funds, one of Cred's asset managers.[67]

- **Grant Lyon:** The co-founder of Arete Capital Partners and has over 30 years' experience in financial restructuring.[68] On November 3, 2020, Cred appointed Lyon as an Independent Director, and he is now the sole remaining member of Cred's Board. In that capacity, Lyon effectively has sole decision-making authority over all matters requiring Board approval.[69]

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[60] Schatt Decl. ¶ 22 (Exhibit 1); Podulka Decl. ¶ 5 (Exhibit 21); Exhibit C, Decl. of Daniel Schatt in Supp. Of Def.'s Opp. To Pl.'s Mot. for Prelim. Inj., *Alexander v. Schatt*, No. 20-CIV-02728 (Cal. Super. Ct. Aug. 27, 2020) (Exhibit 174).

[61] Schatt Decl. ¶ 22 (Exhibit 1).

[62] Podulka Decl. ¶ 2 (Exhibit 21).

[63] *Decl. of Daniyal Inamullah in Supp. of Mot. of the United States Trustee for Entry of an Order Directing the Appointment of a Trustee, or in the Alternative, (I) Directing the Appointment of an Examiner, or (II) Converting the Cases to Chapter 7 Cases* (ECF No. 133) ¶ 1 ("**Inamullah Decl.**") (Exhibit 6).

[64] *Id.* at ¶ 2.

[65] Inamullah Dep. 30:23–31:3 (Exhibit 9).

[66] *Id.* at 31:24–32:2.

[67] Inamullah Decl. ¶ 1 (Exhibit 6).

[68] *Decl. of Grant Lyon in Supp. of Debtors' Obj. to Mot. of James Alexander to Dismiss the Cred Capital, Inc. Case* ¶ 2 (ECF No. 433) ("**Lyon Decl.**") (Exhibit 26).

[69] *Id.* ¶ 2.

- **Matthew ("Matt") Foster:** A managing director and founding partner of Sonoran Capital Advisors, a turnaround, crisis management, and financial advisory firm.[70] Cred hired Foster as its Chief Restructuring Officer ("**CRO**") in November 2020. Foster reports to Cred's Board and manages Cred's day-to-day operations. He is also responsible for assessing and implementing the restructuring of Cred's businesses, including overseeing Cred's liquidity needs. Foster has 15 years of restructuring experience and Cred is his fifth CRO appointment in the last 36 months.[71]

- **Scott Wiley:** Senior Advisor at Sonoran Capital Advisors, a turnaround, crisis management, and financial advisory firm. Wiley is Cred's interim Chief Financial Officer, overseeing Cred's day-to-day accounting, finance, and cash management functions.[72]

- **Paul Maniscalco / Pablo Bonjour (MACCO):** Paul Maniscalco is a senior managing director and Pablo Bonjour is a managing director at MACCO Restructuring Group, LLC ("**MACCO**").[73] MACCO provides interim executive leadership, financial advisory services, and fiduciary services to businesses in financial and operational distress. Bonjour and Maniscalco are financial advisors to Cred. Bonjour has an investment banking and consulting background, having worked with more than 1,000 U.S. and international clients.[74] Maniscalco has over 20 years' experience in corporate finance, capital markets, and business restructurings.[75]

III. RELEVANT CASE BACKGROUND[76]

A. The Commencement of the Chapter 11 Cases and Appointment of Examiner.

The Debtors filed for Chapter 11 relief on November 9, 2020, citing, among other things: (i) material losses incurred in connection with or as a result of the alleged misconduct of its former Chief Capital Officer, James Alexander; (ii) the purported theft of certain cryptocurrency

[70] Exhibit 25 at 34.

[71] *Id.* at 3.

[72] *Id.* at 35.

[73] *Id.* at 32–33.

[74] *Id.* at 32.

[75] *Id.* at 33.

[76] For this section, references made to affirmative actions taken by the "Examiner," necessarily include those actions taken by Examiner's counsel and experts.

assets in connection with a failed investment with QuantCoin; and (iii) the Debtors' deployment of significant assets with moKredit and the subsequent inability or unwillingness of moKredit to return those assets to Cred pursuant to the terms of the parties' agreement.[77]

Amid allegations of fraud, theft, and mismanagement, the Office of the United States Trustee, on December 4, 2020, filed its *Motion for Entry of an Order Directing the Appointment of a Trustee, or in the Alternative, (I) Directing the Appointment of an Examiner, or (II) Converting the Cases to Chapter 7 Cases*.[78] On December 18, 2020, the Court conducted a hearing with respect to this motion and, on December 23, 2020, the Court entered its *Order Denying in Part, and Granting in Part, the Trustee/Examiner Motions*, pursuant to which the Court granted the U.S. Trustee's request for the appointment of an examiner pursuant to Bankruptcy Code Section 1104(c).[79] The Examination Order provides, in pertinent part, that the Examiner will investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the Debtors of or by current or former management of the Debtors, and otherwise perform the duties of an examiner set forth in Bankruptcy Code Sections 1106(a)(3) and 1106(a)(4).

On January 7, 2021, the U.S. Trustee appointed Robert J. Stark as Examiner and filed a motion seeking Court approval of such appointment,[80] and on January 8, 2020, the Court entered an Order approving Mr. Stark's appointment as Examiner.[81]

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[77] *See* Schatt Decl. ¶¶ 18–40 (Exhibit 1).

[78] *See United States Trustee Mot. For Entry of an Order Directing the Appointment of a Trustee, or in the Alternative, (I) Directing the Appointment of an Examiner, or (II) Converting the Cases to Chapter 7 Cases* (ECF No. 133) ("**UST Motion**") (Exhibit 27).

[79] *See Order Den. in Part, and Granting in Part, the Trustee/Examiner Mot.* (ECF No. 281) ("**Examination Order**") (Exhibit 28).

[80] *See App. of the United States Trustee for Order Approving Appointment of Examiner* (ECF No. 330) (Exhibit 29).

Promptly following his appointment, the Examiner and his counsel met and conferred with the U.S. Trustee, the Debtors, and the Committee regarding the scope, timeline, and budget with respect to the Investigation. Thereafter, on January 20, 2021, the Examiner filed his *Proposed Scope, Work Plan, and Budget for Investigation, Prepared and Submitted by Robert J. Stark, as Examiner*,[82] which the Court approved by order dated January 28, 2021.[83] On February 24, 2021, the Examiner filed a proposed amendment to the work plan and budget.[84]

B. The Examiner's Work Plan for the Investigation.

Pursuant to his work plan, the Examiner identified the following specific topics of the Investigation:

(i) investigating the Debtors' business and operations including allegations of comingling corporate and client accounts and possible insider transactions;

(ii) examining the facts and circumstances surrounding the substantial losses the Debtors' endured as a result of the liquidation of certain hedge positions;

(iii) the Debtors' relationship with moKredit, including investments made by the Debtors, and outstanding debt owed by moKredit;

(iv) the facts and circumstances surrounding Lu Hua's transfer of 300 Bitcoin to the Debtors and the related controversy that ensued;

(v) the facts and circumstances surrounding the transfer of 800 Bitcoin to QuantCoin and the losses associated therewith; and,

(vi) the facts and circumstances involving certain dealings between the Debtors and James Alexander.

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[81] *See Order Approving Appointment of Examiner* (ECF No. 338) (Exhibit 30).

[82] *Notice of Filing of Proposed Scope, Work Plan, and Budget for Investigation, Prepared and Submitted by Robert J. Start, as Examiner* (ECF No. 376) ("**Examiner Work Plan**") (Exhibit 31).

[83] *Order Approving Examiner's Proposed Scope, Work Plan, and Budget for Investigation* (ECF No. 431) (Exhibit 32).

[84] *Notice of Filing of Proposed Amend. to Work Plan, and Budget for Investigation, Prepared and Submitted by Robert J. Stark, as Examiner* (ECF No. 552) (Exhibit 33).

Although completing an investigation and report of this scale in approximately 8 weeks was a large undertaking, the Examiner endeavored to complete and file his report in advance of the plan confirmation hearing, presently scheduled for March 9, 2021.

C. The Methods Employed to Conduct the Investigation.

Because of the complex nature of this Investigation and the specialization it demands, the Examiner engaged (a) Brown Rudnick LLP and Ashby & Geddes, P.A. to serve as his counsel, and (b) Ankura Consulting Group, LLC to assist with the digital asset market analysis. Additionally, and as provided in the Examination Order, the Examiner utilized and leveraged work performed by advisors to the Debtors and Creditors' Committee in conducting the Investigation, including Dundon Advisers, LLC and CipherTrace, Inc.

The Examiner obtained documents from the Debtors, the Committee, and other parties in interest. In total, the Examiner received and analyzed approximately 13,000 documents and over 55 gigabytes of information.

The Examiner conducted 23 witness interviews. Because of health and safety protocols, all witness interviews were conducted over video conference. All interviewees participated willingly. The majority of those interviewed were represented by counsel. The following is a list of the persons interviewed in connection with the Investigation and the dates of the interviews:

Interviewee	Title	Date of Interview
Tim Kuhman	General Counsel, Kingdom Trust	February 3, 2021
Barbara J. Valliere	Assistant United States Attorney, United States Attorney's Office for the Northern District of California	February 4, 2021
Alexandra E. Bryant	Special Agent, Federal Bureau of Investigation	February 4, 2021

Matthew Foster	Chief Restructuring Officer, Cred Inc. Managing Director and Founding Partner, Sonoran Capital Advisors	February 8, 2021
Scott Wiley	Interim Chief Financial Officer, Cred Inc. Senior Advisor, Sonoran Capital Advisors	February 9, 2021
Pablo Bonjour	Financial Advisor to Cred Inc. Managing Director, MAACO Restructuring Group	February 10, 2021
Paul Maniscalco	Financial Advisor to Cred Inc. Senior Managing Director, MAACO Restructuring Group	February 10, 2021
Daniyal Inamullah	Former Vice President of Capital Markets, Cred Inc. Former Vice President of Capital Markets, Cred Capital Inc.	February 10, 2021 February 23, 2021
Grant Lyon	Independent Director, Cred Inc. Co-Founder and Managing Partner, Arete Capital Partners	February 11, 2021
Daniel Wheeler	Former General Counsel, Cred Inc.	February 12, 2021
Joseph Podulka	Former Chief Financial Officer, Cred. Inc	February 16, 2021
Daniel Schatt	Co-Founder, Cred Inc. Former Chief Executive Officer, Cred Inc.	February 17, 2021
Mr. C.M.	Creditor and former customer, Cred Inc.	February 18, 2021
Mr. M.M.	Creditor and former customer, Cred Inc.	February 18, 2021
Lu Hua	Founder moKredit Co-Founder, Cred Inc.	February 18, 2021
Mr. C.dL.	Creditor and former customer, Cred Inc.	February 19, 2021
Tonia Tautolo	Interim Chief Financial Officer, Cred Inc.	February 19, 2021
Mr. D.F.	Creditor and former customer, Cred Inc.	February 24, 2021
Mr. E.S.	Creditor and former customer, Cred Inc.	February 24, 2021
Mr. J.S.	Creditor and former customer, Cred Inc.	February 24, 2021
Mr. G.B.	Creditor and former customer, Cred Inc.	February 24, 2021
James Grogan	Paul Hastings	March 2, 2021

James Alexander	Former Chief Capital Officer, Cred Inc. Former Director, Cred Capital Inc.	March 3, 2021

IV. GENERAL BACKGROUND REGARDING THE DEBTORS

A. Corporate History and Organization.

Daniel Schatt and Lu Hua formed Cred, Inc. and its affiliated Debtors in or around May 2018.[85] At inception, Hua and Schatt each owned 50% of the equity in Cred. Before forming Cred, Schatt and Hua worked together at PayPal, overlapping from 2007 until 2011. Hua left PayPal in or around mid-2011 and subsequently formed moKredit, a microcredit lending company in Singapore and Shanghai. Schatt and Hua stayed in contact following their time at PayPal.[86]

In January 2018, Schatt and Hua established an entity named Cyber Quantum in Singapore. Cyber Quantum's stated purpose was to conduct an Initial Coin Offering ("**ICO**") in or around May 2018. The proceeds of the Cyber Quantum ICO would be used to provide initial funding for a different and newly-formed entity, Cred. Through the ICO, Schatt and Hua raised approximately $5 million.[87]

[85] The responsible parties originally organized Cred as an LLC in Delaware, which also was originally known as Libra Credit and also transacted through Cyber Quantum Pte. Ltd., a Singaporean entity. Schatt Dep. 37:1–10 (Exhibit 4); Cred LLC and Subsidiary Financial Statements, 2018 (Exhibit 34).

[86] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Interview with Daniel Schatt, co-Founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[87] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021). According to Alexander, Cyber Quantum raised $26 million in Ethereum during the ICO. The Examiner has not seen any evidence to substantiate this assertion.

Schatt and Hua initially intended for Cred to operate out of China, with Hua (a resident of China) serving as CEO and Schatt (a resident of California) serving as president.[88] At some point in 2018, Schatt and Hua decided to relocate the business to the U.S. in an apparent effort to increase scale.[89] After relocating Cred to the U.S., Schatt assumed the CEO role and Hua resigned his position as an officer of Cred, although Hua remained a member of Cred's Board until November 2020.[90]

Cred brought in more than $135 million in "borrowed" capital from its CredBorrow and CredEarn programs (discussed further below) between December 2018 and October 2020. It did so by offering guaranteed rates of return against investments (CredEarn) and providing loans to institutional and retail customers backed by their pledged cryptocurrency (CredBorrow).

CredEarn customers were told that regardless of the market trends, they would "receive the upside potential of [their] crypto."[91] Cred advertised that customer cryptocurrency was used to lend and transact with a variety of customers including retail borrowers and money managers (but not short-sellers).[92] CredBorrow customers received credit lines based on a loan-to-value ratio calculated on a monthly basis.[93]

Cred customers executed CredEarn or CredBorrow agreements memorializing the terms of the arrangements. The Examiner was provided with copies of certain (but not all) of the agreements under the CredEarn and CredBorrow programs. In those agreements, Cred did not

[88] Schatt Dep. at 20:22–21:12 (Exhibit 4); Interview with Daniel Schatt, co-Founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[89] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[90] Schatt Dep. 21:2–12; 22:4–6; 37:9–38:2 (Exhibit 4).

[91] CredEarn Page, https://mycred.io/earn/ (last visited Mar. 4, 2021).

[92] *Id.*

[93] Standard CredBorrow Multi-Tranche Credit Agreement at 2–3 (Exhibit 36).

make representations respecting or covenant as to how Cred would invest its customers' cryptocurrency.[94] Further, none of the agreements reviewed by the Examiner spoke to whether customer funds or Cred's investments were to be collateralized.

B. Cred's Primary Products.

(a) CredBorrow.

CredBorrow was Cred's first consumer product. Cred launched the CredBorrow program in December 2018 as a mechanism to offer customers loans in U.S. dollars (USD) using a customer's cryptocurrency as collateral for the loan.[95] Cred marketed the program to customers as "cash on your crypto without cashing out," meaning that a customer could lend its cryptocurrency to Cred and receive payment streams from Cred, without having to sell the cryptocurrency.[96]

Under the CredBorrow program, customers would transfer their cryptocurrency to Cred, which would hold such assets in a Cred account (typically with an entity named BitGo), and receive a loan in USD from Cred. CredBorrow loans would typically bear interest at between 9% and 14% on an annual basis, depending on the length of the loan and the underlying collateral.[97] Cred also typically charged a 3% "origination" fee. The credit line was available to

[94] Exhibit 36; Email from J. Alexander to K. Wong, Feb. 12, 2019 (Exhibit 39) (James Alexander sending samples of Cred's Enhanced Yield Agreement and Multi-Tranche Credit Agreement when asked for sample contracts for CredEarn and CredBorrow customers); Enhanced Yield Agreement for CredEarn Customers (Exhibit 40).

[95] CredEarn CredBorrow Information Sheet (Exhibit 35); Interview with Lu Hua, Chief Executive Officer, moKredit, Inc. (Feb. 18, 2021).

[96] CredBorrow Page, https://mycred.io/borrow/ (last visited Mar. 4, 2021).

[97] Exhibit 35; Standard Cred Multi-Tranche Credit Agreement at 2–3 (Exhibit 36).

CredBorrow customers for three years, with payments due annually. The loan-to-value ratio was calculated on a monthly basis.[98]

After Cred received cryptocurrency assets through the CredBorrow program, it often converted the assets to USD or Stablecoin (USDT) – a cryptocurrency with a market value pegged to a "stable asset," in this case U.S. dollars – and used the proceeds to make loans to moKredit for interest rates typically ranging from 18% to 24%.[99] The loan agreements between Cred and moKredit provided that moKredit had to return principal on the sooner of the maturity date of the loan or upon 30 days' notice at Cred's discretion.[100]

(b) **CredEarn.**

Schatt and Hua recognized that the CredBorrow business model was susceptible to the volatility of underlying cryptocurrency prices, which directly impact the collateral value of the loans.[101] Following a significant drop in Bitcoin prices in 2018, Schatt and Hua began developing another business line that could, in theory, compliment the CredBorrow business and off-set certain of the risk attendant to that business.[102]

In February 2019, Cred launched its CredEarn program. Under CredEarn, customers were offered the opportunity to earn interest on their cryptocurrency assets by depositing them with Cred for a predetermined period of time at a set interest rate (similar to a certificate of

[98] CredBorrow Page, https://mycred.io/borrow/ (last visited Mar. 5, 2021).

[99] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Interview with Daniel Schatt, co-Founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[100] *See, e.g.,* Exhibit 36; moKredit Tranche Agreement No. 29, May 1, 2019 (Exhibit 37).

[101] Interview with Daniel Schatt, co-Founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[102] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

deposit).[103] Cred would then convert cryptocurrency assets deposited under the CredEarn program into fiat currency and use the proceeds to make loans.[104] According to Cred's investment thesis, Cred would generate profits based on the spread between the interest rate offered to customers and the rate charged by Cred under the relevant loans.[105]

Cred boasted that customers would "still receive the upside potential of [their] crypto in a bull market."[106] Cred advertised that customer loans were used to lend and transact with a variety of customers, including retail borrowers and money managers, but not to short-sellers.[107] CredEarn contracts did not detail precisely how Cred intended to invest customer assets and made no mention of converting digital assets to USD/Stablecoin (USDT) and loaning those assets to a company in China.[108] As discussed further in Section V(B), the vast majority of CredEarn assets were utilized to make loans to moKredit.

CredEarn enrollment occurred on the 1st and 15th of every month, after Cred conducted a Know Your Customer ("**KYC**") check and executed a yield agreement with the customer.[109] Cred advertised the program on their website as a 6 month program, after which cryptocurrency was returned to the customer. Customers also had the ability to opt for a 3 month auto-enroll.[110] Contracts obtained by the Examiner provided that the agreements between the customer and

[103] Interview with Dan Schatt, co-Founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[104] Crypto-to-Fiat Process Diagram (Exhibit 175).

[105] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[106] CredEarn Page, https://mycred.io/earn/ (last visited Mar. 4, 2021).

[107] *Id.*

[108] Interview with Mr. M.M., Creditor and former customer, Cred Inc. (Feb. 18, 2021).

[109] CredEarn Process and Asset Flow (Exhibit 38).

[110] CredEarn Page, https://mycred.io/earn/ (last visited Mar. 5, 2021).

Cred were structured as so-called "Enhanced Yield Agreements" – agreements that linked to the performance of foreign exchange rates, and thus the potential for a higher return.[111]

In an effort to mitigate the risks associated with converting digital assets to fiat currency Cred established hedge positions through JST. As explained in greater detail below, Cred's positions were intended to protect Cred in the event cryptocurrency prices increased, but created a risk if they decreased.

V. CRED'S OPERATIONS AND CIRCUMSTANCES LEADING TO THE FINANCIAL COLLAPSE

A. Cred's Business Functionality.

1. Cryptocurrency Asset Storage.

Cred held very few assets itself and, instead, worked with certain firms to, among other things, store and initiate transfers of Cred's cryptocurrency assets, typically through a digital "wallet" maintained with the firm.[112] A digital wallet acts as a bank that allows one to deposit, withdraw, and make transactions with cryptocurrencies.[113] Given that cryptocurrencies are not physical, all transactions are recorded on a ledger referred to as a blockchain.[114] By providing a wallet address (every cryptocurrency wallet has a distinct address) an individual can transfer funds to that wallet.[115] Given that all transactions are recorded on the blockchain, it is easy to

[111] Email from J. Alexander to K. Wong, Feb. 12, 2019 (Exhibit 39) (James Alexander sending samples of Cred's Enhanced Yield Agreement and Multi-Tranche Credit Agreement when asked for sample contracts for CredEarn and CredBorrow customers); Enhanced Yield Agreement for CredEarn Customers (Exhibit 40); Exhibit 36.

[112] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021); Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[113] Digital Wallet, https://www.investopedia.com/terms/d/digital-wallet.asp (last visited Mar. 7, 2021).

[114] What is Blockchain Technology, https://www.coindesk.com/learn/blockchain-101/what-is-blockchain-technology (last visited Mar. 7, 2021).

[115] *Id.*

track the total amount of funds designated to a particular wallet.[116] Furthermore, an individual can possess as many digital wallets as he or she wants.[117]

(a) **JST Capital.**

JST Capital was Cred's initial wallet provider through March 2020. During that time, CredEarn deposits were often transmitted directly to a JST wallet.[118] JST converted those deposits into USD/Stablecoin and then executed transfers with moKredit pursuant to Cred's loan agreements with moKredit.[119] Under its arrangement with JST, Cred was unable to confirm receipt of funds for customers until JST sent confirmation that funds had been received.[120]

(b) **Fireblocks.**

In or around February 2020, Cred began to transition from an exclusive relationship with JST. Cred was looking to diversify its investment portfolio and wanted to find a new over-the-counter ("**OTC**") asset custodian that could both hold and facilitate the transfer of Cred's cryptocurrency. At Schatt's direction,[121] Cred partnered with Fireblocks, an asset custodian that both holds and facilitates the transfer of cryptocurrency, to fill the company's OTC need.[122] Cred entered into a licensing agreement with Fireblocks on February 21, 2020.[123]

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[116] What is a Distributed Ledger, https://www.coindesk.com/learn/blockchain-101/what-is-a-distributed-ledger (last visited Mar. 7, 2021).

[117] Digital Wallet, https://www.investopedia.com/terms/d/digital-wallet.asp (last visited Mar. 7, 2021).

[118] Interview with Scott Freeman, JST Capital (Mar. 2, 2021); Chat Log between S. Zhang and T. Perez, Aug. 28, 2019 (Exhibit 41).

[119] Chat Log between S. Zhang and T. Perez, Jul. 8, 2019 (Exhibit 182) (confirming investments did not always go through Cred).

[120] Chat Log between S. Zhang and T. Perez, Dec. 4, 2019 (Exhibit 183).

[121] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[122] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[123] Fireblocks License Agreement, Feb. 21, 2020 (Exhibit 43).

The Fireblocks licensing agreement required Cred to put in place adequate controls to avoid so-called "collusion risk" (i.e., the risk of double-spending cryptocurrency), including enacting protocols and procedures to ensure that passwords and recovery passwords were appropriately stored and tracked.[124] In this respect, Daniyal Inamullah (at the time, Cred's Vice President of Capital Markets) recommended that Cred adopt certain procedures (e.g., joint password managers) to avoid potential collusion and other risks.[125]

Joe Podulka was the Fireblocks "workspace owner," which gave him responsibility for Cred's policies and configuration as they related to Fireblocks, including the decision of who at Cred could access the platform.[126] Although Podulka appeared to agree with Inamullah's suggestion regarding joint password managers, the Examiner found no evidence that this policy was adopted. Ultimately, Podulka, Inamullah, Alexander and Adnan Khakoo (a former fund accountant) had access to Cred's Fireblocks accounts and each had the ability to individually initiate transactions and make transfers with little or no oversight.[127]

To transfer assets, Inamullah, among others with access, digitally submitted transfer requests that were then confirmed or denied by the authorizer. As a matter of informal policy, the initiator of the transaction was not permitted to also authorize the transaction.[128] The sender usually transferred a small test amount to ensure the receiving wallet address was correct. Upon confirmation, the sender then completed the transaction.[129]

[124] Exhibit 43 at 5.2.

[125] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[126] Exhibit 43 at 5.9.

[127] Inamullah Dep. 218:11–17 (Exhibit 9).

[128] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[129] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

When a user sent funds from Fireblocks, the Fireblocks ledger would create an outgoing entry, and Cred's NetSuite accounting platform would record the date of the transaction and where the assets were sent. Fireblocks' system only recorded the destination wallet address.[130] It was the user's responsibility to manually input identifying information regarding the transaction.[131] That rarely occurred such that, according to Scott Wiley (Cred's interim CFO), the information in Cred's journal entries was not particularly meaningful.[132]

Although Inamullah personally adopted an informal policy of requiring two persons to effect transfers (one to authorize and one to initiate) to ensure oversight,[133] that practice was not adopted prior to Cred's transition to Fireblocks.[134] Even then, however, it is unclear whether it was more widely implemented or an effective control.[135]

As a general practice, Cred did not (had no mechanism to) distinguish between its assets in its Fireblocks accounts: (i) customers would transfer assets to Cred's digital wallets; (ii) Cred would transfer those assets to a central concentration account where such assets would be comingled with all other customer deposits; and (iii) Cred would send assets from the concentration account to various asset managers. The Examiner saw no evidence that Cred

[130] Interview with Tonia Tautolo, Interim Controller, Cred Inc. (Feb. 19, 2021).

[131] *Id.*

[132] Interview with Scott Wiley, interim Chief Financial Officer, Cred Inc. (Feb. 9, 2021).

[133] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[134] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[135] The Examiner received conflicting reports on this issue. *Compare* [135] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021) *with* Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021). Also, Cred's interim Controller, Tonia Tautolo, explained that wallets could be "whitelisted," i.e., pre-approved, on Fireblocks prior to a transfer. It was Tautolo's understanding that a wallet address needed to be whitelisted on Cred's Fireblocks system before it could receive a transfer. *See* Interview with Tonia Tautolo, interim Controller, Cred Inc. (Feb. 19, 2021). However, Inamullah indicated that, although wallets could be "whitelisted," it was not a requirement in order to effect an outgoing transfer from a Cred Fireblocks accounts to a particular wallet. Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

distinguished between assets deposited through the CredEarn or CredBorrow programs (or any other programs).

To further complicate matters, customer deposits in Fireblocks were intended to be tracked only manually in an Excel ledger, which was maintained offline and not updated regularly.[136] Cred maintained certain client folders that contained contracts indicating how much certain customers had deposited, but the Examiner has not seen any evidence that Cred kept records of what assets were received in which wallet and when.[137] In all, Cred's comingling of its assets and absence of meaningful financial records made it impracticable for the company to discern whose assets belonged to whom.

Due to the lack of available information for transactions, the Examiner has significant concerns regarding the reliability of Cred's books and records regarding pre-petition transfers sent from Cred's Fireblocks account.

(c) **Uphold.**

Uphold is a cloud-based asset platform that enables users to store, buy, and convert classes of assets.[138] At Cred's founding, Schatt served on Uphold's board of directors and later added Uphold as a partner for Cred in early 2019.[139] For Cred, Uphold assisted with operations and acted as its customer wallet.[140] Throughout 2019, Uphold was also one of Cred's primary

[136] Interview with Tonia Tautolo, interim Controller, Cred Inc. (Feb. 19, 2021).

[137] *Id.*

[138] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021); Uphold About Page, https://uphold.com/en/resources/about (last visited Mar. 4, 2021).

[139] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[140] *Id.*

sources of customer leads.[141] When a customer bought cryptocurrency on Uphold, Uphold would display an advertisement referencing its partnership with Cred and representing that Cred products allowed Uphold customers to earn interest on their assets.[142]

According to Matt Foster (Cred's CRO), Uphold customers could participate in the CredEarn program directly through Uphold's platform (its web application).[143] Uphold was a customer generator for Cred and also operated a wallet service similar to Fireblocks. Under the customer agreements furnished to the Examiner, Cred retained the discretion to invest funds obtained from Uphold customers as it saw fit (no differently than any other CredEarn customer).[144]

2. Diligence Process and Procedures.

As Cred's Chief Capital Officer, James Alexander was tasked with primary responsibility for diligence respecting Cred's investment partners.[145] Alexander delegated diligence responsibilities to Inamullah, Cred's former Vice President of Capital Markets, who stated that, as of his arrival in January 2020, Cred did not have an effective diligence process with respect to its investments, "at least on paper."[146] Although in his sworn deposition Inamullah stated that he was responsible for conducting diligence on behalf of Cred, in his interview with the Examiner, Inamullah disclaimed any responsibility for Cred's diligence function.[147]

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[141] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[142] *Id.*

[143] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 9, 2021).

[144] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[145] Inamullah Dep. 34:15–35:2 (Exhibit 9).

[146] *Id.* at 52:2–14.

[147] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

According to his deposition testimony, Inamullah adopted what can best be described as an informal process for vetting potential investment partners. When evaluating a potential asset manager, Inamullah explained that he would first exchange general compliance information with the party, including beneficial ownership information, background on the business itself, and basic financial information.[148] He would then run the beneficial owner names through the relevant anti-money laundering or KYC software, and contact others in the industry for references.[149] To log information related to a potential investment, Cred used an internal Google form.[150]

Inamullah stated that he would question asset managers about experience, strategies, and points of risk,[151] then would compile his findings into a brief investment proposal (typically 3-5 pages) for consideration by an informal "investment committee," consisting of Schatt, Podulka, Inamullah, Wheeler, and Alexander.[152] In his deposition testimony, Inamullah stated that he developed a diligence checklist to vet investment managers but, in his subsequent interview with the Examiner, he stated that no such list existed.[153] In any event, even in his deposition testimony, Inamullah stated that he rarely used a diligence list during his tenure,[154] and that he took few steps to validate information provided by asset managers.[155]

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[148] Inamullah Dep. 42:15–44:1 (Exhibit 9).

[149] *Id.* at 30:20–25, 35:9–14; 42:15–44:1.

[150] *Id.* at 45:20–46:5.

[151] *Id.* at 42:15–44:1, 53:18–24.

[152] *Id.* at 42:15–44:1. It also appears that Khakoo, Sally Zhang (Senior Accounting Manager), Heidi Ng (Director of Product and Partner Integrations), and Karen Wong (Cred's Head of Finance / CFO prior to Podulka) attended at least some "investment committee" meetings. *See* Cred Investment Committee Meeting Minutes (Exhibit 44).

