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Expert Q&A on Shopping for Distressed Crypto Assets or Troubled Crypto Businesses

by Practical Law Bankruptcy & Restructuring

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An expert Q&A with Joseph A. Castelluccio, Joaquin M. C De Baca, and Douglas E. Spelfogel of Mayer Brown on investing in or acquiring distressed crypto assets and how that can be a lucrative investment strategy for those with a healthy risk appetite and a roadmap for sourcing and evaluating quality assets.

Following a surge in crypto asset prices and crypto-adjacent business valuations leading into the summer of 2022, there has been a sharp increase in crypto companies and assets experiencing:

- Deeply distressed valuations.
- Liquidity crunches.
- Formal insolvency or bankruptcy proceedings.

Practical Law asked Joaquin M. C De Baca and Douglas E. Spelfogel of Mayer Brown's restructuring practice to discuss:

- Opportunities for investing in troubled crypto assets or businesses.
- How distressed investing can be both a:
  - lucrative strategy for those with a healthy risk appetite; and
  - roadmap for sourcing and evaluating quality assets.
- The procedures and potential pitfalls of distressed investing that can make or break the success of an investment.

Joseph A. Castelluccio is a partner in Mayer Brown's New York office and a co-leader of Mayer Brown's Fintech and Digital Assets, Blockchain & Cryptocurrency groups. He advises multinational corporations, financial institutions, and financial investors on a diverse range of M&A, joint ventures, capital raising, and other corporate matters. He represents companies in a range of industries, including fintech, asset management, banking, and insurance, as they navigate the intersection of digital assets, decentralized finance, and financial services.

Joaquin M. C De Baca is a partner in Mayer Brown's New York office and a member of the firm's Global Restructuring practice, which includes both transactional and litigation work in a wide range of in-court and out-of-court workouts and reorganization proceedings. He has represented clients in complex bankruptcy proceedings, debtor-in-possession (DIP) and exit financings, litigations, and international insolvency proceedings, and has negotiated restructuring transactions in an extensive scope of distressed contexts.

Douglas E. Spelfogel is a partner in Mayer Brown's New York office and co-leader of its Global Restructuring practice. He concentrates his practice on representation of financial institutions, indenture trustee banks, lenders, private equity and hedge funds, creditors and creditors' committees, landlords, trustees, officers, directors, and debtors in complex financial restructurings, asset sales, workouts, and business reorganizations, often involving multi-billion dollar transactions, both out-of-court and through Chapter 11 of the Bankruptcy Code.

For curated lists of Practical Law's resources focused on cryptocurrency and digital assets, generally and in bankruptcy, see:

- Crypto Toolkit.
- Crypto Industry Bankruptcy Toolkit.

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Where do investment opportunities lie for distressed crypto assets?

As prices for crypto asset and businesses decline, they become attractive targets for strategic buyers. Investment in or acquisition of distressed crypto assets or businesses presents a significant opportunity for those that can:

- Navigate the asset or business acquisition processes.
- Appropriately price the assets.
- Mitigate risk in these businesses themselves.

Distressed investors with flexibility, discipline, and risk tolerance can reap significant rewards by capitalizing on opportunities to purchase distressed or undervalued crypto assets or crypto-adjacent businesses in any of the following contexts:

- Down rounds of financing (see What is down round investing and what makes it appealing for crypto investors?).
- Secondary sales of investment positions (see What are secondary sales of investments and in what contexts do they arise?).
- A distressed asset sale, either before or as part of a bankruptcy proceeding (see What are the advantages of purchasing distressed assets in and out of bankruptcy?).

What is down round investing and what makes it appealing for crypto investors?

A down round investment is a financing event where a company raises capital, often through an issuance of preferred stock or convertible securities**,** at a lower enterprise valuation than in previous rounds of financing. Various factors can trigger down rounds, including:

- Market downturns.
- Competitive pressures.
- Missed milestones.
- Reduced growth expectations.

In the current digital assets market, these factors and others have combined to dramatically impact asset valuations, making these assets a prime target for under-value acquisition.

Down rounds can have significant implications for both companies and investors, affecting their ownership, control, dilution, and returns. Investors in down rounds should consider the risk factors that come with a down round investment, which include:

- **Uncertain valuations.** Assessing the prospects of a business and formulating a realistic valuation is particularly challenging for companies looking to pivot their products and strategies or otherwise reverse the setbacks that led to the down round.
- **Extended timeline.** Companies raising money in a down round are looking to jumpstart a turnaround that may be years in the future. As a result, it is likely that these companies will require longer timelines to achieve their investment objectives.

