

## **An Investor's Road Map For Distressed Crypto Assets**

By **Joe Castelluccio, Douglas Spelfogel and Matteo Daste** (June 21, 2023, 12:16 PM EDT)

Investing in or acquiring distressed assets can be a lucrative investment strategy for those with a healthy risk appetite and a road map for sourcing and evaluating quality assets.

Following a steep run-up in crypto asset prices and valuations of crypto-adjacent businesses in the last two years, there has been a sharp increase in companies and assets in the space looking at deeply distressed valuations, liquidity crunches, or formal insolvency or bankruptcy proceedings.

Opportunities to invest in or acquire these types of assets will present a significant opportunity for those that can navigate the processes, appropriately price the assets and mitigate risk in the businesses themselves.

For those looking to treasure hunt for distressed or undervalued crypto assets or crypto-adjacent businesses, in this piece we describe three contexts in which these investments can be made: a down round of financing by a business, a secondary sale of an investment position, and asset sales in distressed situations either prior to or as part of a bankruptcy proceeding.

For each of these contexts, we will highlight procedures and potential pitfalls that can make or break the success of an investment.

### **Investments In and Acquisitions of Distressed Digital Assets**

#### ***Down Round Investing***

A down round is a financing event in which a company raises capital — often through an issuance of preferred stock or convertible securities — at a lower valuation than in its previous round of financing.

Down rounds can be triggered by various factors, such as market downturns, competitive pressures, missed milestones or reduced growth expectations. In the current digital assets market environment, all four factors — and others — have combined to have a dramatic effect on valuations.



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Down rounds can have significant implications for both companies and investors.

Investors in down rounds will need to navigate an investment process that may have additional risk factors to account for. Among them, uncertain valuations and extended timelines for looking to pivot products and strategies or otherwise reverse the setbacks that resulted in the down round in the first place.

In parallel with these challenges, however, down rounds can also present opportunities for investors, such as the opportunity for exponentially higher potential investment returns.

For investors with a particularly long time horizon — and an optimistic view on the long-term prospects for digital assets and blockchain technology — down round investments in these sectors may be worth the effort.

For those investors looking to do so, a targeted due diligence effort is critical.

While due diligence of business and legal issues is critical to any investment process, in a down round for a business in the digital assets sector there are some specific questions to ask alongside others that might not be relevant in a different market or context.

*What are the reasons or issues that contributed to the decline in valuation?*

Are these issues unique to the company, industry-wide or systemic? Have they been addressed and are they solvable at all? For example, a rogue employee or mishandled software release can be a significant setback, but is not necessarily fatal to the long-term prospects of a business.

Is the decline in valuation due to uncertainty in the capital markets and slower exit cycles via sale transactions? Exit trends tend to be cyclical and relatively short-lived when compared to longer-term, secular trends in interest rates or other policies.

Keep in mind that multiple factors may play a part, which will lead to different answers to the follow-up questions.

*What will be the key drivers for turnaround and growth in the future?*

Are there roadblocks or impediments to the company's use or maximization of those drivers?

If the company is not already profitable or cash-flow positive, is there a path to achieve either or both without additional financing?

*Are there legal or regulatory changes on the horizon that could affect the business plan or trajectory?*

Even in a sector where legal and regulatory risks cannot be completely eliminated, certain business models or services may be more likely targets for regulators or legal challenges than others.

These include businesses that are retail or consumer facing — as opposed to business-to-business or institutionally focused — or that provide services that have already been the target of regulators and enforcement actions, such as centralized cryptocurrency exchanges.

In addition, companies can take steps to mitigate some of the legal and regulatory risk inherent in the

digital assets sector. Companies that have taken these steps are likely to face fewer future regulatory hurdles in the future and have a correspondingly lower risk profile.

### ***Secondary Sales of Investments***

Secondary sales are transactions in which an existing investor sells its stake in a private company, funds or other illiquid asset to another investor, without the involvement of the issuer company or the asset manager.

In contrast, a primary sale is a direct sale by an issuer company of its own securities to investors.

Secondary sales can arise for several reasons, including an investor's need for liquidity or legal, tax or regulatory constraints on the investor continuing to hold its investment.

In the current market, investors that have seen sharp drops in the valuation of crypto-related investments and corresponding spikes in paper losses on those investments may have incentives to exit those positions. At the same time, a buyer in a secondary sale transaction in this market may be able to pick up an investment at a deep discount to the valuations of two years ago.

In order to execute a secondary sale, there are a few common issues to address.

#### *Transfer of Limitations*

There are likely to be transfer restrictions that require the consent of all or some preferred shareholders before a secondary sale can take place or that provide a right of first offer for existing shareholders — or both.