[153] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[154] Inamullah Dep. 47:23–50:7 (Exhibit 9).

[155] *Id.* at 53:25; 60:15–20.

In his deposition, Inamullah stated that he and Alexander would supplement their diligence efforts by contacting attorneys for counter-parties and other industry professionals, seeking to verify information provided by an asset manager (e.g., corporate documents, financial statements).[156] In all, the diligence process described by Inamullah was, in the Examiner's opinion, informal and appeared, in places, to be cursory.

3. Financial and Accounting Practices.

The Examiner reviewed extensive records and conducted several interviews with key financial personnel, all of whom described incomplete or inadequate accounting practices at Cred.[157] The Examiner's review of Cred's financial documents and transaction history confirmed significant gaps in Cred's accounting and record keeping practices, gaps that were confirmed by the Debtors' advisors, MACCO and Sonoran Capital Advisors.[158]

Although Cred had access to Oracle's NetSuite accounting software to produce financial statements, Cred appears to have relied principally on Microsoft Excel and Google Sheets in place of an integrated accounting function.[159] According to Paul Maniscalco and Pablo Bonjour, MACCO was unable to readily identify Cred's beginning cash balance upon initiating its work

[156] *Id.* at 53:25–60:14.

[157] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 8, 2021); Interview with Scott Wiley, interim Chief Financial Officer, Cred Inc. (Feb. 9, 2021); Interview with Pablo Bonjour and Paul Maniscalco, Financial Advisors, MACCO, (Feb. 10, 2021); Interview with Tonia Tautolo, interim Controller, Cred Inc. (Feb. 19, 2021).

[158] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 8, 2021); Interview with Scott Wiley, interim Chief Financial Officer, Cred Inc. (Feb. 9, 2021); Interview with Pablo Bonjour and Paul Maniscalco, Financial Advisors, MACCO, (Feb. 10, 2021).

[159] Interview with Pablo Bonjour and Paul Maniscalco, Financial Advisors, MACCO, (Feb. 10, 2021); *see, e.g.*, Email from S. Hwang to J. Podulka, Nov. 12, 2020 (Exhibit 45) (referencing Google Sheets); Schedule of Advances (Exhibit 46) (tracking all of Cred's tranches with moKredit in Excel); Email from J. Podulka to F. Cottrell and A. Khakoo, Nov. 18, 2020 (Exhibit 47) (referencing NetSuite); *see also* Accounting Software, Netsuite, https://www.netsuite.com/portal/products/erp/financial-management/finance-accounting.shtml (last visited Mar. 4, 2020).

with Cred due to incomplete accounting records.[160] MACCO representatives had to manually determine Cred's cash balance by obtaining and/or creating financial statements.[161]

Cred's interim Controller, Tonia Tautolo, confirmed that Cred's financial records were in a state of disarray when she arrived in December 2020.[162] Very few transaction records existed, and, in the instances where a transaction record did exist from Uphold or Fireblocks, Cred did not consistently input the statement information into its accounting system, leaving Cred's records incomplete and/or out-of-date.[163] Instead, Cred attempted to track liabilities in what was referred to as the "Cred Ledger" in Excel, which Tautolo described as falling short of any reasonable accounting standards.[164] As just one example, Cred relied on a series of Excel spreadsheets to track tens of millions of dollars' worth of transactions with moKredit. Based on the evidence obtained by the Examiner, these spreadsheets appear to be Cred's only records of when funds moved between Cred, moKredit, and JST.

Further, it appears that Cred did not perform a financial reconciliation of any accounts for the 2020 financial year. The Examiner was able to obtain only unaudited 2019 financial statements for Cred.[165] It bears noting that, although MACCO could not identify the last point at which Cred had a complete and accurate records reconciliation, Armanino LLP – an independent accounting and business consulting firm – produced a signed audit report dated December 31,

[160] Interview with Pablo Bonjour and Paul Maniscalco, Financial Advisors, MACCO, (Feb. 10, 2021).

[161] *Id.*

[162] Interview with Tonia Tautolo, interim Controller, Cred Inc. (Feb. 19, 2021).

[163] *Id.*

[164] Interview with Tonia Tautolo, interim Controller, Cred Inc. (Feb. 19, 2021); Cred LLC General Ledger, 2020 (Exhibit 48).

[165] Cred Financial Statements, 2019 (Exhibit 49).

2018.[166] Cred engaged Armanino to audit Cred's financial statements for the year ending December 31, 2019, but work papers that MACCO examined suggest that the audit was still on-going as of Cred's bankruptcy filing.[167]

Cred did not appear to regularly mark-to-market or record unrealized gains in any system.[168] MACCO informed the Examiner that it did not find profit and loss or mark-to-market account entries in Cred's general ledger.[169] According to Foster, Cred did not complete monthly account reconciliations,[170] which is also inconsistent with financial industry standards.[171]

4. Insurance Coverage.

In soliciting customers, Cred advised potential customers that the company had "one of the most comprehensive insurance policies available,"[172] and provided information about its policies through its website.[173] In certain instances, Cred claimed that customers' cryptocurrency investments were insured up to $100 million through industry-leading custodians like BitGo.[174] In communicating with certain customers, Cred further represented that its asset custodians –namely, BitGo and Bittrex – provided an extra layer of security through their own

[166] Exhibit 34.

[167] Email from J. Podulka to H. Moore and E. Rye, May 21, 2020 (Exhibit 50).

[168] Interview with Pablo Bonjour and Paul Maniscalco, Financial Advisors, MACCO, (Feb. 10, 2021).

[169] *Id.*

[170] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 8, 2021).

[171] *Id.*

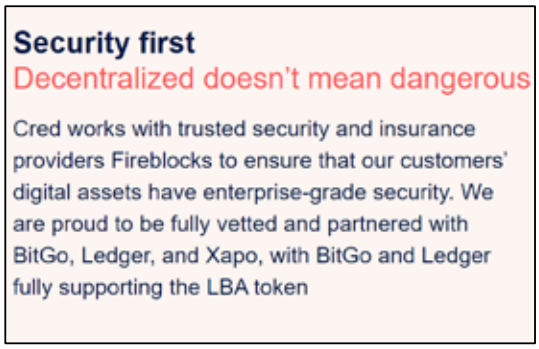
[172] Email from M. Zhang to M. Parrish, June 24, 2020 (Exhibit 59).

[173] Screenshot of Cred website discussing insurance policies (Exhibit 60).

[174] Screenshot of Cred website discussing partnership with BitGo (Exhibit 61); Email chain between M. Zhang and T. Miyauchi, June 19, 2020 (Exhibit 62).

insurance policies.[175] Additionally, Cred touted its cyber hacking coverage obtained through Lockton.[176]

Snapshots from Cred's website are excerpted below:[177]



Cred also sent customers links to blog posts and webpages with insurance information that, according to certain customers, led them to believe that their investment was fully protected by Cred's insurance policies.[178] One customer noted that he placed confidence in Cred due to its "advertised claim to have 'industry leading' insurance."[179] When another customer asked whether Cred would compensate for losses resulting from customers' Bitcoin being hacked or stolen, he was assured that, once assets were in Cred's custody, Cred took "full responsibility for [their] safety and redelivery."[180]

[175] Exhibit 59; Email from T. Perez to C.D. Nov. 14, 2019 (Exhibit 63); Email chain between M. Zhang and J.S., Apr. 15, 2020 (Exhibit 64).

[176] Exhibit 59.

[177] Exhibit 60; Exhibit 61.

[178] Exhibit 59; Interview with Mr. M.M., Investor, Cred. Inc., (Feb. 18, 2021).

[179] Email from D.F. to T. Perez, Nov. 8, 2020 (Exhibit 66).

[180] Exhibit 62.

Based on the information obtained by the Examiner, it appears that Cred's assertions regarding the strength and scope of its insurance coverage were inaccurate and/or overstated. Cred maintained several insurance policies that it acquired through Lockton Insurance Brokers, LLC ("**Lockton**").[181] The policies in effect during 2020 were the following:[182]

- Commercial package from The Hartford Financial Services Group, Inc. ("**The Hartford**").[183] Cred's commercial package from The Hartford provides general liability, property, automotive, and umbrella liability for a total premium of $4,121.[184] The Hartford policy provides $2 million in general liability insurance for each occurrence with a general aggregate limit of $4 million.[185] Cred's umbrella policy provides an additional $1 million coverage limit.[186] Cred renewed its policy from The Hartford in 2020 to extend coverage through November 6, 2021.[187]

- Cyber liability from AXIS Insurance, which provides Cred with cyber liability coverage up to a $5 million limit for a total premium of $29,314.[188] Although the AXIS policy covered certain events, including crisis management, fraud response, and business interruptions up to the full $5 million policy limit, its coverage for "social engineering fraud loss" was subject to a $250,000 coverage limit.[189]

- Errors and omissions ("**E&O**") from Validus Specialty ("**Validus**"), which provides $1 million of coverage for a total premium of $270,000.[190] This policy does not cover third-party losses and contains a "Crypto Currency, Token or Coin Exclusion."[191] That policy exclusion, applies to

[181] Lockton Summary of Insurance, 2020–2021 (Exhibit 51).

[182] Policy terms ran from October 2019 to October 2020 or January 2020 to January 2021. In any event, the coverage periods encompassed all relevant events for the purpose of the insurance claim discussion. *Id.*

[183] Hartford Business Owners Policy, Oct. 1, 2020 (Exhibit 52); Hartford Workers' Compensation and Employers' Liability Busines Insurance Policy, Nov. 30, 2020 (Exhibit 53).

[184] Exhibit 51; Exhibit 52; Exhibit 53.

[185] Exhibit 51.

[186] *Id.*

[187] Exhibit 53.

[188] Certificate of Liability Insurance, Nov. 11, 2020 (Exhibit 54); Axis Insurance Policy (Exhibit 55).

[189] Exhibit 54; Exhibit 55.

[190] Validus Errors and Omissions Policy Declarations (Exhibit 56).

[191] Email from T. Khuu to B. De Lude, D. Schatt, and J. Podulka, Oct. 30, 2020 (Exhibit 146); Exhibit 56 at 31–32.

any claim arising out of "any investment of any kind, whether or not a security, that is in the form of crypto currency, crypto token or coin, digital token or coin" or "any theft, misappropriation, or conversion of any crypto currency, crypto token or coin, digital token or coin."[192]

- Directors and officers insurance ("**D&O**") from Validus, which provides $1 million in coverage for a total premium of $40,000.[193] This policy does not cover third-party losses and contains a cryptocurrency exclusion, as explained above.[194]

- Excess D&O insurance from Euclid Insurance, which provides an additional $1 million in coverage for covered losses exceeding $1 million, for a total premium of $35,200.[195]

- Coverage for lawyers from One Beacon Insurance, which provides $1 million in coverage for Cred's employed lawyers for a total premium of $4,957.[196]

5. Internal Compliance Function.

In 2018, Cred hired InnReg LLC ("**InnReg**") to assist Cred in developing internal compliance protocols addressing, among other things, information security, privacy, credit risk, and marketing products. However, it appears that, as late as June 2020, no compliance program had been created, let alone implemented.[197] In connection with the Investigation, the Examiner requested that Cred produce all of its internal policies concerning trading risk management and leverage limits, but was advised by Cred's counsel that no such document exists. The only responsive document that the Examiner received was an advertising and marketing policy.[198]

[192] Exhibit 146 (ellipses omitted); Exhibit 56 at 31–32.

[193] Validus Directors and Officers Policy Declarations at 3 (Exhibit 57).

[194] Exhibit 57 at 30–31.

[195] Euclid Financial Excess Insurance Policy (Exhibit 58).

[196] Exhibit 51; Exhibit 54.

[197] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[198] Cred Advertising and Marketing Policy (Exhibit 67).

As noted in Sections V(A) and V(F)(3), it appears that Cred's compliance policies with respect to asset transfers were deficient. Inamullah once observed that Cred did not "have robust (or for that matter, any) reporting from [its] primary lender (MoKred) which [made] up ~50% of [its] portfolio."[199]

In June 2020, Cred hired Bethany De Lude to be the company's Chief Information Security Officer. After reviewing Cred's internal controls and procedures, De Lude promptly imposed background checks for all employees and vendors of Cred. Up to that time, this was not a function Cred was performing.[200]

B. Cred's Relationship and Dealings with moKredit.

1. moKredit, In General.

After leaving PayPal in 2011, Lu Hua founded moKredit Inc. to facilitate payment systems for the emerging Chinese mobile gaming market.[201] Hua recruited early PayPal co-workers to join his venture,[202] and the company raised money from angel investors and venture capitalists.[203]

Through moKredit, Hua sought to build a peer-to-peer payment application to connect mobile game customers with developers, while providing an alternative to credit cards for online payments.[204] By initial design, moKredit served as an intermediary that collected a service fee

[199] Email from D. Inamullah to D. Kline, July 6, 2020 (Exhibit 68).

[200] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[201] Exhibit 3 at 3; Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[202] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[203] Exhibit 3 at 6–7.

[204] Exhibit 3 at 6–7.

from borrowers for each loan it originated.[205] The premise for the company was that a customer could submit a short application online, which allowed moKredit to perform a quick credit check and then offer a credit line to mobile users based on the data output.[206] While moKredit initially offered lines of credit ranging from $1.45 to $145, the company soon scaled up to offering loans from $20 to $1,000.[207] Customers would use the credit line subject to a 7-, 14-, or 30-day repayment term.[208]

From 2013 to 2014, moKredit's mobile platform experienced rapid growth.[209] However, the original intermediary concept appeared to reach a plateau after larger competitors entered the market. In response, moKredit pivoted its business model to focus on microcredit lending.[210] After ramping up in 2016, moKredit's business proved to be, at least initially, successful, generating 510 million RMB ($78 million) of revenue, 174 million RMB ($26.5 million) of gross profit, and 93 million RMB ($14 million) of net profit in 2017.[211] Increased competition cut into moKredit's business by 2018, but the company remained profitable.[212]

By this time, moKredit sought to expand its operations, with funding organized through a pool of lenders led by credit unions and high net worth individuals.[213] To access funds,

[205] *Id.* at 9.

[206] *Id.* at 7.

[207] Exhibit 3 at 7; Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[208] Exhibit 3 at 7–8.

[209] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[210] Exhibit 3 at 3.

[211] *Id.* at 12–13.

[212] *Id.*

[213] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

moKredit traditionally paid funding costs ranging from 10-15% to its lenders.[214] moKredit capitalized on a significant spread between its borrowing costs and rates at which it loaned funds to customers, which were as high as 36%[215] on an annual basis.[216]

2. Cred's Business Dealings with moKredit.

On December 27, 2018, Cred entered into its first loan and security agreement with moKredit.[217] Pursuant to the agreement, Cred extended a $100 million line of credit to moKredit.[218] JST was Cred's "paying agent" in connection with its lending arrangement with moKredit.[219] JST received interest payments from moKredit in USDT and subsequently converted and transferred funds back to Cred in USD.[220] JST was paid a percentage of the funds managed based on a monthly "profit share" fee agreement.[221]

In early 2019, Cred began "investing" converted fiat currency from its cryptocurrency assets with moKredit.[222] As Schatt described the deal between the companies, Cred could allocate funds to moKredit at an agreed-upon interest rate – starting at 18-24% per annum and dropping to 12-18% per annum over time[223] – with a callable period within each tranche.[224]

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[214] *Id.*

[215] Initially, moKredit lent against interest rates as high as 80% until the Chinese government capped consumer interest rates at 36%. Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[216] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[217] Exhibit 5.

[218] *Id.*

[219] Exhibit 11.

[220] Exhibit 12.

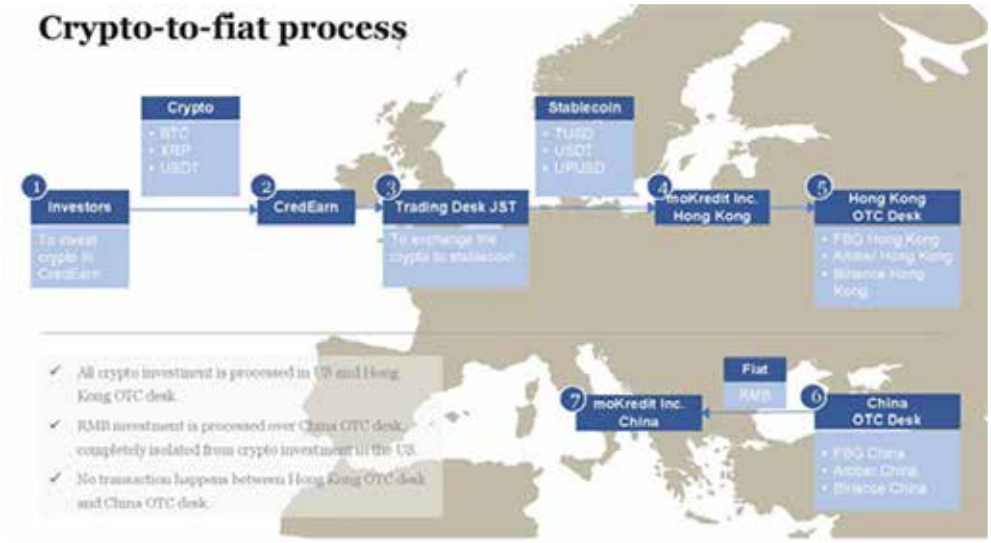
[221] Exhibit 11; Exhibit 13.

[222] Schatt Decl. ¶ 19 (Exhibit 1); Exhibit 46.

[223] Schatt Decl. ¶ 19 (Exhibit 1); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[224] Schatt Dep. 47:18–48:14 (Exhibit 4).

Cred controlled the allocations, which required moKredit to make monthly interest payments on the principal and send principal back upon Cred's request.[225] Cred took cryptocurrency it received from its customers and converted it to fiat currency before transferring it through a series of entities – including JST as Cred's broker – to moKredit. moKredit lent out fiat currency in China (typically through short-term, high interest rate microloans) before returning interest to Cred every 15 days.[226]



Transactions between Cred and moKredit initially reflected attributes of formal arm's-length dealing, with funds frequently sent back and forth, typically through JST as Cred's broker.[227] Cred and moKredit soon shifted to a more casual style of business dealings, often without "proper controls" (e.g., transferring funds before receiving a signed tranche agreement;

[225] *Id.*

[226] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Exhibit 175.

[227] *See, e.g.*, January 2019 transaction documents: Email from K. Wong to L. Hua, Jan. 15, 2019 (Exhibit 70); Exhibit 12; Email from J. Alexander to L. Hua and K. Wong, Jan 22, 2019 (Exhibit 71); Exhibit 11.

not issuing monthly statements for moKredit's loan balance).[228] This might be explained by the companies' connectivity through Hua, even though they were not otherwise legally affiliated. The lack of formality caused confusion about finances and how to account for different payments that the companies routinely sent back-and-forth.[229] Nevertheless, Cred's book of loans to moKredit rapidly grew to approximately $20 million by May 2019 and $40 million by September 2019.[230] As Cred's book of loans to moKredit grew, so too did Cred's risk.[231]

3. Cred's Failed Attempts to Withdraw moKredit Investments.

According to Schatt, by the fourth quarter of 2019, Cred had stopped allocating new funds to moKredit in a purported effort to diversify Cred's asset managers.[232] However, based on the evidence obtained by the Examiner, it appears that allocations to moKredit did not end until the January 2020 timeframe.[233] The majority of Cred's assets were already loaned to

[228] Email from K. Wong to S. Zhang and J. Alexander, Feb. 4, 2019 (Exhibit 72).

[229] Email from K. Wong to L. Hua and D. Schatt, Feb. 13, 2019 (Exhibit 73) (Wong asked, "are we accounting for the loan as a fixed $1.5M or a USD equivalent of an RMB amount?"); Email from K. Wong to H. Ng, J. Alexander, and S. Zhang, Feb. 14, 2019 (Exhibit 74) (Wong: "Although MoKredit will be signing another loan agreement for the amount of the funds, we will not be sending the funds to them this time around as they are paying down the principal on tranche 3."); Email from J. Alexander to K. Wong, Feb. 15, 2019 (Exhibit 75) (Alexander asked Wong: "How do you want to do the accounting for this tranche? Are we adding this as another loan to MoKredit? Or reducing the interest payable on others?" Wong replied, "We agreed to consider this a paydown of principal on tranche 3 (the $1.5M loan), but we also still need to consider it another loan to MoKredit in order for the numbers to foot, right?").

[230] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (February 18, 2021); Schedule of Advances (Exhibit 46).

[231] *See* Email from J. Alexander to K. Wong, May 21, 2019 (Exhibit 77) (Alexander raised inconsistencies or incomplete information in Cred's financial reports to Wong and Schatt: "I recall an initial advance to Cred of about $750k in March, which was to be repaid by the T3 $790k you reference. However, an additional $500k was advanced to Cred. We need to account for any advances to Cred within our loan book. Can you help reconcile the amount please?").

[232] Schatt Dep. 42:13–20 (Exhibit 4).

[233] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Exhibit 46 (last transaction logged is on Jan. 1, 2021).

moKredit.[234] Thus, when Cred experienced a sudden and increased need for liquidity (discussed further in Section V(C)(1)), it was largely reliant on moKredit to make principal payments on loaned funds.[235]

On or about March 12, 2020, Cred attempted to recall $10 million in principal from moKredit, but Hua responded that it was not possible.[236] moKredit's inability to repay the loan when requested was attributed in part to the economic fallout from the COVID-19 pandemic, including large default rates (e.g., 50% - 70%) among moKredit's microloans and the Chinese government's unwillingness to enforce consumer loan agreements.[237]

moKredit's failure to repay the requested principal when called by Cred had a significant and adverse impact on Cred's liquidity and cash flow position.[238] Cred's executive team agreed to an updated plan with Hua for moKredit to repay principal about 10 days later, but moKredit failed to meet the updated plan's schedule.[239] Instead, at Alexander's request, Hua offered personal assistance in the form of a transfer of 300 BTC (discussed further in Section V(E)).[240] Hua alleges that this transfer "was intended as a loan," notwithstanding that Hua signed a Cred

[234] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[235] Schatt Dep. 70:17–72:24 (Exhibit 4).

[236] Email from J. Alexander to L. Hua, D. Inamullah, S. Zhang, and J. Podulka, Mar. 12, 2020 (Exhibit 79); Inamullah Decl. ¶ 14 (Exhibit 6).

[237] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Inamullah Dep. at 77:16–19 (Exhibit 9).

[238] Liquidity Analysis Post March 2020 Flash Crash and Recommended Steps, Apr. 5, 2020 (Exhibit 113); Inamullah Dep. at 113:25–114:7 (Exhibit 9).

[239] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Inamullah Decl. ¶ 10 (Exhibit 6).

[240] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

Capital equity contribution agreement in or around this time exchanging 300 Bitcoin for class B non-voting shares in Cred Capital.[241]

As Bitcoin prices plummeted in March 2020, Cred encountered substantial margin calls in connection with its hedge positions, further eroding Cred's liquidity profile. With a significant portion of its asset base invested with moKredit and, at the time, yielding no return, Cred did not have sufficient liquidity to satisfy the margin calls or reinstate its hedge positions. By June 2020, Cred recognized internally that its moKredit loans were "distressed."[242] As of the Petition Date, moKredit owed Cred no less than $38 million.[243]

4. Potential Conflicts of Interest.

As the founder of moKredit and co-founder of Cred, Hua consulted his personal counsel to determine whether a conflict of interest existed.[244] He purportedly received guidance that, so long as he was only a shareholder in Cred and stayed away from so-called "big" operations, there was no conflict.[245] The Examiner has not seen evidence of Board minutes or other customary documents reflecting the Board's decision-making process. The only "minutes" the Examiner received were those attributed to the "investment committee," which was not a Board committee.

[241] Schatt Dep. 73:22–23 (Exhibit 4); Contribution Agreement between L. Hua and Cred Capital, LLC, Mar. 31, 2020 (Exhibit 80). Hua claims that he did not read the relevant agreement with any level of scrutiny before signing. Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[242] Email from D. Schatt to D. Wheeler, June 16, 2020 (Exhibit 81); Email from D. Inamullah to D. Schatt, J. Podulka, and A. Khakoo, June 29, 2020 (Exhibit 82).

[243] Email from J. Podulka to D. Schatt, Dec. 1, 2020 (Exhibit 83); Cred Near Term Liquidity Analysis, Nov. 7, 2020 (Exhibit 84).

[244] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[245] *Id.*

Hua was, however, one of two members of Cred's Board from its inception until the eve of bankruptcy in November 2020.[246] The Examiner has not been furnished with any information explaining how a Board of two directors could function effectively when one director must be recused from "big" operational issues.

According to Hua, he delegated all decision-making regarding loan amounts and timing to Cred employees after advising them how much capacity he had to take on loans at moKredit.[247] Additionally, Hua states that he ensured that Cred would have the highest priority if it had to call back funds.[248]

The issue of a potential conflict of interest came to a head when moKredit became unable to repay principal.[249] Hua could not identify a serious recourse path for Cred to recall money from moKredit if moKredit was unwilling or unable to repay principal.[250] Schatt confirmed that discussions took place internally about retail customer funds being loaned to an insider-affiliate company that could not repay.[251] Schatt acknowledged that Cred never hired an independent financial advisor to review proposed transactions with moKredit, nor did it seek a fairness opinion.[252] However, Schatt advised the Examiner that he had a level of comfort based on

[246] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021); Email from L. Hua to D. Schatt, J. Grogan, and M. Zuppone, Nov. 4, 2020 (Exhibit 179).

[247] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[248] *Id.*

[249] *Id.*

[250] *Id.*

[251] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[252] Schatt Dep. 45:23–46:2 (Exhibit 4).

Cred's supposed long-term relationship with Hua,[253] and because Hua was purportedly not involved in Cred's day-to-day operations.[254]

5. Diligence and Risk Management Respecting moKredit.

Schatt informed the Examiner that he removed himself from the moKredit due diligence process due to his relationship with Hua, leaving Alexander to manage such efforts.[255] This, again, raises serious questions of Board functionality and business oversight. Schatt represented that, at an incipient stage of this relationship, he sought legal advice from external counsel on a number of issues regarding Cred's interaction with moKredit, including whether there were potential conflicts of interest and what disclosures Cred would need to provide customers.[256] According to Schatt, Cred relied on Wheeler to draft the company's disclosures to customers.[257] Schatt also claims that he consulted external counsel on whether the moKredit loan could be considered a security and whether a partner could be considered a loan broker and therefore subject to lending regulations.[258] moKredit did not have any financing licenses in China, but

[253] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[254] *Id.*

[255] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Schatt Dep. 44:23–47:17 (Exhibit 4) (Alexander "was responsible for the whole due diligence and formulation of the relationship and the contract and evaluating the terms" with moKredit); Schatt Dep. 55:1–7 (Exhibit 4) (confirming Alexander "was the only employee who performed the analysis of due diligence" of moKredit "in collaboration with counsel").

[256] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021). Based on the information provided to the Examiner, the external counsel referenced in this paragraph was not the Debtors' current bankruptcy counsel retained in these Chapter 11 cases.

[257] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[258] *Id.*

Cred and moKredit believed that moKredit did not need a license because, according to them, moKredit fell into China's largely unregulated peer-to-peer lending sector.[259]

Alexander appears to have performed minimal (if any) due diligence with respect to moKredit.[260] The Examiner's review of records and interviews failed to reveal evidence of substantive due diligence in connection with the moKredit relationship, other than Alexander's representations of having done "exhaustive diligence."[261] It does not appear that Cred's Board ever formally approved any moKredit agreements or business dealings.[262]

According to Schatt, Alexander's diligence of moKredit included reviewing financial statements and an investor presentation.[263] Schatt stated that he tasked Alexander with setting up a data room and ensuring that Cred had an appropriate understanding of moKredit's risk profile and the people to whom it lent funds. Schatt was, however, unaware whether Cred received documentation or information regarding moKredit's outstanding consumer loans, and the Examiner did not find evidence of any such records.

6. Disclosures to Customers Regarding moKredit Relationship.

To raise capital for the moKredit loan, Cred needed to raise funds. Cred, primarily through Alexander, spent the first quarter of 2019 marketing its business thesis to cryptocurrency

[259] Email chain between J. Alexander and A. Derar, Apr. 16, 2019 (Exhibit 85); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[260] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021); *see also* moKredit Diligence Checklist, Feb. 11, 2019 (Exhibit 180) (nearly blank due diligence checklist dated after Cred began loaning moKredit funds).

[261] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[262] Schatt Dep. 44:23–45:3 (Exhibit 4).

[263] *Id.* at 46:20–47:2.

holders.[264] According to its pitch materials, Cred operated similar to a commercial bank – offering something akin to certificates of deposit to cryptocurrency customers who lent their assets to Cred through the CredEarn program. Cred would then lend such assets to moKredit at a higher rate (typically 20%) until Cred had to return the cryptocurrency "deposit" back to its customer.[265] Cred offered retail customers up to a 10% return on their cryptocurrency if they agreed to lock up the funds with Cred for at least 6 months.[266] Cred's return came in the form of the spread between the 20% interest paid by moKredit to Cred, and the return paid by Cred to its customers.[267]

The Investigation did not reveal evidence that Cred disclosed to retail customers that funds would be going to China or to an entity founded by a Cred insider.[268] Cred's culture, at least at times, appeared to promote secrecy rather than transparency when potential customers asked questions regarding their assets and the company's investments.[269] One Cred employee expressed concern that, "if I were reading [a statement on Cred's website that pledged assets were loaned 'on a fully collateralized and guaranteed basis'] as a consumer, and I later learned

[264] *See, e.g.*, Email from J. Alexander to J. Bunting, Mar. 14, 2019 (Exhibit 86); Email chain between J. Alexander and R. Flowers, Mar. 15, 2019 (Exhibit 87); Email from J. Alexander to D. Davis, Mar. 14, 2019 (Exhibit 88); moKredit Investment Opportunity Slide Deck, Mar. 2019 (Exhibit 89).

[265] UST Motion (Exhibit 27) ¶ 10; *see also* Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[266] UST Motion (Exhibit 27) ¶ 10; *see also* Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[267] Inamullah Decl. ¶ 10.