In parallel with these challenges, down rounds can also present opportunities for investors, such as:

- **Attractive valuations.** A down round can offer new investors a chance to acquire a stake in a promising business at a discounted valuation with an exponentially higher potential investment return than a traditional investment round.
- **Enhanced investor rights.** A down round can provide new or existing investors with opportunities to negotiate greater investor rights and protections that can enhance their returns or position in the event of a future exit or liquidation, such as:
  - liquidation preferences (see Practice Note, Minority Investments: Overview: Liquidation Preference);
  - anti-dilution protection (see Practice Note, Anti-Dilution Provisions in Private Equity Transactions); or
  - board seats.

What kind of due diligence should an investor do for a down round investment and how does this differ from traditional due diligence?

For those investors looking to make a down round investment, a targeted due diligence effort is crucial. While an in-depth due diligence review of business and legal issues is important in any investment process, in a down round for a business in the digital assets sector, there are some specific key inquiries, including:

- The reasons behind the decline in valuation (see What contributed to the decline in valuation?).
- How the company intends to drive growth (see What are the key drivers of future turnaround and growth?).

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- Any industry-wide laws or regulations that are expected to change (see Are there legal or regulatory changes on the horizon that could impact the business plan or trajectory?).

What contributed to the decline in valuation?

To gain insight into the reasons behind the company's decline in valuation, it is important to understand whether the issues leading to the decline:

- Are solvable. For example, an employee mishandling a software release can cause a significant setback to the company but does not usually damage the long-term prospects of a business.
- Are inherent in the sector (market-wide) or in the nature of the company's business and are they anticipated to be short-lived or long-term. For example, legal and regulatory uncertainty in the digital assets sector is likely to continue in the US in the near-term. Even jurisdictions like Switzerland that have already modernized their crypto-asset regulations could be subject to future challenges by private sector and government operators.
- Are due to uncertainty in the capital markets and M&A, high interest rates, or a combination of both elements. Down trends in M&A, where timelines for deals get extended and valuations are under pressure, tend to be relatively short-lived when compared to longer-term trends in interest rates or other federal monetary policies.

Investors must consider that multiple factors play a part in any valuation decline, and each factor will lead to different answers to the follow-up questions during the diligence process.

What are the key drivers of future turnaround and growth?

Investors make an investment in any asset with a depressed valuation with an eye towards a future increase. Investors should understand:

- What are the roadblocks or impediments to the company's use or maximization of the drivers for future turnaround and growth? For example, does the business have key technology and IP secured and legally protected for both its current and future or proposed usages? Growth plans for the company may require greatly expanded rights or capabilities the business has not yet secured.
- Whether there is a path for the company to become profitable or cash-flow positive without additional financing. Investors must consider if and under what circumstances they may increase their investments in later tranches of the down round or in a subsequent financing round.

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

Certain business models and services are 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.
- That provide services that have already been the target of regulatory and enforcement action, such as centralized cryptocurrency exchanges.

Companies can take steps to mitigate some of the legal and regulatory risk inherent in the digital assets sector by:

- Being aware of the regulatory regimes that apply to specific:
  - business lines;
  - products; or
  - services.
- Having a corresponding compliance infrastructure integrated within the business's culture of innovation.

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

For information on new developments in crypto and digital assets regulations, see Cryptocurrency and Virtual Currency Regulatory Tracker.

What are secondary sales of investments and in what contexts do they arise?

Secondary sales are transactions in which an existing investor sells its stake in a private company, fund, or other illiquid asset to another investor, without the involvement of the issuer company or the asset manager. This is in contrast, a primary sale, which is a direct sale by a company of its own securities or assets to investors.

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Secondary sales can arise when the original or existing investor:

- Needs liquidity.
- Wants to exit an investment that has:
  - reached maturity;
  - underperformed; or
  - no longer fits its portfolio strategy or risk appetite.
- Wants to diversify its portfolio.
- Is looking to rebalance its exposure to certain sectors, geographies, or asset classes because of changes in the valuation or prospects of certain investments, either positive or negative.
- Faces regulatory, tax, or legal constraints that limit the investor's ability or incentive to hold certain investments. For example, changes in the law or legal challenges may make it untenable for an investor to continue holding its investment.

In the current market, investors that have seen sharp drops in the valuation of their crypto-related investments and corresponding spikes in paper losses on those investments are incentivized to exit those positions. In seeking to exit these positions, a secondary sale may provide liquidity for an otherwise illiquid investment. For some investors, this may be necessary even if the valuation is significantly below its peak and the sale is made at a loss.