#### *Confidentiality Restrictions*

Any seller — and any potential buyer — in a secondary sale should confirm that confidentiality restrictions are well understood and observed, even at the early stages of a secondary sale process.

#### *Compliance with Securities Laws*

A secondary sale transaction involving the shares of a private, U.S. company likely need to qualify for exemptions from the onerous requirements of registered securities and registered offerings.

### ***Distressed Asset Sales***

Prior to a company's declaration of bankruptcy — pursuant to Chapter 11 or otherwise — the sale or encumbrance of its assets may result in legal challenges or consequences for the company as the seller, the company's directors and the buyer.

#### *Considerations for Sellers*

A seller needs to be mindful that the asset sales do not create insolvency. This includes reasonable confidence that:

- It is getting a fair — and appropriate — price for the assets;

- The assets are not encumbered or secured by debts owed to creditors; and
- The overall mix of assets after the sale provides the company with sufficient assets and operational capability to continue doing its business and servicing its debt.

Situations involving sales to affiliates can also give rise to fraudulent transfer concerns, conflicts of interest and fiduciary issues. Insider transactions are also subject to heightened scrutiny.

#### *Considerations for Directors of Distressed Companies*

Directors also need to be mindful of the ways in which they discharge their fiduciary duties when a company enters the zone of insolvency.

The zone is a gray area where the company is at risk of no longer being able to pay its debts as they come due. This is important because courts have generally held that when a corporation becomes insolvent, the duties and obligations of officers and directors to the corporation include all residual stakeholders, including creditors.

Because these judgments are often made in hindsight, directors of companies that may be at risk of insolvency — and those that would transact with them — need to carefully navigate the execution of these duties.

Among other considerations, detailed records of board meetings and weighing of factors in decision making can be important and valuable pieces of evidence in claims made against directors for breaches of their fiduciary duties. Consulting independent directors, special committees and outside professionals reduces directors potential exposure for decision making regarding such.

#### *Considerations for Buyers*

Buyers should be mindful that their purchases of assets are not fraudulent conveyances — in other words, a transfer of an asset by a seller to delay or defraud a creditor and/or a transfer for less than fair consideration while the transferor is insolvent or is rendered insolvent.

Sales of assets can be subject to look back provisions and clawback by a bankruptcy court up to two years — or in some cases, more — prior to the bankruptcy filing.

Conversely, a buyer can obtain protections from collateral attack on a transaction where the deal is approved by a bankruptcy court, which provides for a transfer free and clear of any claims, liens, and encumbrances, among other things.

However, this type of formal process opens up a transaction to an auction format, and typically adds time and expenses to the deal.

#### ***Sales Out of Bankruptcy***

As noted above, sales of assets that occur as part of a formal bankruptcy process can provide certain protections to the parties involved in the sale.

For example, assets that are part of a bankruptcy estate — i.e., the assets of a company, or debtor, that

has filed for bankruptcy — can be sold by the estate pursuant to Section 363 of the U.S. Bankruptcy Code or through a bankruptcy plan.

These transactions provide a path for seller and buyer to buy or sell assets typically without risk of post-closing clawbacks and liability, which can be long-term and significant.

In addition, this type of transaction provides a buyer with a chance to extinguish all or substantially all liens and claims on the assets it is purchasing — subject to limitations imposed by law or the applicable court.

A sale process under Section 363 is complex and multifaceted. Typically, a sale under Section 363 can be closed within 30 to 60 days depending upon the particular facts and is subject to higher and better offers.

This type of sale may also provide stalking horse status to the initial buyer, which provides protections to such party, including a break-up fee if the deal does not close because of no fault of the buyer.

These protections typically provide the stalking horse bidder with the inside track to acquire the subject assets, which requires another party to bid incrementally higher than the opening bid for such assets or the stalking horse buyer becomes the successful purchaser.

In addition, many of the considerations for sellers and buyers in a Section 363 transaction are similar to those they face in the zone of insolvency, described above.

### **Key Takeaways and the Road Ahead**

With continued, high-profile regulatory enforcement actions and bankruptcies involving crypto-related businesses, the market for these assets and investments in these businesses is likely to remain turbulent for the foreseeable future.

Notwithstanding these challenges — and unlike the previous crypto winter in 2018 and 2019 — a wide variety of players are continuing to drive development for blockchain applications and crypto-related investments.

As a result, opportunities such as down round investments, secondary sales at discounted valuations, and distressed sales and bankruptcies will continue to present themselves.

Mitigating the risk inherent in these opportunities through legal due diligence and risk assessment, and seeking court approvals through bankruptcy proceedings, may be critical to investors' ability to capitalize on these opportunities.

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