[268] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[269] Cred Employee Chat Logs, Mar. 26, 2019 (Exhibit 90) (Meghan LNU writes: "We should not be disclosing to the public where exactly we are using the assets to generate interest rates." Rafael Cosman: "I have not disclosed anything from any conversations with James to the public and I do not intend on doing so. But I'm concerned because if I were reading that as a consumer, and I later learned all the details of Cred's business, I think I would feel like I was misled.").

all the details of Cred's business, I think I would feel like I was misled."[270] Another employee cautioned not to disclose "public[ly] where exactly we are using the assets to generate interest rates."[271] Alexander did disclose to certain potential customers that Cred was raising funds to send to moKredit in China, most notably in connection with placement of the Luxembourg Bonds.[272]

7. Luxembourg Bonds.[273]

In late 2019, Alexander identified Income Opportunities (Luxembourg) S.A. ("**Income Opportunities**"), a Luxembourg company "acting through its compartment" Cred Global Notes 1,[274] as an entity that might issue bonds backed by moKredit loans.[275] Alexander was a director on the Income Opportunities board of directors.[276]

The initiative culminated in the issuance of $14 million worth of bonds bearing interest at 8%.[277] According to Inamullah, prior to the issuance, Cred's principal loan balance with moKredit was approximately $40 million. Cred essentially securitized approximately $15 million of this exposure, selling $14 million of this receivable to investors through bonds issued by Income Opportunities. Cred retained approximately 10% of the securitization (i.e., the "equity tranche").

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[270] *Id.*

[271] *Id.*

[272] *See, e.g.*, Exhibit 86; Exhibit 87; Exhibit 88.

[273] The information contained in this section is based on a review of all relevant documentation available to the Examiner at the time of drafting. To date, the Examiner has not received, nor reviewed, copies of the individual notes issued under this program.

[274] Income Opportunities Board Minutes, Feb. 4, 2020 (Exhibit 91).

[275] Schatt Dep. 58:19–62:8 (Exhibit 4).

[276] Exhibit 91.

[277] Schatt Dep. 58:19–62:8 (Exhibit 4).

Alexander and Cred's capital markets team were responsible for overseeing funds received in connection with the bond offering.[278] At least two entities purchased the bonds from Cred: JST[279] 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.[280]

The issued bonds were structured as participation interests in moKredit loans, meaning Income Opportunities was responsible for collecting from moKredit upon redemption. According to the Base Prospectus, Cred was not a guarantor or an obligor in any other way respecting the Luxembourg Bonds.[281] By the maturity date (June 30, 2020), Cred was aware of moKredit's 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,[282] thereby buying back more than $14 million dollars of debt it knew could not be repaid.[283] As discussed in the next section, Cred was facing an acute liquidity crisis of its own at the time of this purchase.

[278] *Id.*

[279] JST may have functioned as a broker/dealer, i.e., holding the bonds while attempting to sell them to other investors.

[280] Spreadsheet concerning W. Strong's investment (Exhibit 92).

[281] *See* Exhibit 2.

[282] Email chain between A. Khakoo, H. Ha, D. Inamullah, and M. Zhang, June 30, 2020 (Exhibit 42).

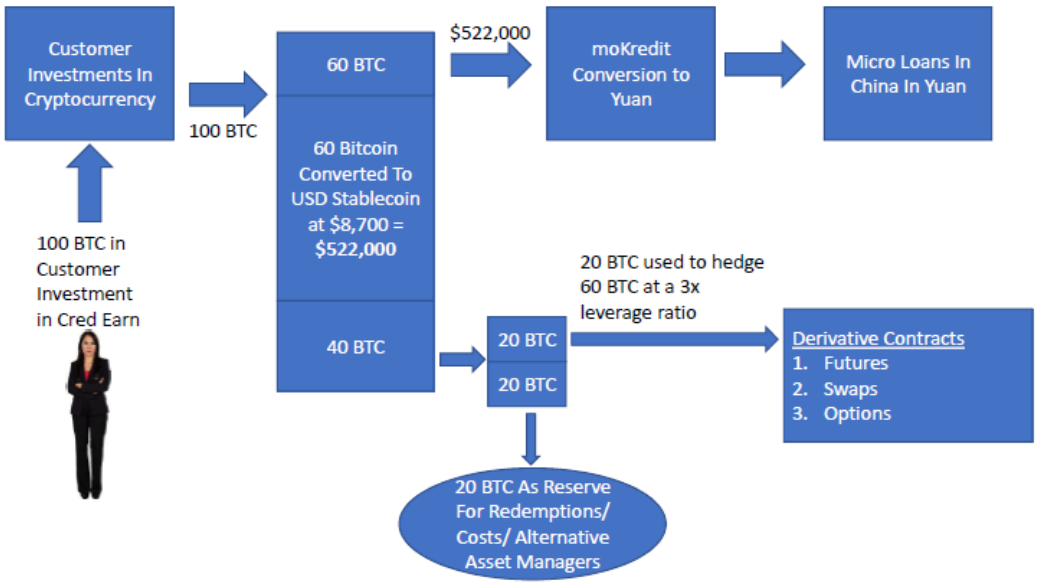
[283] Based on the terms of the Prospectus and Participation Agreements, it appears that Income Opportunities was responsible for redeeming the bonds at the maturity date and failure to do so would result in Income Opportunities' default. *See* Exhibit 2. However, the Examiner neither received nor reviewed the actual notes issued to investors, and therefore cannot say, with a reasonable degree of certainty, whether Cred had any obligation under the bonds.

C. Cred's Pre-Petition Losses and Liquidity Crisis.

1. JST Capital.

Notwithstanding representations to the market, Cred's actual business operations carried significant risks associated with the volatility of digital currency. Converting digital currency to fiat currency compounded that risk. Cred's practice was to do just that. As part of CredEarn, Cred converted customers' cryptocurrency to fiat currency and then loaned the proceeds to moKredit, which would, in turn, extend microloans (presumably far and wide) in fiat currency. Cred sought to mitigate the risk inherent in this strategy by hiring JST as a consultant to assist Cred with a hedging platform.[284] Illustration 1 below shows Cred's hedged investment strategy with respect to CredEarn.

Illustration 1



[284] Inamullah Dep. 105:8–14; 110:4–17 (Exhibit 9) ("[W]e're essentially taking cryptocurrency liabilities in the form of CredEarn participations and translating that into a dollar asset, which is – in moKred. Now, if crypto starts to rise, we will not be able to return the same number of cryptocurrency units back to the customer if we do not hedge the upside exposure.").

Illustration 1 explains by way of hypothetical. As part of the CredEarn program, Cred hypothetically received a 100 Bitcoin cryptocurrency investment from a customer. Cred then took 60 Bitcoin from that investment and converted it into a USD Stablecoin, which it then loaned to moKredit. moKredit, in turn, converted these funds to Yuan and loaned the proceeds to consumers through microfinance loans in China.

Not depicted in Illustration 1 are the payments from moKredit to Cred, which would be expected to come in the form of interest and principal repayments in USD Stablecoin. These payments from moKredit would then be converted back into Bitcoin, which Cred would use to make payments to the customer in respect of the 100 Bitcoin that had been transferred to Cred.

In the hypothetical above, the 60 Bitcoin is converted into USD Stablecoin at an exchange rate of $8,700. This yields $522,000 worth of USD Stablecoin. If the price of Bitcoin was fixed against the U.S. dollar (and did not change at all between the time when the 100 Bitcoin investment was initially made by the customer, and when then investment was fully repaid by Cred), then all interest payments and principal repayments would take place at the same exchange rate. In this scenario, Cred would not need any hedges because the exchange rate between Bitcoin and U.S. dollars remains constant.

However, the price of Bitcoin is not fixed against the U.S. dollar and can fluctuate, sometimes significantly, on a daily basis. If the price of Bitcoin were to increase against the U.S. dollar, then Cred would have less principal and interest to repay the customer. Conversely, if the

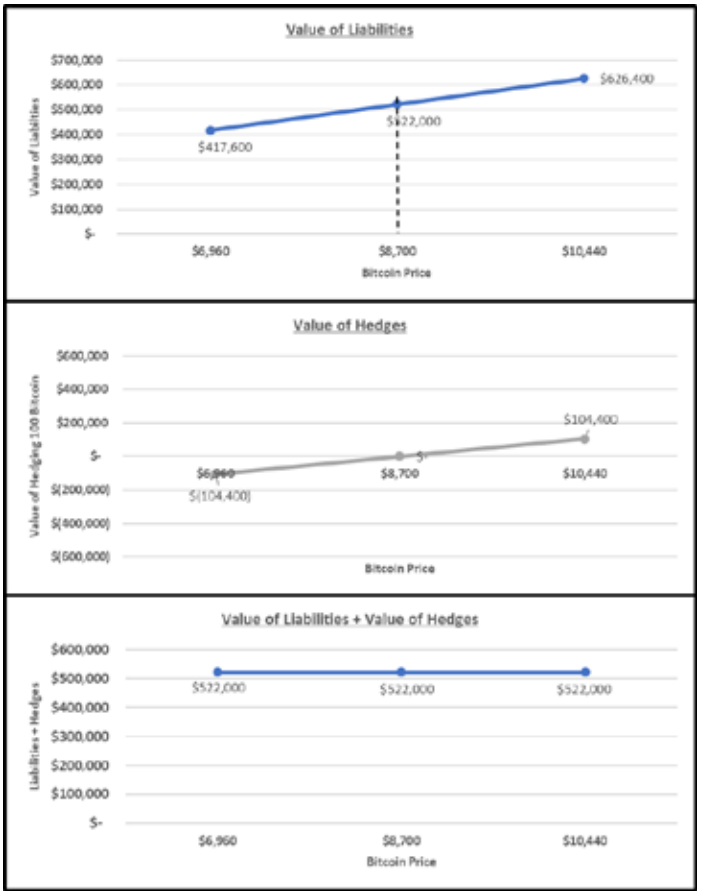
price of Bitcoin were to decrease against U.S. dollar, then Cred would have a surplus of Bitcoin and could repay the customer in full with an excess amount.[285]

Cred purported to minimize risks from fluctuations in the exchange rate. In an effort to achieve a fixed exchange rate, Cred purchased hedging contracts. The hedging contracts were intended to provide Cred with, in effect, a fixed exchange rate based on the time the customer deposited assets and the time Cred loaned the proceeds of such assets to moKredit.

Returning to Illustration 1, Cred used 20 Bitcoin out of the 100 Bitcoin investment to buy hedging contracts. These hedging contracts were generally in the form of futures, swaps, and options contracts. In the hypothetical, Cred used the 20 Bitcoin to buy futures and swaps contracts to fully hedge the 60 Bitcoin it had lent to moKredit. Because Cred was using 20 Bitcoin to hedge the 60 Bitcoin that it had lent out to moKredit, Cred was effectively using a leverage ratio of 3x to achieve this hedge. Illustration 2 below shows how the value of Cred's position would change with changes in the price of Bitcoin.

[285] This is similar to fluctuations in price a person who lives and works in the United States and earns in U.S. dollars would experience when trying to book a hotel in London. The price of the hotel in London would be quoted in British Pounds and therefore the price in U.S. dollars would fluctuate with changes in exchange rates between U.S. dollar and the British Pound. If the U.S. dollar went up in value against the British Pound, the hotel would be cheaper in U.S. dollar terms (i.e., it would take fewer U.S. dollars to book a night at the hotel). Conversely, if the U.S. dollar went down in value against the British pound, the hotel would be more expensive in U.S. dollar terms (i.e., it would take more U.S. dollars to book a night at the hotel). Staying with this example, if the exchange rate between the U.S. dollar and British Pound was 1:1 (meaning someone can purchase 1 British Pound using 1 U.S. dollar) and if one night at the hotel in London cost 100 British Pounds, the equivalent cost in U.S. dollars would be USD 100. However, if before the hotel room was booked the price of U.S. dollars went up by 5%, then the hotel room would be worth USD 95, even though the price in British Pounds was still 100 pounds. Similarly, if the price of U.S. dollars went down by 5%, then the hotel room would be worth USD 105, even though the price in British Pounds was still 100 pounds.

Illustration 2



Considering the first panel in Illustration 2, the 100 Bitcoin received by Cred is its liability since it has to pay this amount back to the customer at the end of the term of the loan. When the loan was made, Cred took 60 Bitcoin and converted it to USD Stablecoin at a rate of $8,700. In doing so it received $522,000 in USD Stablecoin. The first panel illustrates the change in value of the $522,000 as the value of Bitcoin changes. Without any hedges, if the price of Bitcoin were to drop by 20% to $6,960, Cred would need only $417,600 in USD Stablecoin to repay the 100 Bitcoin that the customer invested. Principal repayments from

moKredit would have been $522,000. Therefore, in this scenario, Cred would have a surplus. Conversely, if the price of Bitcoin were to increase by 20% to $10,440, Cred would need $626,400 in USD Stablecoin to pay the 100 Bitcoin. Since moKredit was paying only $522,000, in this scenario, Cred would have a loss.

The second panel illustrates the performance of the hedging contract. As the price of Bitcoin goes up or down, the value of the hedging contract also goes up or down proportionately.

The third panel illustrates the performance of both the 60 Bitcoin liability and the hedging contract. Because the hedge goes up in value on a dollar for dollar basis as the liability goes down, and similarly the hedge goes down in value on a dollar for dollar basis as the liability goes up, the net effect of both positions is that the value of the 60 Bitcoin when converted to USD Stablecoin, loaned to moKredit, returned back to Cred from moKredit and then converted back from USD Stablecoin into Bitcoin, does not change. The transaction is, in this example, considered effectively hedged.

Illustration 3 below demonstrates Cred's net profit and loss on the 100 Bitcoin investment from the customer in Illustration 2, after considering all hedges, interest payments received from moKredit, and interest payments made to the customer. As can be seen, Cred pays 10% to the customer on 100 Bitcoin, and receives 20% on the 60 Bitcoin from moKredit. Because the transaction is fully hedged, there are no profits or losses from any change in the price of Bitcoin. The net profit to Cred in this simplified example after paying interest and principal to the customer is 2 Bitcoin.

Illustration 3

All amounts are in Bitcoin	Principal	Annual Interest Rate	Interest at end of 1-year	Total (at end of 1-year)
Investment received from Customer	100			
Total Funds paid to Customer		10%	10	110
Funds sent to moKredit	60			
Funds received from moKredit net of hedges		20%	12	72
Reserve	20	0%	0	20
Margin returned after closing hedge	20			20
Total Funds Received				112
Profit/Loss (ignoring hedging costs and other operating costs)				**2**

In the simplified example above, once Cred has established its hedging position using 20 Bitcoin to hedge the 60 Bitcoin it had converted to USD Stablecoin, it was fully protected irrespective of any price movements in Bitcoin.

In reality, however, the hedge positions implemented by Cred only protected Cred from a certain amount of decline in Bitcoin prices. This is because, as the price of Bitcoin would decrease, the value of the hedge would become more and more negative. And, because of the 3x leverage, the 20 Bitcoin that had been used as collateral (also known as "margin") to acquire the hedge position would not be sufficient to continue maintaining the hedging position. If the price of Bitcoin were to fall below a particular threshold, the exchange where the hedge had been established could either: (i) issue a "margin call" that would require Cred to post additional collateral; or (ii) in the absence of additional collateral being posted, liquidate the hedge position.

If a hedge position was liquidated, Cred would first experience a loss on the hedge position and, if it was not able to reestablish the hedge position, it would no longer be able to repurchase Bitcoin at the price at which it had originally borrowed funds from the customer. As a result, if Bitcoin prices were to rise above the price at which Cred had borrowed from the

customer ($8,700 in the hypothetical above), assuming the hedge position was liquidated and not subsequently reestablished, then Cred would suffer a loss and may not be able to return the funds. As discussed further below, between March 11, 2020 and March 12, 2020, Bitcoin prices experienced a sharp decline (i.e., a "flash crash"), which ultimately resulted in the termination of Cred's hedges.

At this point, it bears particular observation that none of the risks associated with exchange rates were contractually allocated to any of Cred's customers. Cred did not, for example, covenant to certain levels of hedging responsibility, leaving customers to "own" losses beyond those levels. Rather, to the best of the Examiner's knowledge,[286] Cred assumed all risks associated with currency fluctuations. During interviews with Cred customers, the Examiner was told repeatedly that this was an important attribute of Cred's marketing appeal; it was, essentially, a commitment to customers that Cred would alone "own" this kind of market exposure.

To help implement its hedging strategy, Cred retained JST in late 2018.[287] JST helped Cred establish its hedges using swaps, futures and option positions,[288] and sent daily "Risk

[286] *See* n.3.

[287] JST Consulting Agreement, Dec. 25, 2018 (Exhibit 93).

[288] A swaps position is generally a contract where two parties agree to exchange cash flows from two different financial instruments. For example, an investor may agree to exchange principal and interest payments on a loan in one currency for payments and interest on a loan in another currency. A swaps position typically requires parties to post margin. If the value of the swaps position falls/rises below a certain threshold, the party that has experienced losses may need to post additional margin, in the absence of which the position would likely be liquidated by the counterparty. A futures position is generally a standardized contract that allows the parties to buy or sell a particular asset or security at a predetermined price at a specified time in the future. Like the swaps position, a futures position also typically requires parties to post margin. And like the swaps positions, if the value of the futures position falls/rises below a certain threshold, the party that has experienced losses may need to post additional margin, in the absence of which the position would likely be liquidated by the counterparty. An options position gives the owner of the option the right to either buy (call option) or sell (put option) the underlying position at a fixed price within a certain amount of time. The buyer of the option pays the seller of the option a "premium" for that right. The price of a call option goes up in value as the price of the underlying instrument increases. The price of a put option

Reports" to Cred, detailing Cred's hedge positions and Cred's exposure to liabilities based on Cred's cryptocurrency holdings.[289]

As of February 28, 2020, Cred had transferred digital assets valued at between $71.6 million (market value) and $74.7 million (inception value) to JST.[290] Once JST received the assets, they were allocated as follows:

- JST converted $44 million worth of cryptocurrency received from Cred into USD/Stablecoin (e.g., USDT), the majority of which was transferred to moKredit pursuant to loan arrangements with Cred;
- JST allocated/tracked funds to margin accounts of certain exchanges (including Bittrex, Huobi and Drawbridge) to allow JST to trade on behalf of Cred; and
- JST entered into options, futures and swap transactions for the purpose of hedging Cred's portfolios and generating cash for Cred.[291]

Based on the above allocation of funds, including the hedges established, Cred was essentially fully hedged on a $74.7 million loan book. Therefore, excluding large price movements that would require the posting of additional collateral in its margin account, Cred was protected from Bitcoin price movements.

JST established hedge positions on various cryptocurrencies for Cred.[292] Bitcoin, XRP, Ether and Bitcoin Cash were used to establish the majority of the positions. By February 28, 2020, the market value of Cred's hedge positions was: negative $4,511,511 for swaps,

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increases in value as the price of the underlying instrument decreases. The maximum loss to the buyer of the call and the put options is limited to the premium amount paid by the buyer to the seller of the option.

[289] Interview with Scott Freeman, co-founder and Partner, JST Capital (Mar. 2, 2021); *see, e.g.*, Risk Report, Mar. 12, 2020 (Exhibit 164).

[290] JST Risk Report, Feb. 28, 2020 (Exhibit 117).

[291] Exhibit 117; Emails between JST and Cred regarding a February invoice, Mar. 3, 2020 (Exhibit 121).

[292] BTC, XRP, ETH, BCH, LTC, XLM, OMG and ADA. *See e.g.,* Exhibit 117.

$12,664,998 for futures, and $61,760 for options.[293] The hedge positions, at different exchanges like BitMEX and Huobi, were tracked on the monthly risk reports provided by JST.

The following contracts were reported by JST in its February 28, 2020 risk report for Bitcoin:

SYMBOL	EXPOSURE	MARK PRICE	LEVERAGE	LIQUIDATION PRICE / MARGIN CALL PRICE	SPOT EQUIVALENT	BREAKEVEN PRICE*	LIQUIDATION / MARGIN CALL PROBABILITIES	
							2 DAYS	3 DAYS
BTC	0.00	$8,567						
XBTUSD	177.16	$8,569	33%	$5,795.13	$5,793.13	$5,795.13	0.00%	0.00%
XBTM20	1662.57	$8,814	34%	$6,174.44	$5,927.44	$5,816.28	0.00%	0.00%
XBTH20	839.51	$8,667	24%	$6,943.12	$6,843.12	$6,550.29	0.00%	0.02%
XBT-MARGIN	1188.61	$8,567						
BTC IMPLIED	(65.15)	$8,567						
BTC-Mar	335.02	$8,686	37%	$5,577.20	$5,458.20	$5,494.79	0.00%	0.00%
HUOBI-MARGIN	194.57	$8,567						
swap#24 3/24	282.00	$8,567						
3/27 9250 Call	(117.55)	$8,567						
Drawbridge-Margin	300.00	$8,567						
TOTAL	4,801.24							

As of February 28, 2020, Cred's swaps contract XBTUSD, listed on the BitMex exchange, had a mark price of $8,569 and liquidation price of $5,795.13.[294] XBTUSD is known as a "perpetual swaps" contract. This contract closely tracks the price of Bitcoin in U.S. dollars and gains and losses are experienced based on the change in the price of Bitcoin relative to U.S. dollars. This contract hedged Cred to a notional amount of 177.16 BTC ($1.5 million based on the Risk Report market price of $8,569) using a 3x leverage factor. In other words, Cred had applied approximately 59 BTC in its margin account to enter into the XBTUSD contract amount of 177.16 BTC. If Bitcoin dropped below $5,795.13, the hedge position would be liquidated which is exactly what occurred on March 12, 2020.

The other contracts for Bitcoin traded on the BitMex exchange identified in the JST risk report were "XBTM20" and "XBTH20." These two positions are futures contracts that expire at different dates. XBT-Margin of 1,188.61 Bitcoin reflected the total margin that was posted at the

[293] Exhibit 117.

[294] *Id.*

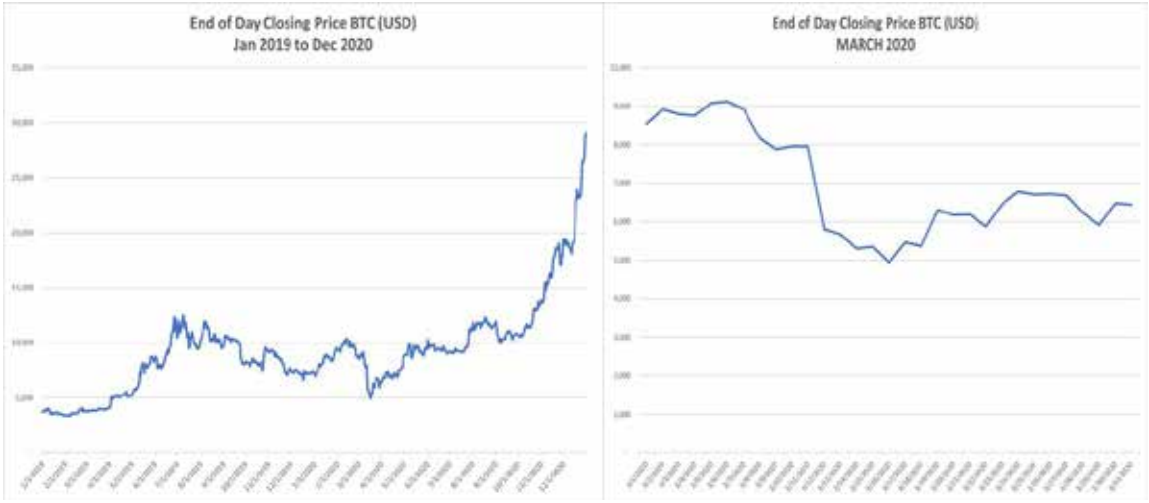
BitMex exchange. "BTC-Mar" was a futures contract traded on the Huobi exchange. "BTC-Implied" was a contract that referenced XRP (instead of U.S. dollars) and also traded on the Huobi exchange. Huobi-Margin of 194.57 was the total Bitcoin in the Huobi margin account.

"Swap#24 3/24" was a bilateral repurchase obligation between Cred and JST. In this contract Cred deposited 282 Bitcoin with JST and Cred loaned funds to JST on an over-collateralized basis in U.S. dollars.

The contract "3/27 9250 Call" was a call option that Cred had sold that was held with an asset manager (Drawbridge), but tracked by JST in its risk report. The "Drawbridge-Margin of 300 Bitcoin" reflected the total Bitcoin that Cred had deposited with Drawbridge.

JST had similar hedging contracts for the other cryptocurrencies as well. Each of these contracts had a price at which they would be liquidated or require additional collateral to be posted to their margin accounts. Using Bitcoin as an example, the liquidation prices for these contracts varied by contract and was between $5,500 and $6,900. This meant that, if the price of Bitcoin were to drop from the February 28, 2020 price of approximately $8,500 such that the contract prices were to decrease to their liquidation price (implying drops of more than 20%), then the contracts would be liquidated if no additional collateral was deposited into the margin accounts. The charts below illustrate the price of Bitcoin in 2019 and 2020 as well as in March 2020:[295]

[295] BTC-USD prices from CoinDesk.



Between March 11 and March 12, 2020, the price of Bitcoin fell from $7,900 to $3,800 overnight. As a result of this price drop, the hedge contracts for all currencies were liquidated. JST's March 17, 2020 risk report illustrates the loss suffered by this dip in the market, with each exposure listed as "0" in the chart below.[296]

SYMBOL	EXPOSURE	MARK PRICE	LEVERAGE	LIQUIDATION PRICE / MARGIN CALL PRICE	SPOT EQUIVALENT	BREAKEVEN PRICE*	LIQUIDATION / MARGIN CALL PROBABILITIES	
							2 DAYS	3 DAYS
BTC	0.00	$5,297						
XBTUSD	0.00	$5,298						
XBTM20	0.00	$5,167						
XBTH20	0.00	$5,224						
XBT-MARGIN	95.44	$5,297						
BTC-IMPLIED	(66.82)	$5,297						
BTC-Mar	0.00	$5,260						
HUOBI-MARGIN	0.00	$5,297						
swap#24 3/24 12.5%	282.00	$5,297						
3/27 9250 Call	(0.00)	$5,297						
Drawbridge-Margin	300.00	$5,297						
TOTAL	610.61							

When the price of Bitcoin fell, Cred lacked sufficient reserves to maintain its hedging positions.[297] On March 12, 2020, JST informed Cred that a drastic overnight move in the markets resulted in the liquidation of all of Cred's Bitcoin futures positions, in addition to the

[296] JST Risk Report Mar. 17, 2020 (Exhibit 118).

[297] Schatt Decl. ¶ 21 (Exhibit 1).

liquidation of some of Cred's XRP futures.[298] Cred's futures profit and loss went from a profit of $12.6 million as of February 28th to a loss of $5.8 million as of March 17th.[299] Similarly, Cred's Swaps profit and loss went from a loss of $4.5 million on February 28, 2020 to a further loss of $10.5 million as of March 17, 2020.[300] The total losses resulting from the "flash crash," as reflected in the change in values in its futures and swaps positions between February 28th and March 17th, was approximately $24 million.[301]

As discussed, Cred had placed margin in various accounts at JST and at exchanges to support its hedging positions.[302] The rapid decline in cryptocurrency prices caused Cred to be overleveraged beyond what was supportable by its margin position, and its futures and swaps positions were, as a result, liquidated by the exchanges.[303] Cred was left with a net short position equal to $27,483,181; for every $100 move in Bitcoin, Cred stood to make or lose approximately $400,000.[304] Further, JST asked Cred to post an additional $3 million of collateral for the outstanding repos that Cred had with JST.[305] At some point in March 2020, Cred ceased using accounts at JST.[306]

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[298] Email from S. Freeman to J. Alexander, H. Ng, D. Schatt, J Podulka, S. Zhang, and D. Inamullah, Mar. 12, 2020 (Exhibit 119).

[299] *Compare* Exhibit 117 *with* JST Risk Report, Mar. 12, 2020 (Exhibit 164).

[300] *Compare* Exhibit 117 *with* JST Risk Report, Mar. 12, 2020 (Exhibit 164).

[301] *Compare* Exhibit 117 *with* JST Risk Report, Mar. 12, 2020 (Exhibit 164).

[302] Email from J. Alexander to D. Inamullah, Mar. 18, 2020 (Exhibit 120).

[303] Inamullah Dep. 105:15-20 (Exhibit 9).

[304] Exhibit 119.

[305] *Id.*

[306] Chat messages between S. Zhang, Han LNU and S. Hwang, Aug. 20, 2020 (Exhibit 165) (Zhang comments that Cred stopped using all JST accounts on March 31, 2020. There is a conversation regarding the disposition of the assets that were held at JST. Han LNU notes that D (Inamullah's nickname) said: "we had some assets to go to FB [Fireblocks]. Most of what we had outstanding was liquidated (i.e., the swaps, futures, and options margin)." There is some confusion as to whether Cred's relationship with JST ended on March 10 or March 31, 2020).

The table below summarizes the losses that Cred experienced from its hedge positions as a result of the March 2020 "flash crash." For example, as of March 11, 2020, the total margin at two of the three Bitcoin margin accounts at JST totaled 977 Bitcoin (excludes 300 Bitcoin at the Drawbridge margin account, which was used for a covered call strategy). After the "flash crash," only 90.4 Bitcoin remained on margin in these two margin accounts combined.[307] As a result, Cred lost 866 Bitcoin from these two margin accounts alone.[308] As illustrated below, based on the mark prices in the JST risk reports from March 11th and 12th, the total loss across all margin accounts at JST was 1,130 Bitcoin.[309]

Calculation of Margin lost as a result of Flash Crash in March 2020

Currency		11-Mar-20	12-Mar-20	Diff	Change in USD 3/11/2020 Prices	Change in USD 3/12/2020 Prices
BTC	Mark Price	7,838	5,872	1,966		
BTC	XBT-Margin	882	90.4	791	$ 6,201,112	$ 4,645,692
BTC	Huobi-Margin	95	-	95	$ 742,964	$ 556,607
BTC	Drawbridge-Margin	300	300	-		
XRP	Mark Price	0.2069	0.1545	0.0524		
XRP	Huobi-Margin	4,586,658	-	4,586,658	$ 948,980	$ 708,639
ETH	Mark Price	196.50	130.1	66.40		
ETH	ETH-Margin	21,468	16,815	4,653	$ 914,342	$ 605,374
BCH	Mark Price	265	169	96		
BCH	BCH-Margin	1,595	1,041	554	$ 146,979	$ 93,794
LTC	Mark Price	48.3	32.0	16.3		
LTC	LTC-Margin	1,187	446	741	$ 35,774	$ 23,701
XLM	Mark Price	0.0505	0.0357	0.0148		
XLM	Options Margin	16,000,000	16,000,000	-		
Total (USD)					$ 8,990,150	$ 6,633,806
Total (BTC)					1,147	1,130

Sources: JST Risk Report, Mar. 11, 2020 (Exhibit 152); Exhibit 164.

[307] JST Risk Report, Mar. 17, 2020 Exhibit 118.

[308] *Id.*

[309] *Id.*

The table below summarizes the repo positions that Cred maintained with JST. As discussed above, JST issued margin calls and demanded that Cred post additional collateral on these repo positions. For the reasons discussed herein, Cred lacked the assets to satisfy JST's margin call and, as a result, JST liquidated these positions. The liquidation of these positions resulted in additional losses to Cred. The total amount due to JST from Cred after considering the repo positions and certain option positions net of the cryptocurrency margin Cred had deposited with JST (and which JST had liquidated) was approximately $3 million.[310]

Currency	Repo Positions	Quantity	Price in USD (March 17, 2020)	USD
BTC	Swap #24 3/24 12.5%	282	5,297	$ 1,493,754
XRP	Swap #21 4/13 7.5%	14,187,651	0.15	$ 2,099,772
XRP	Swap #22 3/16 9.5%	20,000,000	0.15	$ 2,960,000
ETH	Swap #9 open 11%	14,367	117	$ 1,675,192
BCH	Swap #13 open 9.5%	9,472	181	$ 1,714,472
Total				**$ 9,943,190**

Source: Exhibit 118.

On April 5, 2020, Inamullah circulated a Cred LLC liquidity analysis prepared by Cred Capital.[311] The report outlined a liquidity analysis and recommended steps following the March 2020 "flash crash." The futures and swaps positions had been a hedge to protect Cred from an increase in the prices of cryptocurrencies.[312] When Cred's futures and swaps positions were liquidated, however, Cred lost funds in its margin accounts at JST, as well as lost its hedging

[310] JST Cred Exposure Summary (Exhibit 181).

[311] Liquidity Analysis Post March 2020 Flash Crash and Recommended Steps, Apr. 5, 2020 (Exhibit 113).

[312] Email from J. Alexander to D. Inamullah, Mar. 18, 2020 (Exhibit 120).

positions (i.e., the right to purchase the underlying assets at the agreed price).[313] Further exacerbating the problem, Cred lacked sufficient liquidity to reinstate the hedging positions at a reasonable market price.[314] JST issued margin calls for outstanding repo positions, but Cred did not have sufficient liquidity to meet those demands.[315]

Cred intended to reinstate its hedge position by recalling $10 million from moKredit.[316] As discussed further in Section V(B)(3), moKredit did not pay Cred the requested amount. Hua, however, agreed to transfer 300 Bitcoin to Cred in multiple transactions (discussed further in Section V(E)). The 300 Bitcoin was transferred from a Fireblocks wallet at Cred, Inc. to OKEx,[317] and purportedly used to re-appropriate certain hedges on the long side of Bitcoin in March, while Bitcoin prices were still at the bottom of the market.[318] It appears, however, that Cred closed out these hedge position shortly thereafter (at a small profit) and, according to Inamullah, determined that, because they had terminated their relationship with JST, they no longer had the ability/skillset to apply hedges using the derivatives market, leaving Cred effectively "naked" against market fluctuations.

Cred being "naked" against market fluctuation was a significant factor in Cred's demise. Though Cred lost approximately $10-$12 million when its positions were liquidated, Cred's liabilities effectively decreased two-fold as a result of the >50% drop in Bitcoin price. This is because, instead of being able to buy one Bitcoin for $7,900 on March 11, 2020, Cred could buy

[313] Exhibit 120.

[314] Exhibit 113.

[315] *Id.*

[316] *Id.*

[317] Cred, Inc Fireblocks logs (Exhibit 124).

[318] Inamullah Dep. 167:3-19; 188:11-14 (Exhibit 9).

a bit more than two Bitcoin for $7,900 on March 12, 2020. Had Cred had access to the $9 million it needed to establish new hedges at 3x leverage, Cred could have made significant profits on the new hedge positions, both because of establishing the new hedges after the drop in Bitcoin price and the increase that followed in the coming months. These profits from the hedge positions could then have netted out against the losses on Cred's liability positions (Cred's liability position would also go up in U.S. dollar terms as the price of Bitcoin went up). However, because so much of its liquidity was tied up in moKredit, and because Cred had a month earlier given 500 in Bitcoin to QuantCoin, Cred did not have the capital to establish new hedges. Thus, with every increase in Bitcoin (and other cryptocurrency) above Cred's conversion price, Cred's liabilities increased proportionately against a class of assets – loans to moKredit – that Cred never realized. In the months that followed, Bitcoin prices increased from approximately $4,000 in March 2020 to approximately $10,000 in June 2020. Cred's inability to access moKredit capital disabled it from fending off its increasing liability load, until it finally collapsed into bankruptcy.

2. Cred's Other Asset Managers.

(a) **Elevar.**

Cred established a relationship with Elevar LLC ("**Elevar**"), a secondary lending company, in October/November 2019.[319] In the summer of 2019, Schatt instructed Cred employees to seek other income-generating opportunities in order to diversify Cred's portfolio, and Elevar became Cred's first partner toward that end.[320] Inamullah recalled that Alexander

[319] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[320] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

and the founder of Elevar knew each other before Cred's relationship with Elevar began.[321] Under its relationship with Elevar, Cred would lend Elevar cryptocurrency assets (and occasionally fiat currency) at interest rates as high as 16% on an annual basis.[322] Elevar would utilize such assets in lending transactions with consumer lending and telecom receivable finance companies.[323] Inamullah stated that he did not know who at Cred, if anyone, conducted any form of diligence on Elevar before Cred entered into its arrangement.[324] By May 31, 2020, Cred had an asset allocation worth $1,850,000 with Elevar.[325] By September 2020, moKredit and Elevar were described as Cred's only "sources" of finance.[326] On November 12, 2020, Cred attempted to recall its funds with Elevar.[327] However, based on Cred's contract with Elevar, it was not able to access such funds until February 2021.[328]

(b) **Cambrian**

Cambrian is an asset manager whose fund (Cambrian Systematic Strategies, LP) Cred contributed or "subscribed" to.[329] Cred entered into a subscription agreement with Cambrian on July 29, 2019,[330] and wired a $500,000 investment to Cambrian on July 30, 2019.[331] Cred

[321] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[322] Interview with Pablo Bonjour and Paul Maniscalco, Managing Director and Senior Managing Director, MACCO Restructuring Group (Feb. 12, 2021).

[323] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[324] *Id.*

[325] Email from J. Podulka to D. Schatt, July 24, 2020 (Exhibit 94).

[326] Email from D. Inamullah to D. Schatt, A. Khakoo, and J. Podulka, Sept. 16, 2020 (Exhibit 95).

[327] Email from D. Schatt to J. Podulka, Nov. 14, 2020 (Exhibit 96).

[328] Email from D. Inamullah to J. Podulka and D. Schatt, July 13, 2020 (Exhibit 97).

[329] Email chain between J. Podulka, H. Moore, G. Estrada, S. Hwang, H. Ha, Nov. 5, 2020 (Exhibit 98); Cred LLC Subscription Agreement with Cambrian Systematic Strategies LP, July 29, 2020 (Exhibit 99).

[330] Exhibit 99.

[331] Chat log between S. Zhang and J. Alexander, July 30, 2019 (Exhibit 100).

indicated that this figure constituted 1% of the Company's total assets at that time.[332] Inamullah did not personally interface with Cambrian and believed that Alexander led the due diligence on the company.[333] Cred received quarterly statements from Cambrian,[334] and withdrawals were subject to a 30-day notice period.[335] Cred's full redemption of its investment in Cambrian Systematic Strategies, LP was confirmed on January 31, 2020.[336] Cred recalled its assets from Cambrian because Alexander was purportedly unhappy with Cambrian's performance, and because Cred wanted to move assets to another asset manager, 100 Acre Ventures.[337] On February 21, 2020, Cred withdrew 95% of its investment in Cambrian,[338] with the remaining 5% to be wired to Cred upon the finalization of Cambrian's 2020 audit.[339] As of November 5, 2020, Podulka did not believe that Cred had received the remaining 5% of its investment from Cambrian.[340]

(c) **100 Acre Ventures**

Cred began investing with 100 Acre Ventures, a cryptocurrency investment firm, beginning in or around April 2020 on Alexander's recommendation.[341] Inamullah stated that he oversaw the due diligence process for onboarding 100 Acre Ventures, which purportedly

[332] Exhibit 99.

[333] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[334] Chat log between S. Zhang and J. Alexander, Feb. 14, 2020 (Exhibit 184); Cambrian Systematic Strategies LP Quarterly Statement, Sept. 30, 2019 (Exhibit 101).

[335] Email from S. Zhang to J. Alexander, Feb. 6, 2020 (Exhibit 102).

[336] Redemption Confirmation, Jan. 22, 2020 (Exhibit 103).

[337] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[338] Metropolitan Commercial Bank Account Statement, Feb. 28, 2020 (Exhibit 104).

[339] Email from HC Global Fund Services to D. Schatt, Feb. 21, 2020 (Exhibit 105).

[340] *Id.*

[341] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021); 100 Acres Ventures Mission Page, https://www.100acreventures.com/mission (last visited Mar. 4, 2021).

included the exchange of standard corporate documents.[342] Inamullah said that, when Bethany De Lude joined Cred as Chief Information Security Officer in the summer of 2020, she identified deficiencies in the firm's diligence responses and initiated a second round of diligence.[343] Cred paid a 1-2% management fee and 10-20% incentive fee to 100 Acre Ventures for its asset management services.[344] Cred's Adnan Khakoo emailed 100 Acre Ventures to request a full redemption of Cred's assets on June 29, 2020.[345] However, as of October 2020, 100 Acre Ventures owed Cred approximately $1 million.[346]

(d) **Sarson Funds**

Sarson Funds LLC is a third-party marketing company that does not directly manage assets or provide investment advice; rather, the organization is structured in such a way that different entities carry out investing activities and Sarson Funds markets those entities' investment strategies.[347] However, Cred considered Sarson Funds to be the functional equivalent of an asset manager.[348] Sarson Funds also provided certain technical services to Cred.[349] Inamullah proposed Cred engage Sarson Funds to the "investment committee,"[350] and claimed

[342] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[343] *Id.*

[344] *Id.*

[345] Email from A. Khakoo to P. Collins, June 29, 2020 (Exhibit 106).

[346] Email from D. Inamullah to D. Schatt, J. Podulka, D. Wheeler and A. Khakoo, Oct. 1, 2020 (Exhibit 112).

[347] Inamullah Dep. 207:9–208:10 (Exhibit 9).

[348] *Id.* at 205:17–22.

[349] *Id.* at 25:3–26:2; 205:17–21.

[350] *Id.* at 95:11–15.

that he conducted due diligence with respect to the firm.[351] Inamullah now works for Sarson Funds as its Chief Investment Officer.[352]

In March 2020, Cred invested in two Sarson sub-funds: Fifth Khagan, LP,[353] a small coin/small token fund, and AX Momentum, LP, a covered call options fund.[354] Sarson Funds is the general partner of these funds.[355] The premise of Fifth Khagan was to send Sarson Ethereum and invest in products that would outperform Ethereum in the long run.[356] AX Momentum involved selling an out-of-the-money call against Bitcoin to make premium income and then permitting the call to expire or buying it back in accordance with specific parameters.[357] According to Matthew Foster, Cred represented a large portion of the investments in AX Momentum and Fifth Khagan, and profited from those investments.[358] Sarson used an administrator to provide Cred with daily reports on the performance of its investments.[359] Cred allegedly grew its assets by $4 million with Sarson and 100 Acre Ventures between April 2020 and August 2020.[360]

On November 14, 2020, Brittany Keels of Sarson contacted Sundrania—a cloud based fund administration service Sarson used to prepare statements and keep track of its funds—

[351] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[352] *Id.*

[353] Exhibit 14.

[354] Inamullah Dep. 208:24–209:1 (Exhibit 9); Exhibit 14; Exhibit 15.

[355] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 9, 2021).

[356] Inamullah Dep. 89:21–90:1 (Exhibit 9).

[357] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[358] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 9, 2021).

[359] Inamullah Dep. 100:13–16 (Exhibit 9).

[360] Email from J. Podulka to D. Schatt, Aug. 8, 2020 (Exhibit 107); Email from J. Podulka to D. Schatt, Aug. 28, 2020 (Exhibit 108).

investor support seeking to withdraw 75 Bitcoin (approximately $1.2 million at that time) from Cred's AX Momentum account. A 30-day notice period was waived in order to provide Cred with a redemption of 75 Bitcoin on November 30, 2020, and a withdrawal of the remainder of Cred's assets at the end of 2020.[361]

On January 6, 2021, Foster emailed John Sarson giving formal notice that Cred wished to redeem its investments in both the AX Momentum and Fifth Khagan funds.[362] Foster explained that Cred's initial agreement with Sarson required the Company to give Sarson 120 days' notice before retrieving funds. According to Foster, Cred retrieved $4 million worth of Bitcoin in early February 2021, and expected additional returns of $1.5 million in Bitcoin by the end of February, the remainder at the end of March 2021.[363] The Examiner has been advised that Sarson Funds redeemed an additional $1.5 million of Bitcoin in early March 2021.

(e) **Blockfills**

Blockfills is an electronic, off exchange, digital liquidity provider. Blockfills utilizes a so-called "alpha strategy" with respect to its investments.[364] Under this strategy, Blockfills seeks to arbitrage the price difference of its digital currencies and derivatives based on these currencies across various exchanges. As such, the strategy did not rely on the market moving in a particular direction, but rather attempted to make an arbitrage profit independent of market conditions. The risk lay in the technology to be able to execute the arbitrage since, ideally, the arbitrage trades needed to be applied simultaneously across exchanges. Inamullah claims to have conducted

[361] Email from J. Sarson to D. Schatt, A. Khakoo, Nov. 17, 2020 (Exhibit 109).

[362] Email from M. Foster to J. Sarson, Jan 6, 2021 (Exhibit 110).

[363] Interview with Matthew Foster, Chief Restructuring Officer, Cred Inc. (Feb. 9, 2021).

[364] Inamullah Dep. 47:3–7 (Exhibit 9).

diligence regarding Blockfills consisting of a review of corporate organizational documents and information requests regarding beneficial owners.[365] But, unlike most of Cred's asset managers, Blockfills was considered an "offshore" fund and, so, Cred (principally through Dan Wheeler) took additional steps in an effort to make sure it could enforce its agreements with Blockfills.[366] Cred profited from its investments with Blockfills, albeit at lower than originally estimated (8%-10% yield, rather than an estimated 20% yield).[367]

(f) **Drawbridge Lending**

Cred entered into an investment arrangement with Drawbridge Lending in early 2020. Inamullah does not recall Cred having conducted any material diligence on Drawbridge prior to entering into its investment. Drawbridge's model was to act as a fund to run covered calls against Cred's cryptocurrency, including Bitcoin.[368] For example, under the strategy, if Bitcoin was trading at $10,000, Cred sold its covered call options at a strike price of $12,000 for a 3-month term and received a premium for the same (e.g., a premium of $1,500); the idea being that Cred would keep the full premium if the price of Bitcoin stayed below the strike price of $12,000 by the time the call option expired.[369] Records reviewed by the Examiner indicate that Cred entered into only one transaction with Drawbridge, which was closed out by March 2020.[370]

[365] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 23, 2021).

[366] *Id.*

[367] *Id.*

[368] *Id.*

[369] *Id.*

[370] *Id.*

3. Cred Develops, But Does Not Implement, the So-Called "All-Weather" Strategy.

In November 2019, in an apparent response to Cred's significant reliance on (and thus exposure to) moKredit, Cred's "investment committee" developed a so-called "all-weather" investment strategy.[371] Under this strategy (purportedly modeled after a strategy developed by hedge fund manager Ray Dalio[372]), Cred would utilize a mixture of lending, hedging, and arbitrage strategies, with the goal of earning a profit regardless of whether cryptocurrency prices increased or decreased, as had been promised to customers. As part of this strategy, Cred was willing to trade expected yield by recalling principal from moKredit for liquidity – which would, in turn, reduce weighted average return of the loan portfolio for Cred – by allocating more assets to its investment managers.[373]

Although Cred's target allocation rates changed over time, the strategy emphasized diversification and a move away from direct lending and avoiding credit risk.[374] But, following moKredit's inability to repay principal in March 2020, Cred created an internal liquidity analysis dated April 5, 2020 that promoted a heavier reliance on the "all-weather" strategy (although by that time, as described in greater detail herein, a shift in strategy may have been too late) and Cred was unable to fully implement this strategy due to Cred's persisting liquidity issues. [375]

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[371] Inamullah Dep. 117:4–16 (Exhibit 9) (describing the strategy as a "diversified allocation of four or five different types of allocations that Cred should diversify assets into").

[372] Inamullah Dep. 117:4–16 (Exhibit 9); Brett Arends, *Opinion: How did these 'All-Weather' portfolios weather 2020?* MarketWatch (Dec. 21, 2020) (Exhibit 111).

[373] Cred LLC Investment Committee: Liquidity Analysis, Apr. 5, 2020 (Exhibit 113)

[374] Email with attachments from D. Inamullah to D. Schatt, H. Ng, J. Podulka, S. Zhang, and J. Alexander, Feb. 12, 2020 (Exhibit 114); Cred Asset Management Overview at 3, Aug. 2020 (Exhibit 115).

[375] Exhibit 113.

D. Cred's Relationship with QuantCoin.

1. Inception of Relationship.

Further exacerbating the liquidity crisis, Cred, beginning in February 2020, transferred (via a "lockup" agreement) 800 Bitcoin to an entity named QuantCoin, in what Cred alleges was a fraudulent scheme. Cred has, to date, lost the entirety of this investment.

Cred's initial contact with QuantCoin occurred at the Consensus Conference, an "annual gathering of the cryptocurrency and blockchain technology world," in May 2019.[376] There, James Alexander allegedly met Richard Chapman, QuantCoin's purported portfolio manager.[377] According to Joe Podulka, Alexander is the only person who ever met Chapman in person.[378] According to Cred, QuantCoin purported to use a derivatives-based strategy to provide investors with a return of 20-30% per year.[379]

Alexander first mentioned QuantCoin to Dan Schatt in December 2019.[380] According to Alexander, it was Schatt who brought QuantCoin to Alexander;[381] the Examiner is not aware of any evidence corroborating this assertion. At the time, QuantCoin was presented as a strong investment opportunity and, according to Schatt, Alexander indicated that he was performing diligence on the company.[382]

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[376] Consensus: 2019, Coindesk, https://www.coindesk.com/events/consensus-2019 (last visited Mar. 4, 2021).

[377] The record does not reveal who else, if anyone, from Cred attended the conference. Inamullah Decl. ¶ 19 (Exhibit 6); Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[378] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[379] Inamullah Decl. ¶ 20 (Exhibit 6).

[380] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[381] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[382] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

According to Alexander, Schatt served as a reference for QuantCoin and insisted that Cred invest significantly and immediately.[383] Available documents, however, do not support Alexander's version of events. On February 2, 2020, Chapman sent Alexander an email stating, "[s]ince meeting you at the consensus, our performance here exceeded our expectations and the numbers are looking even better than they did when I shared them with you then," and requested a call to discuss "possible collaboration" with Cred.[384] The email exchange indicates that Chapman and Alexander, who were both purportedly traveling in Europe at the time, met in Paris that week to discuss a potential investment by Cred in QuantCoin.[385] Following the meeting, on February 3, 2020, Alexander told Chapman that Cred would move forward with a 500 Bitcoin investment and asked Chapman to provide the offering documents for a February subscription.[386]

In February 2020, Alexander informed Cred's "investment committee" of the potential opportunity with QuantCoin. Based on Alexander's representations and purported due diligence, the "investment committee" approved QuantCoin to manage a portion of Cred's Bitcoin.[387]

The Examiner received conflicting accounts regarding the use of a third-party to conduct due diligence on QuantCoin. It is unclear what, if any, diligence Cred performed on QuantCoin or Richard Chapman prior to making its investments. Schatt claims that Alexander completed due diligence himself; Podulka could not confirm what, if any diligence, was conducted (other than indicating that Alexander did not typically conduct thorough background searches with

[383] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[384] Email chain between J. Alexander and R. Chapman, Feb. 2, 2020 (Exhibit 125).

[385] *Id.*

[386] Email from H. Ng to S. Foster, J. Alexander, S. Zhang, R. Chapman and L. Tabers, Feb. 5, 2020 (Exhibit 126).

[387] Schatt Decl. ¶ 32 (Exhibit 1).

respect to investment opportunities); Inamullah represented that Cred retained a third-party to perform diligence, but the Examiner has not been furnished with evidence corroborating this assertion.[388]

As detailed below, Cred made several investments with QuantCoin, totaling 800 Bitcoin in the aggregate, over several months. Although Cred's capital markets team (at the time, led by Inamullah) was typically responsible for periodically reviewing asset managers, [389] Inamullah did not conduct additional due diligence on QuantCoin following Cred's initial investment, indicating that "there [was] no reason not to believe the original diligence" because Cred's second placement with QuantCoin occurred only ten days after its first.[390] Inamullah stated that he had searched the email addresses provided for QuantCoin representatives on Google and found a "slash page" for at least one.[391]

After Cred's initial Bitcoin transfer to QuantCoin in early February, Alexander emailed Ryan Ortega, a consultant hired by Alexander, on February 11, 2020, seeking diligence support on three asset managers, including QuantCoin. Alexander stated that "we scrambled to make these initial allocation *[sic]* and I need to ensure we didn't miss anything."[392] Although Ortega

[388] Inamullah Decl. ¶ 19 (Exhibit 6). Ryan Ortega may have been the third-party diligence provider used by Alexander. *See* Email from R. Ortega J. Alexander, Mar. 10, 2020, (Exhibit 127) ("Thanks for your time and effort on sourcing and screening managers."); Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[389] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb 16, 2021); Inamullah Dep. 180:12–16 (Exhibit 9).

[390] Inamullah Dep. 152:6–10 (Exhibit 9).

[391] *Id.* at 152:22–153:5.

[392] Exhibit 127.

agreed to assist Alexander, the Examiner has not been furnished with any evidence that Ortega carried out any due diligence work for Alexander or Cred.[393]

Cred's server contained minimal documents regarding the QuantCoin investment and no evidence of material due diligence.[394] Cred apparently did not create a written process governing transfers of funds to outside parties until a few months after the QuantCoin transfers.[395] Further, Cred's General Counsel, Dan Wheeler, did not review the QuantCoin contract before Cred executed it.[396] In fact, Wheeler stated he had never even heard of QuantCoin until after Cred uncovered the alleged fraud (discussed below).[397]

2. Chronology of Material Events Involving Cred and QuantCoin.

(a) On February 4, 2020, Cred executed a subscription agreement with Quanta Capital Feeder Fund, L.P.[398] Schatt signed the agreement authorizing a subscription of 500 Bitcoin in QuantCoin on behalf of Cred, which listed Joe Podulka, Sally Zhang, and James Alexander as additional relationship contacts.[399] Alexander and Chapman subsequently agreed upon certain additional terms via email on February 5, 2020 to be contained in a side letter.[400] The agreement provided that transfers to QuantCoin and interest payable by QuantCoin would be denominated in Bitcoin to avoid translation.[401]

(b) On February 5, 2020, while setting up Cred's initial subscription with QuantCoin, Chapman emailed Alexander to loop in his "admin," a person whom Chapman

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[393] *Id.*

[394] *See* Email from D. Inamullah to J. Podulka and D. Schatt, July 13, 2020 (Exhibit 128) (Inamullah told Podulka he cannot find the fee documents for QuantCoin. It is unclear if these have ever been located); Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[395] Inamullah Dep. 153:25-154:5 (Exhibit 9).

[396] Interview with Daniel Wheeler, former General Counsel, Cred Inc. (Feb. 12, 2021).

[397] *Id.*

[398] Quanta Capital Subscription Agreement, Feb. 4, 2020 (Exhibit 129)

[399] *Id.*

[400] *Id.*

[401] Email from J. Alexander to D. Inamullah and S. Zhang, Mar. 10, 2020 (Exhibit 130).

identified as Scott Foster of Kingdom Trust.[402] Although Kingdom Trust's website lists a Scott Foster as a financial services professional with over 25 years of experience, the Examiner has not been furnished with any evidence indicating that this real Scott Foster was in any way involved with QuantCoin. Chapman asserted that "Foster" would serve as the digital asset custodian and account administrator for the Cred account.[403]

(c) On February 5, 2020, "Foster" sent Inamullah an email that included a wallet address and transfer instructions for the first Bitcoin transfer.[404] Upon receiving the address and instructions, Alexander asked a Cred employee, Sally Zhang, to process the transaction.[405] Another Cred employee, Heidi Ng, sent a test transaction of 0.01 Bitcoin and "Foster" confirmed receipt. Ng then transferred the remaining 499.999 BTC via BITTREX to the wallet address provided by "Foster."[406] Cred completed its initial transfer of 500 Bitcoin to QuantCoin on February 5, 2020,[407] valued at $4,806,710 at the time.[408]

(d) On February 13, 2020, Inamullah sent an email to Chapman inquiring whether QuantCoin required additional paperwork for a further allocation of Bitcoin.[409] Chapman replied that it did not.[410] "Foster" once again provided the wallet address for the transaction, which Inamullah sent to Fireblocks to be "whitelisted," and sent a deposit address image to "Foster" as a security measure to "prevent swap attacks."[411] After "Foster" confirmed the address and receipt of a test transaction for 0.01 Bitcoin, Inamullah executed a transfer of an additional 200 Bitcoin over two separate transactions: 80 Bitcoin on February 13, 2020 (valued at $817,150); and 120 Bitcoin on February 18, 2020 (valued at $1,217,040).[412]

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[402] Exhibit 126.

[403] *Id.*

[404] Email from S. Foster to D. Inamullah, Feb. 13, 2020 (Exhibit 131).

[405] *Id.*

[406] Exhibit 126 (Wallet address: 1HhGiE2JgUqweztdjpd5prpSt3YSkMs5Gk); Transaction Log, Feb. 5, 2020 (Exhibit 132) (Source address: 17Nk1hu2VPRREuANREgASdVyF1HcbY1kJf).

[407] Exhibit 126.

[408] Exhibit 25 at 23.

[409] Exhibit 131.

[410] *Id.*

[411] *Id.*

[412] Exhibit 131; Exhibit 25 at 23.

(e) Beginning in March 2020, "Foster" began providing Cred with monthly investor statements, all containing positive performance updates.[413] "Foster" subsequently provided Cred with status updates and investment reports, and answered questions regarding the QuantCoin relationship.[414] According to Inamullah, the positive performance reports motivated Cred to invest more with QuantCoin while it waited to on-board other asset management funds.[415]

(f) On March 13, 2020, Inamullah asked Chapman if QuantCoin would be able to receive another 200 Bitcoin from Cred.[416] In response to this request, Chapman advised that he could receive 200 additional Bitcoin.[417] Inamullah recommended to the "investment committee" that Cred invest more assets with QuantCoin.[418] However, due to the crash in March, Cred did not send the additional 200 Bitcoin.

(g) In or around April 14, 2020, Inamullah sought to increase Cred's allocation by 100 Bitcoin, after QuantCoin informed Cred that its account exceeded 6% profit in March.[419] Chapman instructed Inamullah to send the funds to the wallet already "whitelisted" on Cred's system. Inamullah sent the customary 0.01 Bitcoin test transaction.[420] Once receipt was confirmed, Inamullah sent the remaining of 99.99 Bitcoin (valued at $711,680).[421] As with prior transfers, the Fireblocks log shows that Inamullah sent this transaction to a wallet address under the name "QuantCoin."[422]

(h) Thereafter, Cred continued to receive positive performance reports on its purported 800 Bitcoin investment.[423]

(i) By May 3, 2020, the market value of Cred's purported Bitcoin investment with QuantCoin totaled $7,026,402.[424]

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[413] Email from S. Foster to D. Inamullah, Mar. 23, 2020 (Exhibit 133); Kingdom Trust Investor Monthly Statement, Feb. 2020 (Exhibit 134); Cred Incident Investigation Report, Nov. 25, 2020 (Exhibit 135) ("The false Scott Foster provided regular performance updates (all positive) on a monthly basis.").

[414] *See e.g.,* Exhibit 135; Email chain between D. Inamullah and S. Foster, May 9, 2020 (Exhibit 137).

[415] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

[416] Email chain between D. Inamullah and R. Chapman, Mar. 15, 2020 (Exhibit 136).

[417] Exhibit 136.

[418] Email from D. Inamullah to J. Podulka, D. Schatt and J. Alexander, Apr. 4, 2020 (Exhibit 122).

[419] Exhibit 137.

[420] Exhibit 135; Exhibit 137.

[421] Exhibit 135; Exhibit 137; Exhibit 25 at 23.

[422] Exhibit 124 (wallet address: 1HhGiE2JgUqweztdjpd5prpSt3YSkMs5Gk).

[423] *See* Email with attachments from S. Foster to A. Khakoo, June 1, 2020 (Exhibit 138).

(j) By June 2020, QuantCoin representatives had become increasingly difficult to contact. On June 1, 2020, "Foster" apologized for a delay in sending Cred the April report, stating that he "was out for the weekend with no internet access."[425]

(k) At a July 9, 2020 meeting of Cred's Board, Cred identified its QuantCoin investments as its best source for obtaining much needed short-term liquidity despite QuantCoin's positive performance.[426]

(l) On July 16, 2020, Inamullah asked Chapman to speak to prospective investors about Cred during its fundraising process, but Chapman replied that he was addressing some medical issues and could not assist.[427]

(m) On July 28, 2020, Cred notified "Foster" by email that Cred wanted to rebalance its portfolio and inquired about a receiving a redemption in the first week of August.[428] "Foster" replied that redemptions generally required one months' notice and that any August redemption would affect other investors' positions, proving costly. "Foster," however, did indicate that he would agree to fulfill a redemption request in the first week of September to provide enough time to wind down the positions.[429]

(n) On July 30, 2020, "Foster" confirmed Cred's request for a $2 million redemption during the first week of September 2020.[430]

(o) After the redemption request, Cred's follow-up emails to Foster and Chapman were returned as "undelivered."[431]

(p) In or around August, Joe Podulka requested that Inamullah obtain July financial statements for the account.

(q) Eventually, Podulka contacted Kingdom Trust directly to verify the account statement.[432] Podulka contacted Kingdom Trust several times by telephone before receiving a response from Kingdom Trust's General Counsel, Tim

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[424] Email from D. Inamullah to J. Podulka, May 3, 2020, (Exhibit 139).

[425] Exhibit 138.

[426] Exhibit 44 (July 9, 2020 meeting notes).

[427] Email from R. Chapman to D. Inamullah, July 16, 2020 (Exhibit 140).

[428] Email from S. Foster to A. Khakoo, July 29, 2020 (Exhibit 141).

[429] Exhibit 141; Inamullah Dep. 154:21-156:16 (Exhibit 9).

[430] Email from S. Foster to A. Khakoo, July 30, 2020 (Exhibit 142).

[431] Email from A. Khakoo to D. Inamullah, Aug. 21, 2020 (Exhibit 143).

[432] Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

Kuhman.[433] On August 26, 2020, Kuhman informed Podulka that the emails from "Foster" were not authentic and that the real Kingdom Trust did not hold any of Cred's assets.[434]

(r) On August 26, 2020, Kingdom Trust advised Cred to immediately report the matter to the FBI and other law enforcement in Cred's jurisdiction.[435] On the same day, Cred's security team, Bethany De Lude (Chief Information Security Officer) and Marie Kacmarik (Director of Information Security) contacted the FBI's San Francisco Division.[436] Over the following days, De Lude and Kacmarik coordinated with the FBI to provide relevant materials and information, and to discuss next steps.[437]

(s) On August 31, 2020, the FBI informed De Lude that it would initiate a formal investigation along with Assistant U.S. Attorney Barbara Valliere.[438] The FBI checked the QuantCoin wallet against law enforcement databases but the wallet came up empty, prompting the need to conduct additional tracing.[439]

(t) On September 8, 2020, Dan Wheeler received an FBI subpoena and managed the information production and submission request with a target completion date of September 24, 2020.[440] Wheeler collected the documents that the FBI requested and spoke to agents about the case.[441]

(u) On September 14, 2020, De Lude recommended that Cred pursue an insurance claim related to QuantCoin, but Podulka did not act at that time.[442]

(v) On October 14, 2020, Special Agent Bryant informed De Lude that it required no further information from Cred.[443]

(w) On November 24, 2020, Cred notified the FBI about its plans to freeze the accounts relating to the transferred Bitcoin.[444]

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[433] *Id.*

[434] Email from T. Kuhman to J. Podulka, Aug. 26, 2020 (Exhibit 144); Exhibit 135.

[435] *Id.*

[436] Exhibit 135.

[437] *Id.*

[438] *Id.*

[439] *Id.*

[440] Email from B. De Lude to D. Schatt, Dec. 8, 2020 (Exhibit 145).

[441] Interview with Daniel Wheeler, former General Counsel, Cred Inc. (Feb. 12, 2021).

[442] Exhibit 145; Email from T. Khuu to B. De Lude, D. Schatt, and J. Podulka, Oct. 30, 2020 (Exhibit 146).

[443] Exhibit 145.

Kingdom Trust operates, *inter alia*, as a custodian and escrow agent for digital and fiat currencies of individuals and institutions.[445] As noted above, Scott Foster is an employee at Kingdom Trust who, it appears, an unidentified individual impersonated while claiming to manage the QuantCoin account in his name. While the real Scott Foster has a company email address of "sfoster@kingdomtrust.com,"[446] all emails Cred received from the purported "Foster" came from "scott.foster@kingdom**s**trust.com" (emphasis added).[447]

As part of an internal investigation at Cred, Podulka and Inamullah researched key contacts and information about QuantCoin and found nothing online or on social media.[448] De Lude asked Inamullah who at Cred authorized the transfers to QuantCoin, but Inamullah suggested that he did not actually know how the authorization process worked.[449] Inamullah recalled that Alexander likely told him to "initiate on the phone or in person" because he could not find anything in email.[450]

As of August 28, 2020, when Cred removed the assets held at QuantCoin and CredBorrow from its asset calculation, Cred had short-term liabilities (using a 6 month redemption calculation) of $100 million compared to purported assets of $80 million.[451] Schatt

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[444] Exhibit 135.

[445] Executive Summary, Kingdom Trust, https://www.kingdomtrust.com/qualified-custodian/executive-summary (last visited Mar. 4, 2021).

[446] Exhibit 135.

[447] Exhibit 126.

[448] Exhibit 135; Email from B. De Lude to D. Inamullah, Aug. 27, 2020 (Exhibit 147).

[449] Email from B. De Lude to D. Inamullah, Aug. 27, 2020 (Exhibit 148).

[450] Exhibit 147.

[451] Exhibit 107 ("Cred Earn liabilities today are about $110M v. assets of about $97M. That asset number includes the Quanta funds. Removing Quanta assets and those with Cred Borrow and the comparing to short-term liabilities, assets are $80M v. short-term (next 6 month redemptions) liabilities of $100M assuming full redemption. Expected

commented to Podulka that the loss of $9 million in assets was "unfortunate," but did not "impair the company's day-to-day operations or pose a significant risk to returning client funds."[452]

Cred continued to present confidence in its ability to grow assets, manage client redemptions, and close the asset gap created by the QuantCoin situation.[453] On September 1, 2020, in response to questions on Cred's write-up of the QuantCoin incident, Podulka stated that the loss from the situation was approximately $7.4 million if recognized in February, but "because the funds didn't actually generate any return, it's not really a loss."[454] As Podulka framed it to a customer, the QuantCoin loss is really "more of a reduction against the budget expectations."[455]

By September 16, 2020, the market value of the QuantCoin loss was $8,758,872.[456] On October 28, 2020, Cred sent a notice to customers regarding the QuantCoin loss.[457]

E. Lu Hua's Transfer of 300 Bitcoin to Cred.

According to Schatt, after Bitcoin dropped in value in March 2020, Alexander sought to recall $10 million from moKredit to provide Cred with liquidity to reestablish its hedge

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redemptions would only be about $30M, so we could frame it differently and compare current non-LBA assets of $84M v. expected redemptions of $30M.").

[452] Exhibit 108. According to Podulka, he made comments to a draft Schatt had already written, which included the "unfortunate" comment. Interview with Joseph Podulka, former Chief Financial Officer, Cred Inc. (Feb. 16, 2021).

[453] Exhibit 108.

[454] Email between J. Podulka and S. Ichimiya, Sept. 1, 2020 (Exhibit 149).

[455] *Id.*

[456] Exhibit 95.

[457] *Decl. of Marc Parrish in Supp. of the Mot. of UpgradeYa Investments, LLC for Relief from Stay under Bankruptcy Code Section 362*, Exhibit G (ECF No. 91) (Exhibit 150).

positions.[458] As discussed in Section V(B)(3), Hua claimed that he was not in a position to satisfy Cred's demands. Instead, Hua proposed a twofold solution: a staggered repayment plan instead, and providing Cred with 300 Bitcoin to assist Cred with reestablishing hedges.[459]

According to Schatt, Alexander indicated that he could utilize the 300 Bitcoin to reestablish Cred's hedge positions, despite the fact that the market value of the 300 Bitcoin at the time totaled only approximately $1.5 million ($8.5 million less than the $10 million requested by Cred).[460] After Cred's hedges were liquidated in March 2020, Cred had a net short cryptocurrency position of approximately $27 million. Using Cred's traditional leverage of 3x, Cred would have needed approximately $9 million in Bitcoin to hedge itself against this short position. Utilizing Cred's traditional leverage of 3x, Cred would only have been able to hedge approximately $4.5 million of its net short position using the 300 Bitcoin ($1.5 million leveraged 3x).

Hua transferred 300 Bitcoin to Cred over five separate transactions: on March 13, 2020, Hua made two transfers of .01 Bitcoin and 49.9 Bitcoin to Cred; on March 14, Hua made another two transfers of 50 Bitcoin and 100 Bitcoin to Cred; and on March 16, Hua transferred the final 100 Bitcoin to Cred.[461]

Hua and Schatt both characterize the Bitcoin transfers as a personal loan made by Hua to Cred. Although the Examiner obtained emails from Hua and Schatt characterizing the transfer as

[458] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[459] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021); Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[460] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[461] *Decl. of Matthew K. Foster in Support of Debtors' Objection to Motion of James Alexander to Dismiss the Cred Capital, Inc. Case* ¶ 6 (ECF No. 434) (Exhibit 153); *see also* Email from S. Hwang to P. Bonjour, H. Ng, and D. Hummer, Dec. 15, 2020 (Exhibit 154).

a loan, the Examiner found no contract, loan agreement, or other documentary evidence supporting this position. Hua did, however, execute a contribution agreement, effective as of March 31, 2020, in which Hua agreed to make a capital contribution of 300 Bitcoin to Cred Capital in exchange for an aggregate of 5,000,000 shares of Class B common stock.[462] Along with Hua, Alexander signed the agreement as President and CEO of Cred Capital.[463]

According to Hua, he signed the contribution agreement without reading it, two weeks after he transferred the Bitcoin to Cred, and had assumed the agreement was a routine Cred lending document.[464] Hua further states that he did not show the document to an attorney before signing it and did not learn that what he had signed was an equity agreement until several months later.[465]

According to Inamullah, the 300 Bitcoin was initially used to establish certain swaps and/or future hedges using Cred's traditional leverage ratio of 3x on the OKEx exchange.[466] Also according to Inamullah, it was determined that, without JST, Cred did not have the knowledge necessary to manage hedges in derivate form (i.e., as swaps or futures). At some point 300 Bitcoin was sent to OKEx; however, the Examiner has not seen any documents supporting any other hedge positions being reestablished. In any event, insofar as hedges existed, they were terminated shortly after they were established.[467]

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[462] Exhibit 80.

[463] *Id.*

[464] Interview with Lu Hua, Chief Executive Officer, moKredit Inc. (Feb. 18, 2021).

[465] *Id.*

[466] Interview with Daniyal Inamullah, former Vice President of Capital Markets at Cred Inc. (Feb. 23, 2021); Inamullah Dep. 191:16–3:3 (Exhibit 9).

[467] Interview with Daniel Schatt, Chief Executive Officer, Cred Inc. (February 17, 2021).

Cred Capital liquidated 75 of Hua's 300 Bitcoin and utilized the proceeds to pay Cred Capital consultants, fund fees associated with the Luxembourg Bonds, and to satisfy minimal balance requirements for Cred Capital's bank account.[468]

F. Cred's Dealings with James Alexander.

1. General Background on James Alexander.

Schatt first met Alexander at a venture capital event in or around 2013.[469] The pair had limited contact over subsequent years, but remained connected via LinkedIn.[470] During Summer 2018, Schatt contacted Alexander and proposed that he provide consulting services for Cred.[471] After working for Cred in this advisory capacity for approximately a month, Alexander met with Hua, Wheeler, and other members of the Cred team in Shanghai.[472] At that point, Cred offered Alexander a permanent position as Chief Capital Officer, commencing in August 2018.[473]

It does not appear that Cred conducted any formal vetting of Alexander prior to making him an offer of employment, nor does it appear that Cred contacted any of Alexander's prior employers.[474]

On December 3, 2007, Alexander was convicted in the United Kingdom for crimes related to illegal money transfers. He was sentenced to three years and four months in prison to

[468] Chat logs between J. Alexander and D. Inamullah, June 24, 2020 (Exhibit 155); Interview with Daniyal Inamullah, former Vice President of Capital Markets at Cred Inc. (Feb 23, 2021).

[469] Interview with Daniel Schatt, Chief Executive Officer, Cred Inc. (February 17, 2021).

[470] *Id.*

[471] *Id.*

[472] *Id.*

[473] *Compare* First Amended Complaint ¶ 14, *Alexander v. Schatt*, No. 20-CIV-02728 (Cal. Super. Ct. Oct. 15, 2020) (Exhibit 22) (stating that Cred hired Alexander on Aug. 27, 2018), *with* Employment Offer Letter for J. Alexander (Exhibit 16) (Alexander's unsigned employment offer letter states that his role would commence on Aug. 1, 2018).

[474] Interview with Daniel Schatt, co-founder and Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

be served at HMP Ford Prison in West Sussex, England. On October 15, 2008, while serving his sentence, there was a prison break at the HMP Ford Prison. It appears that Alexander is a fugitive in the United Kingdom.[475]

In his role as Chief Capital Officer, Alexander was responsible for raising and deploying capital for Cred.[476] In this role, Alexander was granted broad power and discretion over Cred's investment decisions and the control and ability to transfer Cred's assets with little oversight.[477]

Alexander received from Cred an annual salary of $240,000[478] and a $95,523.76 advance against a future profit share.[479] He also received two different types of loans from Cred: a series of LBA token loans, and a cash loan.[480] The precise amount of LBA tokens that Alexander obtained through the loan program is disputed (ranging from 5.2 million to 1.75 million tokens).[481] Given time and information constraints, the Examiner was unable to ascertain if Alexander received additional payments from any other organizations or parties referenced in this Report.

[475] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021); *see* MN Form UCF-17-2, Order Granting Name Change, Aug. 18, 1994 (Exhibit 167); s*ee also* Letter from Andrew Selous MP, Parliamentary Under-Secretary of State for Justice, to Philip Davies MP, House of Commons (Nov. 7, 2014) (Exhibit 168); Rachel Millard, *Exposed: inmates on the run from Ford Prison*, The Argus (Apr. 7, 2015), https://www.theargus.co.uk/news/12873674.exposed-inmates-on-the-run-from-ford-prison/.

[476] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[477] Interview with Daniel Schatt, co-founder and former Chief Executive Officer, Cred Inc. (Feb. 17, 2021).

[478] Exhibit 16.

[479] Exhibit 22 at ¶ 14.

[480] *Id.*

[481] *Compare* Exhibit 22 at ¶ 14 (5.2 million LBA tokens), *with* Employee Loan Agreement I, June 1, 2019 (Exhibit 156) (1,333,333 tokens), Employee Loan Agreement II, June 1, 2019 (Exhibit 157) (375,000 LBA tokens), and Employee Loan Agreement III, June 1, 2019 (Exhibit 158) (41,667 LBA tokens).

2. Organization of Cred Capital.

Alexander was closely involved in the formulation and organization of Debtor Cred Capital.[482] The Examiner notes that, pursuant to its Order entered February 5, 2021, the Court made certain factual findings regarding the organization of Cred Capital and related matters.[483] This Order followed extensive briefing on the matter by the Debtors, the Committee, and Alexander. Specifically, the Court found that:

- the initial certificate of incorporation for Cred Capital, filed with the Delaware Secretary of State on March 10, 2020, was improperly filed; and
- upon discovering the improperly filed incorporation filings, Cred took steps to correct the improper filings and made Schatt and Podulka the directors of Cred Capital.[484]

The Examiner will, therefore, address the facts and circumstances surrounding Cred Capital's formation only as necessary to inform other aspects of this Report.

3. James Alexander's Alleged Misappropriation of Assets.

On June 24, 2020, Alexander instructed Inamullah to transfer 225 Bitcoin and 200,000 USDC to wallet addresses that Alexander provided.[485] Because of the poor state of Cred's books and records, the Examiner could not ascertain whether the 225 Bitcoin was among the same Bitcoin transferred to Cred by Lu Hua.

[482] Exhibit 22 ¶ 7.

[483] *See Order Denying Motion of James Alexander to Dismiss the Cred Capital, Inc. Case* (ECF. No. 487) ("Order Denying Alexander MTD") (Exhibit 159).

[484] *See Id.*

[485] Email from D. Inamullah to D. Schatt and J. Podulka, June 30, 2020 (Exhibit 160); Videotaped Deposition of James Alexander 72:13–15 ("Alexander Dep.") (Exhibit 161).

Inamullah represented that Alexander told him the transfers were being made to a Cred Capital account.[486] When asked how he confirmed this, Inamullah said that a separate entity was onboarded for Cred Capital on Cred's Fireblocks account, and this entity had a separate domain name.[487] In reality, the addresses that Alexander provided were for wallets belonging to an individual named Christopher Giovanni Silvio Spadafora, a consultant to Cred Capital since April 2020.[488] During his deposition, Alexander said he transferred these funds to Spadafora's wallets because Alexander did not have a wallet available to receive the funds at that time, and because he considered Spadafora a "trusted consultant and experienced crypto market participant."[489] However, during his interview with the Examiner, Alexander stated that he transferred the assets to Spadafora's asset management company "alwayshodl" but decided after a few days that "hodl didn't have the standing" to hold and manage the assets so he had them transferred to himself.[490] Further, Alexander stated that Inamullah understood what Alexander was attempting to accomplish through the transfer process.[491] According to Inamullah, he believed that he was, in fact, transferring the funds to a Cred Capital wallet.[492]

Inamullah represents that, when initially questioned about these transfers by Schatt, he believed that the address information had been transmitted by Alexander via Telegram

[486] Inamullah Dep. 158:24–159:4, 165:12–16 (Exhibit 9).

[487] *Id.* at 221:8–13.

[488] Alexander Dep. 72:17–25 (Exhibit 161).

[489] *Id.* 72:17–73:11.

[490] Interview with James Alexander, former Chief Capital Officer, Cred Inc. (Mar. 3, 2021).

[491] *Id.*

[492] Interview with Daniyal Inamullah, former Vice President of Capital Markets, Cred Inc. (Feb. 10, 2021).

messenger and confirmed by Alexander via telephone call.[493] Inamullah said he later remembered that Alexander provided all the necessary information in person because it is "much safer that way."[494] However, Inamullah subsequently advised the Examiner that Alexander sent the wallet addresses to Inamullah via WhatsApp messenger while they were both in the office, and Inamullah copied and pasted the addresses from WhatsApp into Fireblocks in order to complete the transfers.[495] Alexander informed the Examiner that he did not recall his communication with Inamullah regarding the transfer instructions.[496]

Alexander informed the Examiner that he directed the assets be transferred out of the Cred Capital account because he believed that he was the sole director of Cred Capital and that Schatt and Podulka were improperly attempting to take control of Cred Capital.[497] The following provides a chronology and factual observations regarding the relevant asset transfers:

- On July 1, 2020, Alexander received 224.899 Bitcoin from Spadafora.[498]
- On July 15, 2020, Cred filed a complaint against Alexander in California state court seeking, among other things, the recovery of 225 Bitcoin and other assets.[499]
- On July 16, 2020, Alexander liquated 65 of the approximately 225 Bitcoin that he had received by transferring those assets to his Coinbase wallet.[500]

[493] Inamullah Dep. 158:6–18 (Exhibit 9).

[494] *Id.*at 158:18; 160:13–17.

[495] Interview with Daniyal Inamullah, former Vice President of Capital Markets at Cred Inc. (Feb. 23, 2021).

[496] Alexander Dep. 71:14–19 (Exhibit 161).

[497] *Id.* at 69:4–11.

[498] *Id.* at 78:5–9.

[499] Verified First Amended Complaint, *Cred v. Alexander*, No. 20-CIV-02915 (Cal. Super. Ct. Aug. 14, 2020) (Exhibit 23).

[500] Alexander Dep. 83:16–85:2 (Exhibit 161).

- On July 17, 2020, a temporary restraining order and preliminary injunction enjoining Alexander from using or transferring any Cred or Cred Capital digital assets was issued by the California state court.[501]

- On January 16 and 17, 2021, Alexander transferred Bitcoin valued at approximately $1.832 million – in evident conflict with the terms of the California state court's TRO.[502] Specifically, Alexander transferred 50 Bitcoin on January 16th, and 50 additional Bitcoin on January 17th, into his Coinbase wallet to be liquidated into USD. Alexander acknowledged that the transfers did not comport with the TRO, but claimed that a purported medical emergency precipitated his actions.[503]

- At a bankruptcy hearing attended by Alexander on February 3, 2021, the Court determined that an emergency hearing would be held regarding the January 16th and 17th transfers completed by Alexander.[504]

- That same day, Alexander withdrew $10,000 in the form of a cashier's check from an account named "Alexander Custom Management." Alexander stated that this withdrawal was a salary payment to himself,[505] and said he deposited it into a personal account.[506]

- The following day, February 4, 2021, Alexander transferred $100,000 from a Wells Fargo bank account that he managed for Cred Capital to the "Alexander Custom Management" account, and then withdrew $60,000 in cash from that account.[507] Alexander stored this money in the trunk of his car, which, at the time of his deposition, was parked on Finely Avenue in Los Angeles, California, a street on which Alexander previously resided.[508] Alexander stated that he withdrew this cash to settle a purported tax liability, which he stated was a part of his 2020 compensation.[509] Alexander claimed that he had planned to deposit the cash into his personal account the day he withdrew it, but had not had the chance

[501] *Id.* at 85:11–86:11.

[502] Transcript of Zoom Hearing Re: Emergency Motions of the Official Committee of Unsecured Creditors 5:22–6:4, Feb. 5, 2021 (Exhibit 166).

[503] Alexander Dep. 105:20–108:7.

[504] *Id.* at 39:16–40:22.

[505] *Id.* at 47:21–48:18.

[506] *Id.* at 49:24–50:7.

[507] *Id.* at 42:12–45:18.

[508] *Id.* at 14:15–19, 46:15–18.

[509] *Id.* at 47:1–10.

to do so by the date of his deposition, five days later.[510] When asked how much cash was still in his car since withdrawing it over a week prior, Alexander stated that he did not recall and could not remember if he had spent any of the funds, since, as Alexander stated, "cash is fungible."[511]

- According to information that the Examiner received from the Committee's advisors, on February 5, 2021, Alexander returned 49.9980892 BTC and $2,773,489.24 USDC to the estates.[512]

- On February 7, 2021, Alexander returned to the estates an additional $35,000 from a JP Morgan Chase account and $50,355 from a Wells Fargo account.[513]

- The proceeds from the January 16th and 17th Bitcoin transactions totaled approximately $3,437,956.53 in the aggregate. As of the date of his February 9, 2021 deposition, Alexander had returned assets totaling, in the aggregate, approximately $2,773,488. When asked where the approximately $664,468 dollar difference in value between transferred and returned assets was, Alexander refused to answer, stating that the whereabouts of the funds was an "open question."[514]

- Thereafter, Alexander requested a break in the deposition, during which Alexander filed a personal Chapter 11 bankruptcy petition in the Central District of California. Upon return from break, Alexander ended his participation in the Court-ordered deposition.[515]

VI. INVESTIGATIVE CONCLUSIONS

The information that the Examiner was able to obtain and review within the constricted timeframe of the Investigation lends itself to the following conclusions:

General Management/Oversight

1. Lu Hua and Dan Schatt either failed to acknowledge or failed to realize the likely conflict of interest, both fiduciary and personal, that existed in their relationships with each other and between moKredit as a debtor and Cred as a lender.

[510] *Id.* at 52:1–11.

[511] *Id.* at 56:16–19.

[512] Email from J. Evans to E. Gilman, Feb. 28, 2021 (Exhibit 162).

[513] *Id.*

[514] Alexander Dep. 115:6–117:22 (Exhibit 161).

[515] Alexander Dep. 118:3–121:24 (Exhibit 161); Suggestion of Bankruptcy (ECF. No. 500) (Exhibit 163).

2. Dan Schatt likely failed to make reasonable efforts to investigate James Alexander's background prior to hiring him as Cred's Chief Capital Officer. Had Schatt done so, he likely would have learned that Alexander was convicted of a felony and sentenced to prison for acts amounting to fraud, and appears to be a current fugitive in the United Kingdom.

3. Cred likely failed to develop and maintain a standardized and formal process for decision-making pertaining to Cred's liquidity situation, new investment proposals, investment allocations, and risk management strategies.

Accounting Practices

1. Cred failed to keep reliable, defensible records for its trading accounts and never adopted a regular practice of issuing transaction statements.

2. Cred did not endeavor to complete account reconciliations. At the time Cred filed for Chapter 11 relief, it had not reconciled its accounts for fiscal year 2020. The Examiner could not ascertain the last point at which Cred had a complete and accurate records reconciliation.

3. Because of the lack of up-to-date books and records, the Examiner could not ascertain the reliability and efficacy of Cred's stated financial position at any time, up to and including the filing of its Chapter 11 petitions.

4. Cred failed to develop and maintain a standardized, comprehensive protocol for tracking customer deposits and initiating and authorizing transfers. Cred's method for initiating, authorizing, and executing transfers appears to have been informal, with all steps often performed by a single individual without a discernible method for approval or oversight.

5. Cred did not keep consistent records of Fireblocks transactions, and the records it did keep were not comprehensive.

6. Customer deposits derived from Uphold, CredEarn, and CredBorrow, were all maintained together without a standardized, repeatable method for distinguishing whose assets belonged to whom and from which offering they were derived.

Risk/Due Diligence

1. Cred failed to maintain a comprehensive, standardized process for performing due diligence on prospective or current asset managers.

2. Cred failed to incorporate and maintain internal compliance policies, including due diligence policies. It was not until Summer of 2020 that Cred began to initiate background checks on prospective employees and custodians and, even then, those checks do not appear to have been conducted retroactively.

3. Cred's "investment committee" discussed, at least as early as November 2019, pursuing an "all-weather" strategy to diversify Cred's asset allocation and minimize risk. Cred, however, never fully implemented this strategy due to, among other things, continued liquidity issues beginning with the March 2020 crash, the inability to obtain repayment under the moKredit loan, the failed QuantCoin investment, and asset transfers involving Alexander.

moKredit

1. Cred did not receive or review written due diligence materials (e.g., moKredit's asset-to-liability ratio, customer transactions, customer default rate, or customer receivables) before entering into its loan agreement with moKredit.

2. Prior to entering into the moKredit loan agreement, Cred did not take reasonable steps to ensure that it could enforce the loan agreement and effectuate repayment in the event that moKredit, a company located and doing business in China, defaulted or was otherwise unwilling or unable to satisfy its repayment obligations.

3. Cred and moKredit appeared to operate without "proper controls." Cred transferred funds without signed tranche agreements and failed to issue periodic statements. As a result, Cred's informal accounting system – comprised of an Excel spreadsheet and a Google document – remained out-of-date and likely inadequate to track tens of millions of dollars of transactions between the companies.

QuantCoin

1. Cred did not conduct material due diligence prior to transferring 800 Bitcoin to QuantCoin. Cred management relied on statements made by James Alexander that QuantCoin due diligence was properly conducted without receiving any evidence substantiating such a claim.

2. Dan Schatt signed the QuantCoin subscription agreement before it was reviewed by Cred's general counsel and adequate diligence was performed.

3. Despite assertions made by Alexander, it does not appear that he conducted due diligence of QuantCoin on Cred's behalf.

4. Daniyal Inamullah also did not conduct any due diligence of QuantCoin and, despite being the main contact on the account and initiating Cred's transfer of funds, Inamullah attempted to distance himself from the relationship thereafter by blaming the lack of diligence on the absence of a written process.

5. After the series of Bitcoin transfers to QuantCoin, Cred, with reasonable diligence, could have discovered that, contrary to QuantCoin's assertions, Kingdom Trust did not have a relationship with QuantCoin and the real Scott Foster was not managing the Cred account.

Hedge Positions

1. Cred hired outside consultant JST Capital to assist Cred in operating a cryptocurrency hedging program.

2. Certain hedges established under this program failed to protect Cred from a downturn in the market and, instead, likely caused Cred to incur significant losses when the price of Bitcoin dropped significantly overnight on March 11, 2020.

3. The decision not to reestablish its hedge positions after the March 2020 "flash crash" left Cred exposed ("naked") to market fluctuations. As the price of Bitcoin increased towards the end of March and beyond, so too did Cred's liabilities.

Luxembourg Bonds

1. At the time that Cred purchased the Luxembourg Bonds, it knew that moKredit would be unable to make the payments necessary to repay them.

2. Cred's decision to purchase the Luxembourg Bonds in June 2020 (at par) significantly and adversely impacted Cred's already tenuous liquidity position.

300 Lu Hua Bitcoin

1. After moKredit failed to repay $10 million of its principal balance, Hua sent 300 Bitcoin to Cred. In or around this time, Hua executed an equity contribution agreement under which Hua agreed to transfer 300 Bitcoin in exchange for equity in Cred Capital. Thus, despite Hua and Schatt's characterization of the Bitcoin transfer as a loan, the documentary evidence suggests an equity placement.

2. Although Cred appears to have indicated that it intended to use the 300 Bitcoin to reestablish hedges liquidated by JST in the March 2020 crash, it does not appear that 300 Bitcoin would have been sufficient to reestablish such hedges.

Certain Representations Made by or Attributed to Cred

1. It appears that, in certain instances, Cred mischaracterized the nature of its collateralization. The funds Cred lent to moKredit and other asset managers after converting CredBorrow and CredEarn deposits to fiat currency were largely not collateralized.

2. It appears that, in certain instances, Cred mischaracterized the nature of its insurance coverage.

3. In communications with customers after the discovery of the failed QuantCoin investment, Cred indicated that the loss was insignificant and did not pose a significant risk to client funds. At the same time, certain Cred employees were recommending that

Cred pull 100% of its assets from three asset managers in an effort to address liquidity concerns stemming, in part, from the failed QuantCoin investment.

4. It appears that Cred understated its assets-to-liabilities gap internally and mischaracterized its ability to close that gap to customers in or around August 2020, a time at which Cred knew that moKredit was either unable or unwilling to pay down the principal balance on the moKredit loan.

KATTEN MUCHIN ROSENMAN LLP
Craig A. Barbarosh (SBN 160224)
craig.barbarosh@kattenlaw.com
650 Town Center Drive, Suite 700
Costa Mesa, CA 92626-7122
Telephone: (714) 966-6822

Jessica M. Mickelsen (SBN 277581)
jessica.mickelsen@kattenlaw.com
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
Telephone: (310) 788-4425
Facsimile: (310) 788-4471

Peter A. Siddiqui (*pro hac vice*)
peter.siddiqui@kattenlaw.com
525 W. Monroe Street
Chicago, IL 60661-3693
Telephone: (312) 902-5455
Facsimile: (312) 902-1061

Counsel for Debtors and Debtors-In-Possession
Hashfast Technologies LLC and HashFast LLC

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

(SAN FRANCISCO DIVISION)

In re: HASHFAST TECHNOLOGIES LLC, a California limited liability company, Debtor and Debtor-In-Possession ☒ Affects HASHFAST LLC, a Delaware limited liability company, Debtor and Debtor-In-Possession	Case No. 14-30725 (Substantively Consolidated with In re HashFast LLC, Case No. 14-30866) Chapter 11
HASHFAST TECHNOLOGIES LLC, a California limited liability company, and HASHFAST LLC, a Delaware limited liability company, Plaintiffs, vs. MARC A. LOWE, an individual, *aka* Cypherdoc and/or Cipherdoc,	Adversary Case No. _____ **COMPLAINT FOR:** **1. AVOIDANCE OF PREFERENTIAL TRANSFERS;** **2. AVOIDANCE OF FRAUDULENT TRANSFERS;** **3. AVOIDANCE OF FRAUDULENT TRANSFERS (CONSTRUCTIVE FRAUD); AND** **4. RECOVERY OF AVOIDED**

Defendant.	**TRANSFERS** [11 U.S.C. §§ 544, 547; 548, and 550 and Cal. Civil Code §§ 3439.04, 3439.05, and 3439.07] Status Conference: Date: TBD Time: TBD Place: Courtroom 22 U.S. Bankruptcy Court 235 Pine Street San Francisco, CA 94104

COMPLAINT

HashFast Technologies LLC, a California limited liability company ("HashFast Technologies"), and HashFast LLC, a Delaware limited liability company ("HashFast", collectively with HashFast Technologies, the "Debtors" and each a "Debtor"), by and through its undersigned counsel, bring this complaint (the "Complaint") against Defendant Marc A. Lowe, an individual, a/k/a Cypherdoc and/or Cipherdoc (the "Defendant"), and in support of this Complaint state as follows:

JURISDICTION

1. This adversary proceeding arises out of and is related to the above-captioned, substantively consolidated bankruptcy cases (collectively, the "Bankruptcy Cases") of *In re HashFast Technologies, LLC*, case no. 14-30725 DM (the "HFT Bankruptcy Case"), and *In re HashFast, LLC*, case no. 14-30866 DM (the "HF Bankruptcy Case"), pending before the United States Bankruptcy Court for the Northern District of California, San Francisco Division (the "Court"), and/or the claims alleged herein arise under title 11 of the United States Code (the "Bankruptcy Code"). This Court has jurisdiction pursuant to 28 U.S.C. §§ 157 and 1334.

2. The causes of action set forth herein constitute core proceedings pursuant to 28 U.S.C. § 157(b)(2)(A), (H), and/or (O), and/or relate to the Bankruptcy Cases. To the extent the Court determines that any claim and/or cause of action alleged herein does not constitute a core proceeding, the Debtors hereby consent to this Court's adjudication of the claims and/or causes of action and to the entry of final orders and judgments in this adversary proceeding.

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

3. Venue is appropriate pursuant to 28 U.S.C. §§ 1391, 1408, and 1409 as this is the district in which the Bankruptcy Cases are pending and in which the relevant conduct complained of herein took place.

4. On May 9, 2014 (the "Petition Date"), certain petitioning creditors filed a chapter 7 Involuntary Petition in the Court against Hashfast Technologies under title 11 of the Bankruptcy Code [Lead Case Doc. No. 1].

5. On June 3, 2014, HashFast Technologies filed its Conditional Consent to an Order for Relief [Doc. No. 36] and its Motion to Convert to Chapter 11 [Lead Case Doc. No. 35].

6. The Bankruptcy Court entered its order converting HashFast Technologies' case to one under chapter 11 of the Bankruptcy Code on June 5, 2014 [Lead Case Doc. No. 40].

7. On June 6, 2014, HashFast filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code.

BACKGROUND

8. The Debtors design, develop, manufacture and sell certain computer chips and equipment, including Application Specific Integrated Circuit, or ASIC, semiconductors, for the sole purpose of auditing transaction data for the Bitcoin networks, also known as "Bitcoin mining." On or about June 2013, the Debtors began designing their first generation Golden Nonce (the "GN1"), with the assistance of Sandgate Technologies ("Sandgate") and Uniquify, Inc. ("Uniquify"). Following the development of the GN1, the Debtors worked with DXCorr Design (the "DXC") to design and develop subsequent generations of the GN1.

9. On or about July 2013, HFT began advertising a special purpose computer system built around the GN1 (the "BabyJet") for sale and started accepting orders for the "batch one" BabyJets in early August 2013. The BabyJet and GN1 chip sold well from the time they were launched—specifically, between July and December 2013, the Debtors sold approximately $18,000,000 in computers, chips, and accessories.

10. On or about July 29, 2013, Defendant Marc A. Lowe ("Defendant") visited the Debtors' headquarters to ostensibly tour the facility and meet the members and employees of HFT prior to purchasing one or more of the Debtors' products. During the tour, the Defendant met with

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

Eduardo de Castro, the Chief Executive Officer of HFT and co-owner of HF. As a result of the visit, the Defendant purchased four terra-hash per second of hashing power through the acquisition of eight GN1 chips or three to four fully assembled BabyJets (the "Computers") for the sum of $36,000, inclusive of sales tax—a $7,150 discount off of the list price (the "Sale"). The Defendant paid the discounted purchase price for the Computers by personal check dated July 29, 2013.

11. Subsequent to the visit, a memorandum of understanding dated August 5, 2013 (the "MOU") was executed by the Defendant and HFT. By and through the MOU, the Defendant agreed to endorse the Debtors and their products by posting comments and responding to certain inquiries on various Bitcoin-related forums and/or message boards, including Bitcointalk.org. In exchange for such "services", the Defendant was to receive ten percent (10%) of the base sale price (i.e., gross sale proceeds) for the first 550 "batch one" BabyJets sold by the Debtors, payable in BTC (the "MOU Compensation"). According to the MOU, the Defendant was entitled to the MOU Compensation regardless of whether the "endorsement" contributed in any way to the sale of any BabyJet or other HFT product. A true and correct copy of the MOU is attached hereto as Exhibit A and is incorporated herein by reference. At the time the MOU was executed, HFT was offering the BabyJets for sale at a base price of approximately $5,600 or 56 BTC.

12. The Debtors are informed and believe and based thereon allege that the Defendant is a medical doctor without any experience marketing or advertising BTC mining hardware or hardware manufacturers.

13. In addition to the business relationship established by the MOU, the Defendant also purports to have joined HFT's board of advisors in late-July or early-August 2013. As the Defendant stated in a post dated August 8, 2013: "I have also been asked to join [HFT's] Board of Advisors." A true and correct copy of the August 8, 2013 post is attached hereto at pages 1-3 of Exhibit B and incorporated herein by reference. The Debtors allege that the Defendant had direct and regular contact with the Debtors' members, principals, directors, and employees—individuals generally unavailable to ordinary customers and creditors.

14. On or about August 8, 2013, the Defendant began posting commentary regarding HFT and the Debtors' products on Bitcointalk.org under a thread titled "HashFast Endorsement."

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

Between August 8, 2013, and September 9, 2013, the Defendant posted approximately 160 comments and updates (an average of 5 posts per day) regarding, among other things, the roll-out and sale of the BabyJet. The Defendant's posts, however, were not limited to salient matters; rather, the Defendant also engaged "trolls" in irrelevant and lengthy debate regarding numerous topics, including, but not limited to, economics and the philosophy underlying BTC. The irrelevant commentary accounts for a substantial portion of the approximately 160 posts, a sample of which is attached hereto at pages 3-227 of Exhibit B and incorporated herein by reference.

15. In or about early September 2013, HFT pre-sold the first 550 BabyJets. Thereafter, on or about September 4, 2013, the Defendant requested payment in accordance with the MOU. A true and correct copy of the request is attached hereto as Exhibit C and incorporated herein by reference. The Defendant calculated that he was owed a total of $308,000 in BTC at the exchange rate applicable on August 8, 2013, and requested payment of 3242.1 BTC within seven (7) days.

16. The Debtors were unable to pay immediately the requested amount due to the limited availability of funds and BTC. Indeed, the Debtors did not make the first distribution of BTC to the Defendant on account of the MOU until September 5, 2013.

17. In total, the Debtors transferred 3000 BTC to the Defendant (the "MOU Payment") from two different BTC wallets belonging to HFT. The Debtors transferred the MOU Payment to the Defendant via four deposits into a BTC wallet specified by and belonging to the Defendant[1] bearing account number xUDJ9 (the "Wallet")—specifically: (a) 2000 BTC on September 5, 2013; (b) 250 BTC on September 14, 2013; (c) 250 BTC on September 22, 2013; and (d) 500 BTC on September 23, 2013 (collectively, the "Transfers"). A true and correct copy of the transaction record is attached hereto as Exhibit D and incorporated herein by reference. With the exception of one BTC, the Transfers are currently in the Wallet and, to the best of the Debtors' knowledge, have never been moved out of the Wallet.

18. At the times of the Transfers, the BTC transferred to the Defendant were worth

[1] A true and correct copy of correspondence from the Defendant identifying the Wallet is attached hereto as Exhibit E and incorporated herein by reference.

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

$363,861.43. [2] Based on the value of the BTC at the time of the transfers, the Defendant received approximately $11,370 per day or $2,274 per post on the "HashFast Endorsement" thread on Bitcointalk.org. By contrast, the highest salary paid to any principal or employee of HFT and/or HF was $144,000 for the entire calendar year of 2013.

19. At or about the time the Defendant was "endorsing" the Debtors and their products, the Debtors attempted to recruit other persons to provide the same or similar services. A true and correct copy of such correspondence is attached hereto as Exhibit F and incorporated herein by reference. However, in stark contrast to the MOU Payment, the other parties were offered $150 or a little more than 1 BTC per week (approximately 0.0014% of the compensation paid to the Defendant) to post two to four comments per day on certain online discussion boards or forums—roughly $21.43 per day or $10.71 per post (based on two comments per day).

20. At the time of the Transfers, the Debtors owed substantial sums of money and/or equipment to numerous customers and/or vendors. Many of these obligations remain unpaid and constitute general unsecured claims against the Estate. As of September 30, 2013, the Debtors' balance sheet had a negative equity balance of about $5 million.

21. Additionally, at or about the time of the Transfers, the Debtors were incurring significant liabilities in the course of their operations that ultimately exceeded the Debtors' ability to repay. More precisely, despite an inability to deliver the BabyJet or GN1, the Debtors continued to accept orders for these products and promised guaranteed delivery dates that the Debtors failed to meet. In an effort to meet these timelines, the Debtors ordered products on expedited delivery schedules, which substantially increased the production costs of the GN1 and BabyJet. Due to the increased costs and other associated overhead, the Debtors were unable to realize a profit from their operations or meet their financial and/or delivery obligations.

[2] On September 5, 2013, one BTC was worth $120.5333 (US). On September 14, 2013, one BTC was worth $124.0813 (US). On September 22, 2013, one BTC was worth $122.651 (US). On September 23, 2013, one BTC was worth $122.2235 (US). *See* Historical Bitcoin Price Index, available at http://www.coindesk.com/price/ (last visited Dec. 22, 2014). As of January 14, 2015, the Transfers are worth approximately $555,000, which is based on a value of $185.00 (US) per BTC. *See* Historical Bitcoin Price Index, available at http://www.coindesk.com/price/ (last visited Jan. 14, 2015). As of the commencement of the HF Bankruptcy on May 9, 2014, the Transfers were worth approximately $1,344,705. *Id.* At the 1-year height in the BTC market in early-December 2013, the Transfers had a value in excess of $3,400,000. *Id.*

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KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

22. Ultimately, the Debtors were unable to fulfill many of the orders on or before the guaranteed delivery date (December 31, 2013), including, but not limited to, many of the "batch one" orders upon which the MOU Payment was premised. As a result, many customers began demanding refunds for their purchases in or about January 2014. As the Debtors lacked sufficient funds and/or BTC to pay all the refunds requested and remained unable to fill customer orders, multiple customers commenced lawsuits against the Debtors in an effort to obtain a refund in currency and/or BTC.

23. Like many other customers, the Defendant requested a refund of the $36,000 he paid in association with the Sale in or about January 2014. The Defendant received a full refund of the $36,000 purchase price plus a five percent (5%) bonus, for a total of $37,800, on January 10, 2014 (the "Refund"). The Refund was paid from HFT's account at Silicon Valley Bank via a wire transfer to the Defendant.

24. The Debtors are informed and believe and based thereon alleges that the Defendant currently holds the specific BTC paid by HFT in the Wallet.

FIRST CLAIM FOR RELIEF

AVOIDANCE OF PREFERENTIAL TRANSFERS

[11 U.S.C. § 547(b)]

25. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 24 as if fully set forth herein.

26. At the time of the Refund, the Defendant was a creditor of one or both of the Debtors by virtue of the Sale.

27. The currency used to pay the Refund constituted property belonging to one or both of the Debtors at the time of its payment.

28. The Refund was paid on account of an antecedent debt owing to the Defendant as a result of Debtors' inability to fulfill the Sale. More precisely, upon the Debtors' failure to deliver the Computers on or before December 31, 2013, the Defendant became a creditor of the Debtors.

29. By virtue of his involvement with one or both of the Debtors, including their members, principals, directors and employees, the Defendant constituted an insider within the

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KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

meaning of 11 U.S.C. §§ 101(31) at the time of the Refund as the Defendant possessed authority and/or influence over the Debtors and their principals, and was previously engaged in a joint venture with the Debtors pursuant to the MOU for the sale of 550 BabyJets.

30. The Refund was paid on or about January 10, 2014, within one year of the HFT Petition Date and HF Petition Date (the "Preference Period").

31. As a result of the Refund, the Defendant received payment in full on account of an antecedent debt that would have constituted a general unsecured claim against the Estate if not paid prepetition.

32. If the Refund had not been paid within the Preference Period, the Defendant would not have received the full Refund in the context of a chapter 7 liquidation as the Debtors were and still are insolvent and unable to pay all general unsecured creditors in full, including, but not limited to, the claims relating to refund requests of creditors otherwise similarly-situated to the Defendant.

33. By reason of the foregoing, the Refund is avoidable pursuant to 11 U.S.C. § 547.

SECOND CLAIM FOR RELIEF

AVOIDANCE OF FRAUDULENT TRANSFERS

[11 U.S.C. § 544 and Cal. Civil Code § 3439.04(a)(2)]

34. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 33 as if fully set forth herein.

35. The Transfers occurred within the four-year period immediately preceding the HFT Petition Date and HF Petition Date.

36. The Defendant received the Transfers, and he continues to hold the BTC transferred in the Wallet.

37. The BTC that comprised the Transfers constituted property belonging to one or both of the Debtors at the time of the Transfers.

38. The Debtors received less than reasonably equivalent value in exchange for the Transfers. More precisely, the value of the "services" provided by the Defendants and received by the Debtors (i.e., posting 160 comments on Bitcoin-related forums over a period of approximately

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

one month) was less valuable than the consideration provided in exchange for such "services"—namely, BTC worth more than $350,000 at the time of the Transfers.

39. Several customers and/or vendors held claims against the Debtors at the time of the Transfers, including, but not limited to, Pete Morici.

40. At the time of the Transfers, the Debtors were engaged in the designing, manufacture and sale of the GN1 and BabyJet. The Debtors, however, lacked sufficient capital to maintain operations and, as a result, resorted to utilizing customer, pre-purchase funds and selling BTC in an effort to maintain operations. Following the payment of the MOU Payment, the Debtors possessed (and still possess) unreasonably small assets in relation to the business and the scale of the transactions required to maintain productivity—a deficiency that ultimately led to the failure of the business and bankruptcy.

41. Additionally, at the time of the Transfers, the Debtors were incurring substantial liabilities in the operation of their business that exceeded their ability to repay. More precisely, the Debtors were unable to fulfill existing orders for the BabyJets and/or GN1 chip, or remain current with the vendors that manufactured the component parts and/or assembled the Debtors' products at the time of the Transfers. As a result, the Debtors were incurring substantial liabilities, and they lacked the financial capability to repay.

42. At present, the claims against the Estate total approximately $40,754,674. The total assets presently held are insufficient to pay all the claims against the Estate. Recovery of the Transfers is necessary to satisfy the claims of creditors asserted against the Estate.

43. By reason of the foregoing, the Transfers are avoidable pursuant to 11 U.S.C. § 544 and Cal. Civil Code § 3439.04.

THIRD CLAIM FOR RELIEF

AVOIDANCE OF FRAUDULENT TRANSFERS (CONSTRUCTIVE FRAUD)

[11 U.S.C. § 544 and Cal. Civil Code § 3439.05]

44. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 43 as if fully set forth herein.

45. The Transfers occurred within the four-year period immediately preceding the HFT

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KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

Petition Date and HF Petition Date.

46. The Defendant received the Transfers, and he continues to hold the BTC transferred in the Wallet.

47. The BTC that comprised the Transfers constituted property belonging to one or both of the Debtors at the time of the Transfers.

48. The Debtors received less than reasonably equivalent value in exchange for the Transfers.

49. Several customers and/or vendors held claims against the Debtors at the time of the Transfers, including, but not limited to, Pete Morici.

50. At present, the claims against the Estate total approximately $40,754,674. The total assets presently held are insufficient to pay all the claims against the Estate. Recovery of the Transfers is necessary to satisfy the claims of creditors asserted against the Estate.

51. The Debtors were insolvent at the time of or became insolvent as a result of the Transfers to the Defendant—namely, at the time of or as a result of the Transfers, the Debtors were unable to meet all their obligations as they became due and/or were insolvent on a balance sheet basis due to the fact that their liabilities were greater than their assets.

52. By reason of the foregoing, the Transfers are avoidable pursuant to 11 U.S.C. § 544 and Cal. Civil Code § 3439.05.

FOURTH CLAIM FOR RELIEF

AVOIDANCE OF FRAUDULENT TRANSFERS (CONSTRUCTIVE FRAUD)

[11 U.S.C. § 548(a)(1)(B)]

53. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 52 as if fully set forth herein.

54. The Transfers occurred within the two-year period immediately preceding the HFT Petition Date and HF Petition Date.

55. The Defendant received the Transfers, and he continues to hold the BTC transferred in the Wallet.

56. The BTC used to pay the MOU Payment constituted property belonging to one or

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

both of the Debtors at the time of the Transfers.

57. The Debtors received less than reasonably equivalent value in exchange for the Transfers.

58. The Debtors were insolvent at the time of or became insolvent as a result of the Transfers to the Defendant.

59. At the time of the Transfers, the Debtors were engaged or were about to engage in a business and/or transaction relating to the design, manufacture and sale of special purpose BTC mining processors and computers. As a result of the Transfers, the Debtors possessed unreasonably small capital to continue its business venture, especially in light of the Debtors' liabilities.

60. At the time of the Transfers, the Debtors incurred further liabilities associated with their business enterprise beyond the Debtors' ability to repay as such debts matured.

61. By reason of the foregoing, the Transfers are avoidable pursuant to 11 U.S.C. § 548(a)(1)(B).

FIFTH CLAIM FOR RELIEF

RECOVERY OF AVOIDED TRANSFERS

[11 U.S.C. § 550]

62. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 61 as if fully set forth herein.

63. By reason of the foregoing, the Debtors are entitled to recover the Transfers and the Refund for the benefit of the Estate pursuant to 11 U.S.C. § 550(a)(1).

SIXTH CLAIM FOR RELIEF

RECOVERY OF AVOIDED TRANSFERS

[Cal. Civil Code § 3439.07]

64. The Debtors repeat and reallege the allegations contained in Paragraphs 1 through 63 as if fully set forth herein.

65. By reason of the foregoing, the Debtors are entitled to recover the Transfers and the Refund for the benefit of the Estate pursuant to California Civil Code § 3439.07.

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

PRAYER FOR RELIEF

WHEREFORE, the Debtors pray as follows:

66. As to the First Claim for Relief, that the Refund be avoided for the benefit of the Estate;

67. As to the Second Claim for Relief, that the Transfers be avoided for the benefit of the Estate;

68. As to the Third Claim for Relief, that the Transfers be avoided for the benefit of the Estate;

69. As to the Fourth Claim for Relief, that the Transfers be avoided for the benefit of the Estate;

70. As to the Fifth Claim for Relief, that the Estate recover the Transfers and Refund and be awarded damages, and judgment be entered in the Estate's favor against the Defendant, plus interest at the maximum legal rate from the date of each of these payments, or such other amount as shall be shown by proof prior to judgment herein;

71. As to the Sixth Claim for Relief, that the Estate recover the Transfers and Refund and be awarded damages and judgment be entered in the Estate's favor against the Defendant, plus interest at the maximum legal rate from the date of each of these payments, or such other amount as shall be shown by proof prior to judgment herein; and

72. Any and all additional and further relief as this Court may deem just and proper.

Dated: February 17, 2015

KATTEN MUCHIN ROSENMAN LLP
Jessica M. Mickelsen
Peter A. Siddiqui

By:/s/ Jessica M. Mickelsen
Counsel for Debtors and Debtors-In-Possession
HashFast Technologies LLC and HashFast LLC

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

KATTEN MUCHIN ROSENMAN LLP
Craig A. Barbarosh (SBN 160224)
craig.barbarosh@kattenlaw.com
650 Town Center Drive, Suite 700
Costa Mesa, CA 92626-7122
Telephone: (714) 966-6822

Jessica M. Mickelsen (SBN 277581)
jessica.mickelsen@kattenlaw.com
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
Telephone: (310) 788-4425
Facsimile: (310) 788-4471

Peter A. Siddiqui (*pro hac vice*)
peter.siddiqui@kattenlaw.com
525 W. Monroe Street
Chicago, IL 60661-3693
Telephone: (312) 902-5455
Facsimile: (312) 902-1061

Counsel for Debtors and Debtors-In-Possession
Hashfast Technologies LLC and HashFast LLC

UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

(SAN FRANCISCO DIVISION)

In re:	Case No. 14-30725
HASHFAST TECHNOLOGIES LLC, a California limited liability company,	(Substantively Consolidated with In re HashFast LLC, Case No. 14-30866)
Debtor and Debtor-In-Possession	Chapter 11
☒ Affects HASHFAST LLC, a Delaware limited liability company,	
Debtor and Debtor-In-Possession	
HASHFAST TECHNOLOGIES LLC, a California limited liability company, and HASHFAST LLC, a Delaware limited liability company,	Adversary Case No. 15-03011
Plaintiffs,	**MOTION FOR ISSUANCE OF RIGHT TO ATTACH ORDER AND WRIT OF ATTACHMENT; MEMORANDUM OF POINTS AND AUTHORITIES; DECLARATION IN SUPPORT THEREOF**
vs.	
MARC A. LOWE, an individual, *aka*	[Cal. Code. Civ. P. § 484.090(a) and (b); Cal.

Cypherdoc and/or Cipherdoc, DEFENDANT.	Civ. Code § 3439.07(a)(2)] Hearing: Date: TBD Time: TBD Place: Courtroom 22 U.S. Bankruptcy Court 235 Pine Street San Francisco, CA 94104

HashFast Technologies LLC, a California limited liability company ("HFT"), and HashFast LLC, a Delaware limited liability company ("HF", collectively with HFT, the "Debtors" and each a "Debtor") hereby moves the above-referenced court (the "Court") for the issuance of a right to attach order and writ of attachment pursuant to California Code of Civil Procedure ("CCP") § 484.090(a) and (b) and California Civil Code ("CC") § 3439.07(a)(2) as to certain Bitcoins ("BTC") fraudulently transferred to MARC A. LOWE (the "Defendant" or "Lowe") on or about September 2013 (the "Motion"). In support of the Motion, the Debtors respectfully submit the following:

MEMORANDUM OF POINTS AND AUTHORITIES

I. INTRODUCTION

In exchange for minimal and potentially ineffectual services, HashFast Technologies transferred 3000 BTC to the Defendant through a series of transfers in or about September 2013 (the "Transfers") per the terms of a memorandum of understanding dated August 5, 2013 (the "MOU"). At the time of the Transfers, the BTC tendered to the Defendant had a value in excess of $360,000—a value far exceeding the reasonable value of the services provided by the Defendant. The Defendant presently holds the BTC subject to the Transfers (the "MOU Payment") in a BTC wallet bearing account number xUDJ9 (the "Wallet").

The Debtors commenced the above-captioned adversary proceeding to recover the MOU Payment for the benefit of the Estate. The Debtors hereby seeks to attach the BTC transferred to

Katten
Katten Muchin Rosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310-788-4400 tel 310-788-4471 fax

the Defendant and presently held in the Wallet[1] to secure any potential judgment obtained against Lowe in the AP. Absent the issuance of a writ of attachment, the bankruptcy estates and their creditors may be unable to recover the fraudulently transferred BTC, which are now worth in excess of $650,000 and which would provide a substantial benefit to the creditors. Accordingly, the Committee respectfully requests that the Court issue a right to attach order and writ of attachment pursuant to CCP § 484.090(a) and (b) and CC § 3439.07(a)(2).

II. STATEMENT OF FACTS

1. Prior to the commencement of the above-captioned bankruptcy cases (collectively, the "Bankruptcy Cases"), the Debtors were engaged in the business of designing, manufacturing, and selling special purpose semiconductors and computers utilized to "mine" BTC.

2. The Debtors are informed and believe that the Defendant has been at all relevant times a medical doctor apparently engaged in the mining of BTC. The Debtors are also informed and believe that the Defendant frequently utilizes the alias "Cypherdoc" and/or "Cipherdoc" when posting comments on Bitcoin-related forums and message boards.

3. On or about July 29, 2013, the Defendant visited the Debtors' headquarters to tour the facility and meet the members and employees of HFT prior to purchasing one or more the BTC "mining" computers manufactured by HFT (the "BabyJet"). During the visit, the Defendant met with Eduardo de Castro, the chief executive officer of HFT in July 2013 and co-owner of HF.

4. Immediately following the Defendant's visit to the Debtors' facility, the Defendant and HFT entered into the MOU. By and through the MOU, the Defendant agreed to endorse the Debtors and their products by posting comments and responding to certain inquiries on Bitcoin-related forums and/or message boards, including Bitcointalk.org. In exchange for these purported "services", the Defendant was to receive ten percent (10%) of the base sale price (i.e., gross sale proceeds) in BTC for the first 550 BabyJets sold by the Debtors. According to the MOU, the Defendant was entitled to such payment regardless of whether the "endorsement" contributed in any way to the sale of any BabyJet. A true and correct copy of the MOU is attached to the

[1] At present, the Wallet contains 2999.00041 BTC, consisting of the originally transferred BTC net of a small withdrawal.

Declaration of Victor Delaglio (the "Delaglio Declaration") as **Exhibit A** and is incorporated herein by reference. At the time the MOU was executed, HFT was offering the BabyJets for sale with a base price of approximate $5,600 or 56 BTC.

5. On or about August 8, 2013, the Defendant began posting comments regarding HFT and the Debtors' products on Bitcointalk.org under a thread titled "HashFast Endorsement." Between August 8, 2013, and September 9, 2013, the Defendant posted a total of 160 comments and updates (an average of five posts per day) regarding, among other topics, the roll-out and sale of the BabyJet. The Defendant's posts, however, were not limited to salient matters; rather, the Defendant also engaged "trolls" in irrelevant and lengthy debate regarding numerous topics, including, but not limited to, economics and the philosophy underlying Bitcoin. The irrelevant commentary accounts for a substantial portion of the approximately 160 posts, a true and correct sample of which is attached to the Delaglio Declaration as **Exhibit B** and incorporated herein by reference. A review of the "HashFast Endorsement" thread suggests that few individuals utilized the forums and/or reviewed the Defendants' postings in deciding whether to purchase the Debtors' products.

6. In or about early September 2013, the Debtors pre-sold the first 550 BabyJets.

7. On or about September 4, 2013, the Defendant requested payment in accordance with the MOU. A true and correct copy of the correspondence is attached to the Delaglio Declaration as **Exhibit C** and is incorporated herein by reference. The Defendant calculated that he was owed a total of $308,000 in BTC at the exchange rate applicable on August 8, 2013 (the date of the first post), and, thus, requested payment of 3242.1 BTC within seven days.

8. The Debtors thereafter transferred a total of 3000 BTC to the Defendant (the so-called "MOU Payment") from two different Bitcoin wallets belonging to HFT. The Debtors made the MOU Payment via four transfers into a Bitcoin wallet specified by the Defendant[2] bearing account number xUDJ9 (the so-called "Wallet")—specifically: (a) 2000 BTC on September 5, 2013; (b) 250 BTC on September 14, 2013; (c) 250 BTC on September 22, 2013;

[2] A true and correct copy of the correspondence in which the Defendant specifies the BTC wallet for payment is attached to the Delaglio Declaration as **Exhibit D** and is incorporated herein by reference.

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

and (d) 500 BTC on September 23, 2013 (collectively, the "Transfers"). A true and correct copy of the transaction record for the Wallet is attached to the Delaglio Declaration as **Exhibit E** and is incorporated herein by reference. With the exception of one BTC, the transferred BTC remain in the Wallet and, to the best of the Debtors' knowledge, have never been moved out of the Wallet. *See* Ex. E. The Debtors' are informed and believes that the Defendant has access to the Wallet and the BTC contained therein, and possesses the authority to transfer such BTC.

9. At the time of the Transfers, the BTC were worth approximately $363,000.[3] Thus, under the MOU, the Defendant received approximately $11,370 per day or $2,274 per post.

10. At or about the time the Defendant was "endorsing" the Debtors and their products, the Debtors attempted to recruit other persons to provide the same or similar services. A true and correct copy of an example of such correspondence is attached to the Delaglio Declaration as **Exhibit F** and is incorporated herein by reference. However, in stark contrast to the MOU Payment, the other parties were offered $150 or approximately one (1) BTC *per week* (approximately 0.0014% of the compensation paid to the Defendant) to post two to four comments per a day on certain online discussion boards or forums—roughly $21.43 per day or $10.71 per post (based on two comments per day). *See* Ex. F.

11. After accepting numerous orders (including the 550 orders upon which the MOU Payment was purportedly based), the Debtors were unable to fulfill many of the orders on or before the guaranteed delivery date, which led to demands for refunds in early 2014. As the Debtors lacked sufficient funds to pay all the refunds requested and remained unable to fill customer orders, multiple lawsuits were commenced against the Debtors.[4]

12. Ultimately, the failure to fulfill customer orders and the commencement of multiple lawsuits resulted in the commencement of an involuntary bankruptcy case under chapter

[3] On September 5, 2013, one BTC was worth $120.5333 (US). On September 14, 2013, one BTC was worth $124.0813 (US). On September 22, 2013, one BTC was worth $122.651 (US). On September 23, 2013, one BTC was worth $122.2235 (US). *See* Historical Bitcoin Price Index, available at http://www.coindesk.com/price/ (last visited Dec. 22, 2014).

[4] Like many other customers, the Defendant requested a refund of the $36,000 he paid in association with his order for four terra-hash per second of hashing power by the acquisition of eight Golden Nonce processors or three to four fully assembled BabyJets. The Defendant received a full refund of the purchase price plus a five percent (5%) bonus on or about January 10, 2014.

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

7 of title 11 of the United States Code (the "Bankruptcy Code") against HFT (the "HFT Bankruptcy") on or about May 9, 2014 (the "HFT Petition Date"). On or about June 3, 2014, HFT consented to entry of an order for relief and converted the HFT Bankruptcy to one under chapter 11. HF filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code (the "HF Bankruptcy") on or about June 6, 2014 (the "HF Petition Date").

13. The Court entered an order substantively consolidating the bankruptcy estates in the Bankruptcy Cases (collectively, the "Estate") on or about September 28, 2014.

14. The Debtors commenced the Adversary Proceeding to recover the 3000 BTC transferred to the Defendant pursuant to the MOU on or about February 17, 2015. In the complaint (the "Complaint"), the Debtors seek to avoid the Transfers under multiple theories, including as a constructive fraudulent transfer under California law.[5] Docket Entry ("D.E.") 1 at Count 3.

III. DISCUSSION

Fed. R. Civ. P. 64 provides in pertinent part that "[a]t the commencement of and throughout an action, every remedy is available that, under the law of the state where the court is located, provides for seizing a person or property to secure satisfaction of the potential judgment." Fed. R. Civ. P. 64(a). Attachment and sequestration are among the remedies within the gamut of Fed. R. Civ. P. 64. *See* Fed. R. Civ. Pro. 64(b).

Under California law, a pre-judgment attachment is "a provisional remedy to aid in the collection of a money demand." *Blastrac, N.A. v. Concrete Solutions & Supply*, 678 F.Supp.2d 1001, 1004 (C.D. Cal. 2012) (citations omitted). To warrant the issuance of an attachment, the movant must establish:

1. The claim(s) alleged support issuance of an attachment order;
2. Probable validity of the claim(s) substantiating the issuance of the attachment order;
3. The attachment is not sought for a purpose other than the recovery on the claim(s) upon which the attachment is based; and

[5] The claims asserted in the Adversary Proceeding are not subject to any automatic stay under the Bankruptcy Code and have not been discharged or otherwise waived. *See* Cal. Civ. P. Code §484.020(d).

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KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

4. The amount to be secured by the attachment is greater than zero.

Cal. Civ. P. Code § 484.090(a). Each element is satisfied here.

A. California Fraudulent Transfer Claim Permits Attachment

Pursuant to CC § 3439.07(a), "[i]n an action for relief against a transfer or obligation under this chapter, a creditor … may obtain: … (2) [a]n attachment or other provisional remedy against the asset transferred or its proceeds in accordance with the procedures" described in CCP § 481.010, *et seq*. The third cause of action in the Complaint seeks to recover the Transfers (i.e., the actual BTC paid to the Defendant in accordance with MOU) under 11 U.S.C. § 544 and CC §§ 3439.05 and 3439.07. Accordingly, attachment is an available remedy.

B. The Fraudulent Transfer Claim is Valid

In order to establish the "probable validity of the claim upon which the attachment is based," the Debtors need only show that it is more likely than not that it will obtain a judgment against Defendant. *See* Cal. Code Civ. Proc. §§ 481.190 and 484.090(a)(2); *see also Blastrac*, 678 F.Supp.2d. at 1005; *Kemp Bros. Const. Inc. v. Titan Elec. Corp.*, 146 Cal.App.4th 1474, 1476 (2007). Here, the Debtors assert causes of action to avoid the Transfers under CCP §§ 3439.04 and 3439.05.

1. The Debtors are Likely to Succeed on a Constructive Fraud Theory Pursuant to Cal. Civ. Code § 3439.05

In order to sustain a claim for constructive fraudulently transfer under CC § 3439.05, the claimant must prove by a preponderance of the evidence that: (1) the debtor held an interest in the property transferred; (2) the transfer occurred within four years of the petition date; (3) the transferor was insolvent at the time of the transfer or became insolvent as a result of the transfer; and (4) the transferor received less than reasonably equivalent value for the property transferred. Cal. Civ.Code §§ 3439.05 and 3439.09; *Greenspan v. Orrick, Herrington & Sutcliffe LLP, et al. (In re Brobeck, Phleger & Harrison LLP)*, 408 B.R. 318, 340-341, 347 (Bankr. N.D. Cal. 2009).

It is beyond dispute that the BTC transferred to the Defendant belonged to the Debtors and that the Transfers occurred within four years of the HFT Petition Date. It is also beyond dispute

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KattenMuchinRosenman LLP
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Los Angeles, CA 90067-3012
310-788-4400 tel 310-788-4471 fax

that at the time of the Transfers, the Debtors were unable to meet their obligations to creditors and vendors, and were insolvent based on their assets and outstanding liabilities. Indeed, as of September 30, 2013, the Debtors' balance sheet had a negative equity balance of about $5 million.

Thus, the remaining issue is whether the "services" provided by the Defendant were worth 3000 BTC. "Determining whether a debtor received a reasonably equivalent value is a two-step process." *Greenspan*, 408 B.R. at 341. First, the Court must determine whether the debtor received any "value" in exchange for the transfer. *Id.* Under California law, the satisfaction of an antecedent debt constitutes "value." Cal. Civ. Code § 3439.03. In the instant case, the Transfer was paid to satisfy the amount owing under the MOU (an antecedent debt). Thus, the Debtors received "value" for the MOU Payment.

Second, "if there was value in exchange, the court must determine whether the value of what was transferred was reasonably equivalent to what the debtor received." *Greenspan*, 408 B.R. at 341. "Reasonable equivalence does not require exact equality in value, but means 'approximately equivalent' or 'roughly equivalent.'" *Id.* "Because the policy behind fraudulent transfer law is to preserve assets of the estate, reasonably equivalent value is determined from the standpoint of creditors; it is not determined from the defendant's perspective." *Brandt v. nVidia Corp. (In re 3dfx Interactive, Inc.)*, 389 B.R. 842, 863 (Bankr. N.D. Cal. 2008), *citing Frontier Bank v. Brown (In re Northern Merch., Inc.)*, 371 F.3d 1056, 1059 (9th Cir. 2004) (proper focus is on the net effect of the transfers on debtor's estate and the funds available to unsecured creditors); *see Kirkland v. Risso,* 98 Cal.App.3d 971, 977, 159 Cal.Rptr. 798 (1979) (California courts apply same standard). "The determination of reasonable equivalence must be made as of the time of the transfer." *Greenspan*, 408 B.R. at 342, *citing BFP v. Resolution Trust Corp.*, 511 U.S. 531, 546 (1994).

As with the other elements, it is beyond reasonable dispute that the Debtors did not receive "value" "reasonably equivalent" to the 3000 BTC paid to the Defendant. Simply put, the "services" provided by the Defendant were minimal while the compensation was astronomical.

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KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

Over the period of approximately one month, the Defendant "endorsed" HFT by posting comments on Bitcointalk.org relating to HFT and the Debtors' products as well as numerous irrelevant topics. In exchange for these often brief and irrelevant comments, the Defendant received 3000 BTC in or about September 2013. At the time of the Transfers, the BTC transferred to the Defendant were worth $363,861.43.[6] In other words, the Defendant received approximately ***$11,370 per day*** or ***$2,274 per post***.

In addition to the fact that the compensation was astronomical, the compensation paid to the Defendant was completely out of line with the compensation offered to other Bitcoin commentators to provide the same or similar services. At or about the time the Defendant was posting his "endorsements," the Debtors sought to employ other parties to endorse HFT and the Debtors' products on Bitcoin-related forums. As consideration, the Debtors offered these other parties $150 or approximately 1 BTC *per week*—approximately *0.0014% of the compensation paid to the Defendant*. The disparity between the MOU Payment and the compensation offered to others to provide the same service(s) as the Defendant demonstrates that the "services" provided by the Defendant were not reasonably equivalent in value to the MOU Payment. Indeed, based on the offers to other endorsers, it appears that the MOU Payment was approximately ***700 times*** the reasonable value of the Defendant's endorsement.

Finally, there is no evidence that the Defendant's "endorsement" resulted in any of the 550 BabyJet sales that purportedly substantiate the MOU Payment and, in fact, the MOU payment was not even predicated on any connection to the 550 sales. Moreover, based on a review of the relevant message board, it appears that few individuals reviewed the message board or relied upon the Defendant's "endorsement" when purchasing a BabyJet—further evidencing the *de minimis* value of the "services" the Defendant rendered.

In sum, the Defendant received more than 3000 BTC (which were worth more than $360,000 at the time of the Transfers and are now worth more than $650,000) from the Debtors while providing little, if any, benefit at a time when the Debtors were insolvent. Thus, based on

[6] *See* n. 2, *supra*. At the time of the MOU Payment, the annual salaries for all employees of HFT totaled $852,000 or $71,000 per month (approximately one-fifth of the MOU Payment).

the information available, the Debtors are more likely than not to prevail on the constructive fraudulent transfer claim underlying the request for issuance of a writ of attachment.

2. The Debtors are Also Likely to Succeed on a Constructive Fraud Theory Under Cal. Civ. Code § 3439.04(a)(2)

The Debtors are also likely to succeed on the fraudulent transfer claim asserted under CC § 3439.04(a)(2), which provides:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation as follows: [¶] (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonable small in relation to the business or transaction. (B) Intended to incur, or believed or reasonably should have believed that he or she [or it] would incur, debts beyond his or her [or its] ability to pay as they became due.

Cal. Civ. Code § 3439.04(a)(2).

The Debtors clearly transferred 3000 BTC to the Defendant in or about September 2013. And the Debtors were indebted to certain creditors at the time of the Transfers and are currently indebted to a number of individuals and entities—a fact that precipitated the Bankruptcy Case.

Accordingly, the questions remain (1) whether the Debtors received "reasonably equivalent value" for the Transfers and (2) whether at the time of the Transfers the Debtors (a) were engaged in a business with unreasonably small capital or (b) intended to incur or reasonably should have anticipated incurring debts beyond its ability to repay as they became due.

As to the first element, and as discussed more fully above, the Debtors received little if any benefit from the Defendant's purported "services" while the Defendant received more than $360,000 in BTC—an amount approximately 700 times more than that offered to others to provide the same or similar "endorsements." Accordingly, the Debtors respectfully submit that the MOU Payment substantially exceeded the value of the "services" rendered.

The present circumstances also satisfy the second element. At the time of the Transfers, the Debtors' operations were in full swing. The Debtors were continuing to take new orders for ASIC processors and BabyJets. The Debtors were also incurring substantial liability to vendors

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

in an effort to obtain the components necessary to fulfill the orders. Based on the volume of sales and the costs associated with the manufacture of the ASIC and BabyJets, the Debtors had insufficient capital to effectively operate the business—a fact demonstrated by the Debtors' inability to deliver customer orders or pay the refunds and the resulting litigation and bankruptcy as well as the fact that, as of September 30, 2013, the Debtors' balance sheet had a negative equity balance of about $5 million.

Despite unreasonably small capital to operate the enterprise, the Debtors continued to incur debts to customers and vendors in an effort to salvage the operation. More specifically, the Debtors continued to accept customer orders for ASIC processors and BabyJets at a time they were unable to fulfill existing orders and, more importantly, unable to fulfill the orders being accepted. Additionally, in an effort to "right the ship," the Debtors continued to place orders for necessary components without the financial wherewithal to pay such vendors as the invoices became due—a fact that resulted in vendors refusing to deliver or continue manufacturing essential components, including, but not limited to, the ASIC processors themselves.

In sum, the Debtors received less than reasonably equivalent value for the Transfers and paid the MOU Payment at a time that the Debtors were unable to fulfill their other financial obligations and were grossly undercapitalized. Accordingly, the Committee is likely to succeed on its CC § 3439.04(a)(2) cause of action.

C. The Attachment is not Sought for an Improper Purpose

By and through the Adversary Proceeding, the Debtors seek to recover the MOU Payment in BTC. Accordingly, the Debtors seek to attach the 3000 BTC in the Wallet to ensure that 3000 BTC are available to satisfy any judgment obtained in the Adversary Proceeding. The Debtors are not seeking to attach the BTC in the Wallet for any other purpose.

D. The Amount to be Secured is Greater than Zero

The Debtors seek to attach the 3000 BTC fraudulently transferred to the Defendant pending the adjudication of the Adversary Proceeding. At the time of the Transfers, the BTC

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

fraudulently transferred to the Defendant were worth more than $350,000. At present, 3000 BTC are worth more than $650,000. Accordingly, the amount to be attached is greater than zero.

IV. CONCLUSION

Based on the preceding, the Debtors respectfully request that the Court enter an order: (1) granting the Motion in its entirety; (2) issue a right to attach order and authorize the Debtors to attach 2999 BTC held in the Wallet; and (3) granting such further and additional relief the Court deems just and appropriate.

Dated: February 19, 2015

KATTEN MUCHIN ROSENMAN LLP
Jessica M. Mickelsen
Peter A. Siddiqui

By:/s/ Jessica M. Mickelson
Counsel for Debtors and Debtors-In-Possession
HashFast Technologies LLC and HashFast LLC

Katten
KattenMuchinRosenman LLP
2029 Century Park East, Suite 2600
Los Angeles, CA 90067-3012
310.788.4400 tel 310.788.4471 fax

BRIAN E. KLEIN (SBN 258486)
BAKER MARQUART LLP
10990 Wilshire Boulevard, Fourth Floor
Los Angeles, California 90024
Telephone: (424) 652-7800
Facsimile: (424) 652-7850
Email: bklein@bakermarquart.com

DAVID M. POITRAS, APC (SBN 141309)
JEFFER MANGELS BUTLER & MITCHELL LLP
1900 Avenue of the Stars, 7th Floor
Los Angeles, California 90067-4308
Telephone: (310) 203-8080
Facsimile: (310) 203-0567
Email: dpoitras@jmbm.com

Attorneys for Defendant Dr. Marc A. Lowe

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

In re: HASHFAST TECHNOLOGIES LLC, a California limited liability company, Debtor and Debtor in Possession	Case No. 14-30725 (Substantively Consolidated with In re HashFast LLC, Case No. 14-30866) Chapter 11 Adversary Case No. 15-03011
☐ Affects HASHFAST LLC, a Delaware limited liability company, Debtor and Debtor in Possession	
HASHFAST TECHNOLOGIES LLC, a California limited liability company, and HASHFAST LLC, a Delaware limited liability company, Plaintiffs, vs. MARC A. LOWE, an individual, aka Cypherdoc and/or Cipherdoc, Defendant.	**DEFENDANT DR. MARC A. LOWE'S OPPOSITION TO DEBTORS' MOTION FOR ISSUANCE OF RIGHT TO ATTACH ORDER AND WRIT OF ATTACHMENT** **Hearing Date:** Date: April 24, 2015 Time: 10:00 a.m. Place: 235 Pine St., 22nd Floor San Francisco, CA 94104 Judge: Honorable Dennis Montali

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INTRODUCTION

Defendant Dr. Marc A. Lowe ("Dr. Lowe") opposes the *Motion for Issuance of Right to Attach Order and Writ of Attachment* (the "Motion to Attach")[Docket No. 5] filed by HashFast Technologies, LLC and HashFast, LLC, both plaintiffs and debtors and debtors in possession (collectively, "HashFast"). The Court should deny the Motion to Attach because neither the facts nor the law support the granting of such an extraordinary pre-judgment remedy. HashFast unjustifiably seeks a windfall of the digital currency (i.e., the bitcoins) properly paid to Dr. Lowe for important and valuable services he rendered to HashFast per its request. In the Motion to Attach, HashFast makes sweeping and wholly unsubstantiated claims and, not surprisingly, fails to come close to meeting the stringent legal standard required to obtain a right to attach order under California law.

HashFast hired Dr. Lowe to promote its first product, bitcoin mining hardware called the BabyJet, on Bitcointalk.org ("Bitcointalk"), the world's leading forum for discussion, news, and advertisement for all things related to bitcoin, including mining hardware. Dr. Lowe, using a pseudonym (in this case, "Cypherdoc") as is a common practice on forums like Bitcointalk, had become one of Bitcointalk's most respected and prolific posters during the relevant timeframe. As such, Dr. Lowe's endorsement carried tremendous weight with the large and vibrant Bitcoin community that flocked to Bitcointalk and it made sound business sense for HashFast to engage him to endorse the rollout of the BabyJet. As history shows, a successful rollout of the BabyJet was critical to the success or failure of HashFast's business. In the exercise of its reasonable business judgment, and to put its best foot forward regarding the critical rollout of the BabyJet, HashFast engaged Dr. Lowe and agreed to pay him the amount at issue as set forth in the Memorandum of Understanding (the "MOU"). *See,* Exhibit 1 to Lowe Decl. The Motion to Attach includes no admissible evidence (or even persuasive argument) whereby a Court can or should second guess HashFast's business judgment concerning the compensation agreed to and paid to Dr. Lowe.

Per the arms-length negotiated agreement with HashFast, Dr. Lowe did precisely what was asked of him (i.e., he posted extensively about BabyJets) and even more (i.e., he promoted BabyJets repeatedly in his bitcoin newsletter and in personal messages to fellow bitcoiners). He did so

because he reasonably believed (based on what he saw and heard from HashFast) that HashFast would deliver a great product within the time frame promised. As a result of his efforts, in part, the initial batch of BabyJets sold out in less than three weeks, generating millions in revenue for HashFast. Thereafter, approximately $15 million more in BabyJets were sold, again, in part due to Dr. Lowe's input and efforts. For his valuable services, HashFast paid Dr. Lowe approximately $300,000[1] in accordance with the terms of the MOU, in the form of the digital currency bitcoins (in this case, 3,000 bitcoins), which equates to a 10% commission on sales of the first 550 BabyJets (not a flat fixed payout unrelated to performance or estimated sales).

As even HashFast is forced to acknowledge in its Motion to Attach (but underplays), attachment is a harsh remedy that deprives a defendant of its property before a plaintiff's claim is proven. For that reason, it is disfavored and every requirement is construed strictly against a plaintiff. Here, HashFast utterly fails to meet the stringent burden it bears – it cannot show that it is likely to succeed on its fraudulent transfer claims for numerous reasons discussed below. Moreover, HashFast has failed to submit any admissible evidence to support its position (let alone credible evidence), and Dr. Lowe has numerous defenses to HashFast's unsubstantiated allegations.

The thrust of the Motion to Attach is that HashFast is entitled to attach Dr. Lowe's 3,000 bitcoins based on unsupported contentions that he (Dr. Lowe) received the bitcoins while HashFast was insolvent and that the services he rendered "may have been ineffective" and did not constitute value reasonably equivalent compared to the amount paid. HashFast's position is problematic for a number of reasons. First, the Motion to Attach contains no admissible evidence to support the alleged claims. The Motion to Attach can and should be denied on this basis alone. Second, HashFast makes no effort to show that Dr. Lowe did not adequately perform the duties that HashFast contracted with him to perform (nor could it succeed in doing so). Third, HashFast relies solely on its own unfounded opinion that the services Dr. Lowe performed for HashFast were

[1] During the time period in question the price of a bitcoin fluctuated tremendously, particularly depending on which exchange you looked to for pricing information. HashFast's approximation of $360,000 in its motion is on the high end. $300,000 represents a more reasonable middle point.

"minimal and ***potentially*** ineffectual." (Mot. at 2:18. (emphasis added).) Rather than provide actual, credible evidence to support its allegations (of which there is none), HashFast offers up a series of tautological statements whereby whatever it alleges is purportedly "indisputable" or "beyond dispute." (*See, e.g.,* Mot. at 7:26.) Such unsupported and self-serving statements are patently insufficient, particularly in light of the heightened legal standard required to obtain a right to attach order. Fourth, HashFast also unjustifiably seeks a windfall by seeking to attach the digital currency (i.e., the 3,000 bitcoins) Dr. Lowe was paid versus the conceded value of the amount transferred on the transfer date. As conceded in the Motion to Attach and the Complaint, Dr. Lowe was owed approximately $308,000 for his services. The medium of exchange for payment of this amount was 3,000 bitcoins. The value of a bitcoin happens to have risen in value from approximately $100 on the date of transfer to approximately $250 as of this filing, and those 3,000 bitcoins therefore have a current value of approximately $750,000. Thus, although the amount in dispute, at most, is approximately $300,000, HashFast seeks to attach bitcoins worth approximately $750,000 (more than double what is in dispute). Lastly, although it is not his burden here, the evidence will show that Dr. Lowe did in fact make substantial contributions to HashFast's sales through his advertising posts on Bitcointalk, his newsletter, and by reaching out to other bitcoiners personally. Dr. Lowe therefore fully earned the money HashFast paid him and such amount was reasonably equivalent to the value of the services he rendered to HashFast.

HashFast does not meet, and cannot meet, the stringent burden necessary to secure attachment of the money HashFast paid Dr. Lowe for his valuable services. Because the evidence and the law do not support HashFast's position, the Court must deny the Motion to Attach.

FACTUAL BACKGROUND

- **Dr. Lowe's Involvement with Bitcoin and Bitcointalk**

1. Dr. Lowe is a well-respected and experienced ophthalmologist, who first heard of and became interested in bitcoin in January 2011. (Declaration of Dr. Lowe ("Lowe Decl.") ¶ 2.) This was only two years after the first bitcoin was issued in January 2009. At the time, very few people were paying attention to bitcoin, and thus Dr. Lowe is one of bitcoin's earliest adopters.

2. Bitcoin is an online ledger invented by Satoshi Nakomoto (a pseudonym) in a 2008 white paper.[2] (Lowe Decl. Ex. B.) The ledger (i.e., Bitcoin) was launched online in January 2009.[3] The ledger allows for the proof and transfer of ownership without the need for a trusted third party.[4] The unit of account the ledger uses are bitcoins.[5] Bitcoins are a digital currency, and new bitcoins are created through "mining," which involves the use of specialty hardware that verifies and records the transactions on the online ledger (and which is explained in greater detail below in paragraph 9).[6]

3. In 2011, Bitcointalk was launched.[7] In July 2012, Bitcointalk reached its one millionth post.[8] From its launch through the present, it has been the world's leading online forum for discussion of all things related to bitcoin.

4. From the time Dr. Lowe first learned of bitcoin in 2011 through the events at issue in 2013, bitcoin was not well covered by the mainstream media, so those interested in it, like Dr. Lowe, had to look for information elsewhere on the internet. Online forums like Bitcointalk sprang up to serve as clearinghouses and modern day think tanks for news, commentary, and advertising related to bitcoin and bitcoin products. Bitcointalk's influence is more widely felt in the bitcoin world than one would expect of a typical message board or online forum because it was one of the first places in the world for people to discuss bitcoin. As such, Bitcointalk was and remains an important and reliable source of information for companies looking to promote bitcoin-related products to an interested target demographic.

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[2] http://en.wikipedia.org/wiki/Bitcoin (The forum had resided on www.bitcoin.org before moving to www.bitcointalk.org in July 2011). *See,* Exhibit 2 to Lowe Decl.

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] https://en.bitcoin.it/wiki/BitcoinTalk_Forum

[8] *Id.*

5. In 2011, Dr. Lowe learned of Bitcointalk. Initially, he was a casual reader of the forum and did not post. (Lowe Decl. ¶ 3.) In April 2011, he registered as a user, securing the user name of "Cypherdoc", and he began posting on the forum. (Lowe Decl. ¶ 4.)

6. Since his first post, Dr. Lowe has become one of the most prominent and well-respected posters on Bitcointalk. In August 2011, he started the "Gold" thread, which has almost 1 million views and which averages 4,000 views a day. (Lowe Decl. ¶ 5.) The thread has become so popular, in large part to Dr. Lowe's accurate predictions that the price of gold and silver would collapse, while the value of bitcoin rose. (Lowe Decl. ¶ 5.)

7. During the time period he was dealing with HashFast, Dr. Lowe was the number three poster, overall in terms of frequency, on Bitcointalk. (Lowe Decl. ¶ 6.) Today, he is the number two poster out of approximately 500,000 Bitcointalk participants. (Lowe Decl. ¶ 7.)

8. These are not a trivial statistics. In May 2013, an important academic paper that analyzed the Bitcoin community cited Dr. Lowe as an "influential member of the Bitcoin community," (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2263707.) That paper, by prominent European academics, notes that Dr. Lowe is one of the five most influential members of the Bitcoin community after Bitcoin's pseudonymous founder, Satoshi Nakamoto.[9]

9. As Dr. Lowe became more and more interested in bitcoin, he got involved in mining bitcoins. (Lowe Decl. ¶ 8.) Bitcoin mining works in essence like this: bitcoin miners use special software and hardware to try to solve a complex math problem, and if they are the first to do so, they are issued a certain number of bitcoins in exchange.[10] Bitcoin mining is decentralized so anyone with an internet connection and the proper software and equipment can try to mine bitcoins.[11] As more and more people and companies flocked to bitcoin mining as the value has

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[9] *Id.* at 16. Dr. Lowe is not explicitly named in the paper because at the time he was only known as "Cypherdoc"; however, he is identifiable because the paper acknowledges and references his "Hero member" status on Bitcointalk and his first forum posting date (without identifying him). *Id.* at 12.

[10] http://en.wikipedia.org/wiki/Bitcoin.

[11] *Id.*

risen, the hardware required to mine successfully has become very sophisticated and specialized because miners all compete against each other and the bitcoin protocol creates more difficult math problems for the miners to solve.[12]

10. In 2011, Dr. Lowe mined his first bitcoins using custom GPU miners. (Lowe Decl. ¶ 8.) By 2013, to successfully mine, Dr. Lowe needed more powerful hardware, and he began looking to purchase bitcoin mining hardware that various companies were beginning to manufacturer. (Lowe Decl. ¶ 8.)

- **Dr. Lowe's Involvement with HashFast (July 2013 – January 2014)**

11. On July 24, 2013, Dr. Lowe became aware of HashFast through HashFast's public announcement on Bitcointalk in the hardware forum. (Lowe Decl. ¶ 9.) In that post, HashFast announced that it was a new business located in San Jose and that it had the premier hardware processing capability necessary to enable bitcoin miners to work at the highest level. (Lowe Decl. ¶ 9.) The post further invited any interested parties to visit the HashFast facility and evaluate HashFast's business. (Lowe Decl. ¶ 9.) Dr. Lowe immediately became intrigued, for a variety of reasons, including the stated power of the equipment and the fact that HashFast was located in Northern California (a relatively easy day trip from his home). (Lowe Decl. ¶ 10.) The most important reason, however, was the opportunity to be amongst the first purchasers of the system. (Lowe Decl. ¶ 10.) For a miner, being an early purchaser of the latest mining hardware is an important key to mining successfully. (Lowe Decl. ¶ 10.)

12. On July 28, 2013, Dr. Lowe responded to HashFast's thread on Bitcointalk, stating that he would be in town on July 29 and would like to tour the HashFast facilities. (Lowe Decl. ¶ 11.) A HashFast representative set up a tour. (Lowe Decl. ¶ 11.) On July 29, Dr. Lowe traveled to HashFast's San Jose facility. (Lowe Decl. ¶ 11.) There, he met Chief Executive Officer Eduardo de Castro ("de Castro") and Chief Technology Officer Simon Barber ("Barber"). (Lowe Decl. ¶ 11.) While there, Dr. Lowe placed an order for approximately $36,000 worth of HashFast's BabyJet bitcoin mining hardware that were then due for release in October 2013. (Lowe Decl. ¶

[12] *Id.*

12.) This was the very first confirmed order for the BabyJet. (Lowe Decl. ¶ 12.) Dr. Lowe placed his order based on his tour of the facilities, Barber's and de Castro's detailed representations concerning the performance of the system, and his desire to be amongst the first to order the new system (again, a key factor in successful bitcoin mining). (Lowe. Decl. ¶ 12.)

13. While there, Barber and de Castro mentioned that they would like for Dr. Lowe to help with HashFast's launch of the BabyJet. (Lowe Decl. ¶ 13.) Specifically, they mentioned that they needed marketing and endorsements help from prominent members of the bitcoin community, and that he was such a member. (Lowe Decl. ¶ 13.) As set forth above, by that time, Dr. Lowe had become well-respected on Bitcointalk. (See paragraphs7-8 above.)

14. Following the July 29 meeting at HashFast's facility, Dr. Lowe and HashFast representatives discussed how Dr. Lowe could help with the launch of the BabyJet. (Lowe Decl. ¶ 14.) Ultimately, an arms-length agreement was reached whereby Dr. Lowe agreed to endorse the BabyJet in the bitcoin community in exchange for a percentage of sales. (Lowe Decl. ¶ 14.) The MOU was signed on or around August 7, 2013, and in it Dr. Lowe agreed to endorse the BabyJet in return for payment of 10% of the proceeds of the first 550 BabyJets sold. (Lowe Decl. ¶ 15, Ex. A.) In turn, HashFast agreed to pay Dr. Lowe 10% of actual sales because, in its reasonable business judgment, it recognized that Dr. Lowe's endorsements and postings on Bitcointalk would be critical to a successful launch of the BabyJet and the future of the company in general. (Lowe Decl. ¶ 15, Ex. A.) Dr. Lowe agreed to endorse the BabyJet because he reasonably believed in the technology and HashFast's ability to timely deliver the product to market, as evidenced by his own purchase of four BabyJets. (Lowe Decl. ¶ 16.)

15. On August 8, 2013, Dr. Lowe started a new thread dedicated to the BabyJet in Bitcointalk's hardware forum, in which, among things, he posted detailed endorsements of the BabyJet and disclosed that he would be paid for his endorsement. (Lowe Decl. ¶ 17.) This thread represented the official opening of HashFast's sales of the BabyJet. (Lowe Decl. ¶ 17.) Crucially, like most online forums, posts only stay towards the top of the forum (and thus are relevant from a marketing prospective) to the extent that other users read or post on a given thread. In essence, continued traffic to a given thread keeps it on the front-page. (Lowe Decl. ¶ 18.) Thus, Dr. Lowe's

postings on the BabyJet were especially valuable in driving traffic and keeping the thread towards the top of the forum during the initial sales period. (Lowe Decl. ¶ 19.) Dr. Lowe posted hundreds of times in the forum, spread out across at least five separate threads, and of course even so-called "unrelated" threads contributed to driving traffic and keeping the HashFast thread front and center before its target audience. (Lowe Decl. ¶ 19.) Posts on Bitcointalk represented almost the totality of HashFast's marketing strategy. (Lowe Decl. ¶ 20.)

16. In addition to his postings on Bitcointalk, Dr. Lowe informed several subscribers to his newsletter, "Financial Risk Analytics" about HashFast, a number of whom decided to buy the BabyJet on that basis. (Lowe Decl. ¶ 21.) Dr. Lowe also fielded personal messages from several users on Bitcointalk, a number of whom decided to purchase one or more BabyJets for that reason. (Lowe Decl. ¶ 22.)

17. Further, throughout this time period, Dr. Lowe was advising HashFast on its marketing interactions with the forum. (Lowe Decl. ¶ 23.) HashFast repeatedly acknowledged the value of his endorsement. (Lowe Decl. ¶ 23.) Indeed, as a result, HashFast wanted Dr. Lowe to join its "Board of Advisors" after the completion of the sales of the first batch of BabyJets, which occurred on August 25, although he did not do so.[13] (Lowe Decl. ¶ 23.)

18. As a result of Dr. Lowe's manifold and extensive efforts, the initial run of 550 BabyJets sold out in 17 days (from August 8–25), and Dr. Lowe received payment for his services per the terms of the MOU, albeit spread out during September 2013. (Lowe Decl. ¶ 24.) Rather than dollars, he accepted 3,000 bitcoins. (Lowe Decl. ¶ 24.) During this time period, one bitcoin was worth approximately $100,[14] and thus he received approximately $300,000 in bitcoins. This was a 10% commission on total sales completed, not a flat fixed payout unrelated to performance or estimated sales. (Lowe Decl. ¶ 25.)

19. The sale of the initial batch of 550 BabyJets had brought in over $3.0 million in revenue (550 x $5,600 = $3.08 million). Future BabyJet sales brought in an additional $15 million.

[13] Dr. Lowe never joined any Board of Advisors.

[14] As noted in footnote 1, the price of bitcoin fluctuated a lot during this time period.

20. Throughout this time period, Dr. Lowe believed HashFast would deliver the BabyJet on time and that it would perform at the level HashFast said it would. (Lowe Decl. ¶ 27.) It was not until late December 2013 that Dr. Lowe became concerned that HashFast would not be able to deliver the BabyJet in a timely manner, and he voiced those concerns, both on Bitcointalk and directly to HashFast. (Lowe Decl. ¶ 28.) December 31, 2013 was the previously publicly announced delivery/refund date. (Lowe Decl. ¶ 29.)

LEGAL STANDARD

Attachment is a "harsh remedy because it causes the defendant to lose control of his property before the plaintiff's claim is adjudicated." *Martin v. Aboyan,* 148 Cal. App. 3d 826, 831 (1983); *Blastrac, N.A. v. Concrete Solutions & Supply,* 678 F. Supp. 2d 1001, 1004 (C.D. Cal. 2010). For that reason, "the requirements for the issuance of a writ of attachment are strictly construed against the applicant." *Id.* Accordingly, the burden is on the applicant to establish each element necessary for an attachment order by a preponderance of the evidence." *Id.* at 1004-05.

A court may not issue a writ of attachment unless a plaintiff meets the following four factors:

1. The claim upon which the attachment is based is one upon which an attachment may be issued;

2. Probable validity of the claim(s) substantiating the issuance of an attachment order;

3. The attachment is not sought for a purpose other than the recovery on the claim upon which the attachment is based; and

4. The amount to be secured by the attachment is greater than zero.

Cal. Code. Civ. Proc. § 484.090(a). In determining the probable validity of a claim, a court must consider the relative merits of the positions of the respective parties and make a determination as to the probable outcome of the litigation. *Blastrac*, 678 F.Supp.2d at 1005. Not only must a plaintiff make out a *prima facie* case for its claim, the plaintiff must also show that the defenses raised are less than likely to succeed. *See Pet Food Express, Ltd. V. Royal Canin USA Inc.,* 2009 WL 2252108 at *5 (N.D. Cal. 2009). If an applicant fails to do this, it has not established the probable validity of the claim, and a right to attach order cannot issue. *Id.*

ARGUMENT

The Motion to Attach, which is exclusively tied to the fraudulent transfer claims[15] (the second through fourth causes of action in the Complaint), fails primarily for the following reasons. First, HashFast, despite having the burden here, has submitted no credible or admissible evidence whatsoever that, even if proven, would support a right to attach order. Second, HashFast is unlikely to prevail on any fraudulent transfer theory.

I. HashFast Has Not Submitted Any Admissible Evidence To Support Attachment

Under California law, the burden is on HashFast to establish each element necessary for an attachment order by a preponderance of the evidence. *Blastrac*, 678 F. Supp. 2d at 1001. This is to be done by sworn affidavit. *Id.* The law requires that the declaration or affidavit in support of a request for a writ of attachment show, on the facts presented, that the applicant is entitled to judgment on which the claim is based. Cal. Code Civ. Proc. § 484.030. HashFast has failed to submit either admissible evidence or evidence that is credible to carry the burden showing it is entitled to a right to attach order.

The only evidence HashFast submitted in support of the Motion to Attach is the page and a half declaration of Victor Delaglio (the "Delaglio Declaration"), who is described as a "Director of Province, Inc." who is "assisting" the CRO of HashFast. The declaration states that it is "[b]ased on [declarant's] own personal knowledge of the facts." (Delaglio Declaration ¶2.) As set forth in detail in Dr. Lowe's concurrently filed *Evidentiary Objections and Motion to Strike Delaglio Declaration*, Mr. Delaglio does not have personal knowledge of any of the "facts" set forth in his declaration, as required by Federal Rule of Evidence 602 (among the many evidentiary problems with his declaration). An application to employ Peter Kravitz "and others at Province, Inc."[16] as CRO was not filed with the Court until November 21, 2014, over 14 months after the events at issue in the Complaint and the Motion to Attach. Accordingly, it cannot be disputed that Mr. Delaglio does not

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[15] HashFast has not sought a right to attach order for the preference claim, which is the first claim for relief. If HashFast had sought attachment based on the preference claim, it would fail to meet the attachment standard for similar reasons as set forth herein.

[16] Such as Mr. Delaglio.

have personal knowledge of matters pertaining to HashFast that occurred more than 14 months before he was introduced to HashFast.

Moreover, the Delaglio Declaration references six documents in support of the Motion to Attach, yet the declaration does nothing to authenticate the documents or even attempt to set forth any foundation to admit these documents as business records of HashFast. Therefore, the entirety of the Delaglio Declaration and its referenced exhibits are inadmissible in this proceeding and the Court should strike them altogether.

Even more telling, perhaps, is that, admissible or not, the Delaglio Declaration makes no reference whatsoever to: (i) the solvency of HashFast on the date of the transfers at issue (neither balance sheet, equitable nor unreasonably small capital); (ii) the existence of creditors of HashFast before or after the transfers at issue; or (iii) the issue of reasonably equivalent value. Based upon HashFast's failure to provide any admissible evidence concerning the facts and claims at issue in this proceeding, the Motion to Attach must be denied.[17]

Notwithstanding the foregoing, and assuming any part of the Delaglio Declaration is deemed admissible (which it is not), none of the Delaglio Declaration's exhibits (which are Exhibits A-F) or "factual assertions" come remotely close to carrying HashFast's heavy burden here.

Exhibits A-E are the MOU between HashFast and Dr. Lowe, a selective/incomplete sampling of some of Dr. Lowe's posts, and documentation showing Dr. Lowe asked for and received payment in accordance with the MOU. These exhibits and the related statements of Mr. Delaglio (¶¶ 4-9) only show that Dr. Lowe complied with the terms of the MOU, which HashFast does not dispute, and that he was compensated in accordance with the MOU. This obviously does not meet HashFast's burden of showing that Dr. Lowe was overpaid. As HashFast implicitly concedes in the Delaglio Declaration, Dr. Lowe entered into an arms-length agreement with

[17] Moreover, it bears mentioning that the Delaglio Declaration fails to comply with the most basic factual provisions of the attachment statute, which require that an applicant swear under oath (either by declaration or verified complaint) that the attachment is not sought for a purpose of other than a recovery, a precise statement of the amount to be secured by the attachment, and the factual basis for the right to attach. *Cal. Code Civ. Proc.* §§ 482.020, 484.020, 484.030. None of the required statements are included in the Delaglio Declaration.

HashFast, did what the contract asked of him, and was compensated in accordance with the terms of the MOU. All of this is certainly not evidence that Dr. Lowe was paid more than his services were worth, which HashFast must show. Quite the opposite, it is evidence of properly paid for performance.

Without the proper context, the only portion of the Delaglio Declaration that arguably might support HashFast's claim regarding value is the last paragraph (¶ 10) and its related exhibit (Exhibit F). There, Mr. Delaglio states that "at or about the time" Dr. Lowe was endorsing HashFast and the BabyJet, HashFast "attempted to recruit others to provide the same or similar services." It then concludes by referencing, as a purported example, Exhibit F. Exhibit F is a single email dated October 12, 2013, purportedly from HashFast to someone named "Will" offering him $15 dollars per hour for 1-2 supporting posts each day. (Delaglio Declaration Ex. F.)

This lone email and the related statement do not meet HashFast's burden either. At the outset, it should be noted that there is no evidence that anyone else actually entered into an agreement similar to the MOU – it only references unsuccessful attempts to recruit other incomparable people for other services. It must also be noted that the attestation claims that the email was sent "[a]t or about the time [Dr. Lowe] was endorsing the [HashFast and the BabyJets]…" (Delaglio Declaration ¶ 10.) This statement is materially inaccurate. The email at issue was sent on October 12, over two months after Dr. Lowe had commenced rendering services and over one month after his services were complete and paid for in connection with the sale of the first 550 BabyJets. The time discrepancy between early August 2013 (when Dr. Lowe was engaged and started posting) and mid-October 2013 is critical because by mid-October, the BabyJet had been successfully launched and sales were plentiful. Accordingly, it would seem to make sense that after a successful product launch, future promoters would be compensated with less money because the product was already established in the marketplace.

Second, even if the "Will" email had been sent in August or September when Dr. Lowe was performing under the MOU, it begs the question, so what? It is not evidence of anything. Neither the Delaglio Declaration nor the Motion to Attach submit any evidence or even argument who "Will" is or that "Will's" endorsement would be of comparable value to Dr. Lowe's, one of the

most respected posters on Bitcointalk. (*See* Delaglio Declaration ¶ 10; Mot. at 9:7-17.) Nor is there any indication that "Will" or any of the other people who were supposedly offered endorsement contracts actually accepted HashFast's offer. In that case, it is fair to assume that it was rejected because it undervalued the services required of even "Will," particularly in light of HashFast's burden here.

Moreover, there is not even an argument that the purported services "Will" was to perform were sufficiently similar to those that Dr. Lowe did in fact perform, such that the difference in compensation was unreasonable. If anything, the evidence shows the opposite. Dr. Lowe was brought on during the crucial product launch, when the hardware was of most value and unknown in the marketplace. (Lowe Decl. ¶¶ 17-23.) He was brought in to create an explicit endorsement thread, and he provided other services. (Lowe Decl. ¶¶ 17-23.) In contrast, after this critical juncture had passed and when the initial run of the BabyJet had sold out, it appears the purported offer made to "Will" (and unidentified others) required merely a few supporting posts in preexisting threads. Finally, if Dr. Lowe gave reasonably equivalent value (as he did) for the services rendered, it does not matter what others were offered.

Overall, HashFast fails to meet its evidentiary burden for a myriad of reasons, and even if it could change that fact (which it cannot), it cannot do so at this stage because it is not permitted to offer new evidence. HashFast is stuck with its deficient "evidentiary" submission.

II. HashFast Has Not Carried Its Burden to Establish the Probable Validity of its Constructive Fraudulent Transfer Claims

In the Complaint, HashFast asserts three claims for relief (the Complaint's second through fourth claims) based upon allegations that the transfers at issue are avoidable as constructively fraudulent transfers (the "Fraudulent Transfer Claims"). The Fraudulent Transfer Claims are predicated upon 11 U.S.C. § 544 and California Civil Code § 3439.04(a)(2); California Civil Code § 3439.05; and 11 U.S.C. § 548(a)(1)(B). To obtain a writ of attachment pursuant to each of these statutes, at a minimum, HashFast must satisfy by a preponderance of the evidence (at least) these three prongs: (1) it was insolvent on the date of each transfer; (2) it did not receive reasonably

equivalent value in exchange for each transfer; and (3) there are/were present or future creditors whose claims remain unpaid. Here, HashFast has not satisfied any of the three prongs.

a) HashFast Has Not Shown Insolvency At The Time Of Transfer (The First Prong)

The above fraudulent transfer statutes utilize one of three tests for insolvency, the balance sheet test, equitable insolvency, or the unreasonably small capital test. As set forth above, HashFast has failed to submit any evidence concerning solvency under either of these tests, admissible or not. HashFast has therefore failed to satisfy the first prong.

b) HashFast Has Not Shown It Did Not Receive Reasonably Equivalent Value (The Second Prong)

1. There is No Evidence to Support Lack of Reasonably Equivalent Value. HashFast received more than reasonably equivalent value from Dr. Lowe. Although Dr. Lowe does not bear the burden here (HashFast does), the evidence included in this Opposition shows just that. Moreover, as set forth above, HashFast has failed to submit any evidence concerning value, admissible or not. Thus, HashFast has failed to satisfy the second prong.

2. The Value Exchanged Only Needs to be Approximately Equivalent. The above fraudulent transfer statutes define a critical element of a constructively fraudulent transfer as a transfer for which the debtor did not receive "reasonably equivalent value." To determine whether the transfers sought to be avoided by a trustee were constructively fraudulent, a court must determine the value of what the debtor transferred and the value of what the debtor received. A court must then determine whether the latter value is reasonably equivalent to the former. "Reasonable equivalence" does not require exact equality in value. *In re Carbaat*, 357 B.R. 553, 560 (Bankr. N.D. Cal. 2006). A balance must be struck between the need to not permit grantors to profoundly impair their ability to discharge obligations to creditors, and the reality that parties need leeway to make deals "some good, some not so good..." *Chomakos v. Allard Jr.*, 170 B.R. 585, 591 (Bankr. E.D. Mich. 1993). This is especially true when the valuation involves services instead of tangible goods as one to one comparisons of value are difficult. *Id.*

3. Satisfaction of an Antecedent Debt is Not a Fraudulent Transfer. As conceded in the Motion to Attach, "[u]nder California law, the satisfaction of an antecedent debt constitutes 'value.' Cal. Civ. Code § 3439.03. In the instant case, the Transfer was paid to satisfy the amount owing under the MOU (an antecedent debt). Thus, the Debtors received 'value' for the MOU Payment." (*See* Mot. 8:8-11.) From this principle, it is generally held and understood that payments on account of antecedent debts are not fraudulent transfers under both state and federal law.[18] "Payment on an antecedent debt is ordinarily not recoverable as a fraudulent transfer, the debt being deemed valid consideration for such payment. 11 U.S.C. § 548(d)(2)(A)." *In re United Energy Corporation,* 102 B.R. 757, 763 (BAP 9th Cir. 1989); *see also Mayors v. Commissioner of Internal Revenue,* 785 F.2d 757, 761 (9th Cir. 1986) (quoting *Bank of California v. Virtue & Scheck, Inc.,* 190 Cal.Rptr. 54, 65 (1983) (applying California law) ("[t]he essential issue before the jury was whether the entire transaction was enacted in good faith. If the parties in good faith believed that the promise was binding, then the consideration was good")); *Atlanta Shipping Corporation, Inc. v. Chemical Bank,* 818 F.2d 240, 249-50 (2d Cir. 1987) ("[f]air consideration is given for an obligation '[w]hen in exchange for such . . . obligation, as a fair equivalent therefor, and in good faith . . . an antecedent debt is satisfied . . . .' In general, repayment of an antecedent debt constitutes fair consideration unless the transferee is an officer, director or major shareholder of the transferor."). Thus, the MOU payment itself cannot be a fraudulent transfer (and the Complaint does not seek avoidance of the obligation), and therefore, the Motion to Attach must be denied.

4. The Facts Do Not Support Any Claim That Reasonably Equivalent Value Was Not Exchanged. Of course, promotion / advertising can be difficult to value as it encompasses both direct and indirect benefits and the effects of advertising can be hard to quantify. However, even applying the most restrictive standard, any purchasers who bought a BabyJet on account of Dr. Lowe or became aware of the BabyJet on account of Dr. Lowe's activities provide readily definable monetary value to HashFast. For the time period from when Dr. Lowe began endorsing the BabyJet

[18] Moreover, 11 U.S.C. § 548(d)(2)(A) specifically provides that "value" means the satisfaction or a present or antecedent debt.

on HashFast's behalf (on August 7, 2013), to the time the first batch of BabyJets sold out (approximately 17 days later), HashFast has not put forward any evidence that anyone else marketed or endorsed the BabyJet on HashFast's behalf during that time period. Nor has HashFast put forward any evidence that might tend to show that Dr. Lowe was not a substantial factor in the sales (not that there is any). Further, since Dr. Lowe was only getting a 10% commission on the first 550 BabyJets sold, he does not need to show that he was a factor in all or even a large portion of the sales, as HashFast suggests. (*See* Mot. at 9.) Moreover, HashFast ignores all the sales made after the initial batch of BabyJets was sold, which amount to approximately $15 million in additional sales. It is fair to say that Dr. Lowe's endorsements and postings, which had a material positive impact on the sale of the first 550 units, carried over and positively influenced ongoing sales, providing further significant value to HashFast.

As demonstrated above, other than a single random email, HashFast has made no effort to present actual evidence that Dr. Lowe's services were not reasonably equivalent to the compensation received. HashFast simply relies on the arguments of its attorneys, who are relying on an inadmissible declaration, which presents no admissible or probative details regarding value.

Importantly, HashFast does not cite a single example of anyone with a similar reputation as Dr. Lowe, performing similar services, for less pay, during a similar time period, and what that person was paid. Nor has HashFast presented any evidence or legal authority that 10% of the proceeds of the first 550 BabyJets sold is unreasonable, particularly when Dr. Lowe was apparently the only outside party promoting the product. Instead, HashFast resorts to self-serving arguments and entirely unsubstantiated pronouncements that it is "beyond reasonable dispute" that HashFast did not receive such value. (*See, e.g.*, Mot. at 8:25.) This is obviously not even close to enough evidence to meet their burden.

By contrast, Dr. Lowe has submitted evidence that certain people did purchase because of his endorsements and other activities. (Lowe Decl. ¶ ¶ 21-22.) Not only did he repeatedly post on Bitcointalk, he reached out to prospective purchasers from his newsletter, and there is credible evidence that many of them purchased and/or became aware of the BabyJet on that basis. (Lowe Decl. ¶ ¶ 21-22.)

Additionally, HashFast's motion contains an outright falsehood. HashFast claims that based on a review of the message board, "it appears that few individuals reviewed the message board or relied upon the [Dr. Lowe's] endorsement when purchasing a BabyJet..." (Mot. at 9:20-23.) Initially, it should be noted that HashFast, provides no evidence to support this claim. It is yet another, in a long line, of self-serving and entirely unsubstantiated statements. Setting that ongoing problem aside, simply looking at the message board itself belies this claim. The partial thread they submitted as Exhibit B (only one aspect of Dr. Lowe's efforts on behalf of HashFast) indicates that it was read 25,661 times. That does not necessarily mean that it was read 25,661 times during the relevant time period, but it is strong evidence that his endorsement generated thousands of views when the BabyJet was for sale. This is especially important because the BabyJet was a niche product for an extremely niche market, so thousands of views in a forum, that attracts the right demographic, is substantial, against the sale of the 550 BabyJets at issue.

Moreover, between Dr. Lowe's endorsement and the end of the thread, where he announces he is no longer being paid, contains well over 500 unique postings. Dr. Lowe's unique postings were critical because posts only stay towards the top of the forum (and thus are relevant from a marketing prospective) to the extent that other users read or post on a given thread. (Lowe Decl. ¶¶ 18-19.) There is no basis to assert, as HashFast appears to do, that few individuals reviewed the message board, especially in light of the product being repeatedly endorsed (which naturally appealed to a small highly selective target demographic). Of course, this does not even take into account all the users who personally messaged Dr. Lowe on Bitcointalk after seeing the thread; or any of the other substantial work performed by Dr. Lowe to generate customers for HashFast. (Lowe Decl. ¶¶ 17-23.)

Simply put, HashFast submitted no evidence that might tend to show Dr. Lowe's services were ineffective or not reasonably equivalent to the value received. Instead, the Motion to Attach relies on, at best, unsupported allegations. Dr. Lowe, on the other hand, has submitted such evidence, even though it is unnecessary to do so because the burden here is on HashFast. Tellingly, HashFast is not even confident enough in its theory to definitively give an opinion that his services were ineffectual. Instead, HashFast merely states that Dr. Lowe's services were "potentially"

ineffectual. (Mot. at 2:18.) Certainly, depriving a defendant of his property prior to due process of the law should require more than a half-hearted statement that he "might not" have earned it.

c) HashFast Has Not Shown The Existence of Creditors (The Third Prong)

To have standing to pursue a fraudulent transfer claim, HashFast must prove the existence of creditors with unpaid claims. The Motion to Attach includes no evidence on this issue. Accordingly, HashFast has failed to satisfy the third prong

III. Any Judgment or Attachment is Limited to the Value of the Transfers as of the Date of Transfers

It is unclear from the Complaint whether HashFast is seeking the return of the bitcoins themselves or the amount the parties otherwise agreed as reasonable consideration, the $300,000 paid pursuant to the MOU. If HashFast is entitled to any recovery, which it is not, it may only recover the dollar value on the date of transfer which the Court may find exceeds the value received by HashFast. As the Motion to Attach acknowledges, "[t]he determination of reasonable equivalence must be made at the time of the transfer." *In re Brobeck, Phleger & Harrison, LLP,* 408 B.R. 340, 342 (Bankr. N.D. Cal. 2009), *citing BFP v. Resolution Trust Corp.,* 511 U.S. 531, 546 (1994); *see also In re Pajaro Dunes Rental Agency, Inc.,* 174 B.R. 557, 578 (Bankr. N.D.Cal. 1994)("all assets involved in the contested transfer should be measured at their market value at the time of transfer."); *In re Ozark Restaurant Equipment Co., Inc.,* 850 F.2d 342, 344-45 (8th Cir. 1988). Neither appreciation nor depreciation in the value of the assets after the transfer affects the calculation of consideration. *In re Newman,* 15 B.R. 658, 660 (S.D.N.Y. 1981); 4 *Collier* ¶ 548.09 at 548-116."); *see also* Cal. Civil Code §3439.08 and 11 U.S.C. §548(c).

CONCLUSION

For all of the foregoing reasons, the Motion to Attach must be denied. HashFast has failed to meet its burden. Dr. Lowe prays for relief in accordance with the foregoing and for such other and further relief as the Court may deem just and proper.

Respectfully submitted,

BAKER MARQUART LLP
BRIAN E. KLEIN

- and -

Dated: April 10, 2015

JEFFER MANGELS BUTLER & MITCHELL LLP
DAVID M. POITRAS, APC

By: */s/ David M. Poitras*
DAVID M. POITRAS
Attorneys for Defendant
Dr. Marc A. Lowe

Faculty

Darren Azman is a partner in the New York office of McDermott Will & Emery and focuses his practice on corporate restructurings, creditors' rights and distressed acquisitions. His clients include private-equity sponsors, troubled companies, official creditors' committees, financial and strategic purchasers of distressed assets, and other constituents in connection with in-court and out-of-court restructurings. Mr. Azman has distinct restructuring experience in the fields of energy, manufacturing, health care, technology, maritime and transportation, cryptocurrency and cross-border restructurings, including insolvency proceedings in Brazil, Germany, Japan and Korea. He also acts as a trusted advisor to emerging companies by helping them navigate a wide range of business and legal issues, including capital formation, licensing, developing and leveraging intellectual property, strategic alliances, regulatory compliance, employee and labor matters, litigation and general corporate matters. During law school, Mr. Azman took a leave of absence to start a health care technology company in New York, which still exists today. His clients include emerging companies in the technology, healthcare, energy, blockchain, cryptocurrency, telecommunications and media space. Mr. Azman was honored as a member of ABI's 2021 class of "40 Under 40" and has been recognized in *The American Lawyer* as Litigator of the Week Runner-Up (February 2021), *The Best Lawyers in America* as one of the "Ones to Watch" for Bankruptcy and Debtor Credit Rights/Insolvency and Reorganization Law for 2021, and Turnarounds & Workouts as a 202 Outstanding Young Restructuring Lawyer. He also was part of the team that won the ABI Asset Sales Committee's Asset Sale of the Year for his work as lead debtor's counsel in *In re Agera Energy*. Mr. Azman received his B.S. *magna cum laude* from Bentley University and his J.D. *cum laude* from Georgetown University Law Center.

Richard A. Chesley is a co-U.S. managing partner of DLA Piper in Chicago and New York, and chairs its Restructuring Practice. He focuses his practice on corporate restructuring with an emphasis on bankruptcy transactions, both in the U.S. and internationally. Mr. Chesley has served as restructuring counsel in a number of chapter 11 proceedings, including the recently completed chapter 11 cases of LK Bennett, Appvion, Abengoa US Holding LLC (including the related chapter 15 proceeding), LLC and its affiliates, Vertellus Specialties, Orchard Supply Hardware Stores, Velti plc, PJ Finance Inc., and Trident Microsystems Inc. and its subsidiaries in Asia and Europe. He recently worked on chapter 15 filings for bankruptcy protections through U.S. courts for U.K.-based Arcadia Group, the parent company of Topshop and Topman. He has served as debtors' counsel in a number of other chapter 11 proceedings, including Kaiser Aluminum Corp., National Century Financial Enterprises, Federated Department Stores, Elder-Beerman Stores, Montgomery Ward, Purina Mills, The Loewen Group, PFF Bancorp, Contech LLC, Morton Industrial Group, Vermillion, Inc, Fairfield Residential and its subsidiaries and East West Resort Development. Mr. Chesley also represented Authentic Brands Group in a number of its acquisitions in chapter 11, including Nine West, Aeropostale, Barneys New York, Prince Sports and Hickey Freeman, and a number of acquisitions outside of court, including the Marilyn Monroe brand. In addition, he has led a number of out-of-court restructurings, including Arendal, Norwood Promotional Products, Examination Management Services Inc. and Educational Media Publishing Group. Mr. Chesley has served as counsel to official creditors' committees in the Polaroid Corp., Stratosphere Hotel, MobileMedia Communications, Edison Brothers Stores, Grant Geophysical and Mercury Finance matters. He also has represented a number of other constituencies in bankruptcy proceedings throughout the U.S., including finan-

cial advisors, real estate acquirors, liquidators and other significant creditors, ranging from UBS in multiple restructurings relating to the sub-prime crisis to Tiger Woods in the Planet Hollywood chapter 11 proceedings. In addition, Mr. Chesley handles litigation matters throughout the country stemming from bankruptcy proceedings. Once he firmly established his restructuring law career and before joining DLA Piper, he worked at Houlihan Lokey Howard & Zukin, a financial advisory firm with which he still works closely. While there, he served as senior vice president and restructuring general counsel. In addition to his firmwide legal responsibilities, he was also a member of Houlihan Lokey's financial restructuring group, working on the restructuring of Nextel International, CTI Movil, and United Airlines. Mr. Chesley has served a number of *pro bono* clients in the U.S. and globally, and received the firm's *Pro Bono* award in 2016. He received his B.A. from Northwestern University and his J.D. from the University of Cincinnati College of Law, where he served on the editorial board of its law review.

Ori Katz is a partner in the Finance and Bankruptcy Practice Group of Sheppard, Mullin, Richter & Hampton LLP in San Francisco, where he specializes in business bankruptcies and other aspects of insolvency law. He has represented debtors, creditors, creditors' committees, parties purchasing assets out of bankruptcy and parties involved in bankruptcy litigation, and he has successfully reorganized companies in a wide range of industries, including real estate, retail, construction, biotech, telecommunications, media and the Internet. Mr. Katz has represented lenders and loan servicers in connection with receiverships, loan workouts, restructurings, foreclosures and borrower bankruptcies, and has acted as receivership counsel in connection with various appointments. He is a frequent speaker on bankruptcy and insolvency law matters, and he taught a seminar on business bankruptcy and corporate reorganization at UC Hastings College of the Law in 2013 and 2014. Mr. Katz is currently a director of the Bay Area Bankruptcy Forum and a past co-chair of the Insolvency Law Conference's California Bankruptcy Forum. He is also a member of the State Bar of California Insolvency Law Committee's Business Law Section, and he sits on the advisory board of ABI's Southwest Bankruptcy Conference. Mr. Katz has been listed in *Chambers and Partners*, the *Legal 500* and *Northern California Super Lawyers*. He received his B.A. in 1996 from the University of California, Santa Barbara and his J.D. from Boston University School of Law in 2000.

Lewis S. Rosenbloom is the chief legal and strategic affairs officer of Inveniam in Chicago and leverages his 40+-year career in business, finance and law by stewarding Inveniam's corporate growth strategies and relationships and legal affairs. He has a background in both finance and law, and as well as expertise in special situations and M&A, and he is often called upon to provide guidance to start-ups, early stage and mature businesses. In addition to his role with Inveniam, Mr. Rosenbloom continues to oversee Rosenbloom Advisors, an advisory firm focused on growth strategies and efficient project management and strategic vision to help manage Inveniam's and his own complex business, financial and legal affairs. Prior to forming Rosenbloom Advisors, he maintained a tax and accounting practice with a predecessor to Ernst & Young, held two securities licenses as an investment and securities advisor and dealer, and chaired worldwide business, governance, corporate finance, mergers & acquisitions, commercial litigation and restructuring practices at some of the world's largest law firms. Mr. Rosenbloom is a frequent author and lecturer, and has been recognized by numerous organizations and in various publications. He is admitted to practice before the U.S. Supreme Court, the U.S. Courts of Appeals for the Third, Seventh and Ninth Circuits, and the U.S. District Court and Trial Bar for the Northern District of Illinois. Mr. Rosenbloom received his B.A. in 1973 from Lake Forest College, his degree in accounting and finance and computer science from

Northwestern University Kellogg School of Business in 1974, and his J.D. *summa cum laude* from DePaul University School of Law in 1976.