A buyer in a secondary sale transaction in this market may use the depressed valuation to their advantage and pick up an investment at a deep discount to the valuations of two years ago, even where the company is not currently fundraising or otherwise looking to market its securities.

What are the limitations on a secondary sale?

A secondary sale is subject to several limitations, including:

- **Transfer limitations.** Most shares in private, investor-backed companies are subject to contractual obligations between the existing shareholders and the company. There are likely to be transfer restrictions that either:
  - require the consent of all or some preferred shareholders before a secondary sale can take place; or
  - provide a right of first offer for existing shareholders.
  - If a secondary sale does not abide by these procedures, any purported secondary sale could be invalidated.
- **Confidentiality restrictions.** Investors are often bound by confidentiality restrictions, which limit the scope of information a prospective seller can provide to a secondary buyer. This is an issue on both the seller and the buyer side of a secondary sale transaction. If a company or its other shareholders object to the sharing of confidential information after information about the company has been shared by a prospective seller, a buyer could be out of luck. Any potential buyer in a secondary sale must confirm that confidentiality restrictions are 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 US company is subject to US securities laws governing the shares themselves, and the marketing and sale of those shares, even though the shares would not likely be registered with the Securities and Exchange Commission. In certain cases, there are exemptions (such as Rule 144A) from the onerous requirements of registered securities and registered offerings based on exacting criteria for:
  - the selling shareholder;
  - the secondary buyer; and
  - the transaction itself.

What are the advantages of purchasing distressed assets in and out of bankruptcy?

Investors can purchase distressed assets either prior to a company's bankruptcy or during a company's Chapter 11 bankruptcy through a section 363 sale.

Before bankruptcy, the sale or encumbrance of the company's assets can result in legal challenges or consequences for:

- The seller company (see What are the key considerations for sellers in a prepetition distressed sale?).
- The company's directors (see What are the key considerations for directors in a prepetition distressed sale?).
- The buyer (see What are the key considerations for buyers in a prepetition distressed sale?).

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What are the key considerations for sellers in a prepetition distressed sale?

A seller in a distressed asset sale must be mindful that the asset sale does not lead the company to insolvency. This includes reasonable confidence that:

- The sale price for the assets is fair and appropriate.
- The assets are not encumbered or secured by debts owed to creditors.
- 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.

Where there are issues regarding the transferability of a subject class of assets, either because of regulatory issues or claims and encumbrances against the assets, a sale through bankruptcy provides for a court ordered process free and clear of many of the legal impediments that may impact a traditional sale transaction (see What are the benefits of purchasing distressed assets through bankruptcy?).

Situations involving sales to affiliates can also give rise to perceived conflicts, which may require additional disclosure or the involvement of independent fiduciary decision makers.

What are the key considerations for directors in a prepetition distressed sale?

Directors need to be mindful of the ways in which they discharge their fiduciary duties when a company enters the "zone of insolvency." The zone of insolvency is a legal gray area where the company is at risk of no longer being able to pay its debts as they come due. Courts have generally held that, when a corporation becomes insolvent, the duties and obligations of officers and directors to the corporation include a duty to all residual stakeholders, including creditors (see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations: Directors' Fiduciary Duties: Corporations in the Zone of Insolvency and Insolvent Corporations).

A company may pass through the zone of insolvency in an instant or it may teeter on the brink for an extended period. Directors of companies that may be at risk of insolvency, and parties that would transact with them, must carefully navigate the execution of their duties because the judgment on when a company is in the zone of insolvency is often made in hindsight by courts. Important and valuable pieces of evidence in successfully defending claims made against directors for breaches of their fiduciary duties, among other considerations, include:

- Keeping detailed records of board deliberations and weighing of factors in decision making.
- Obtaining company valuations from outside experts.
- Seeking professional opinions regarding potential insolvency.
- Appointing a special committee to approve a given transaction.

These actions typically provide protections to officers and directors from potential claims for breach of fiduciary duty where a company is operating within the zone of insolvency (see Practice Note, Crucial Steps to be Taken by the Board of Directors of Financially Troubled Companies).

What are the key considerations for buyers in a prepetition distressed sale?

Buyers should ensure that their purchases of assets cannot be deemed:

- Intentional fraudulent conveyances of asset by a seller attempting to delay or defraud creditors (see Practice Note, Fraudulent Conveyances in Bankruptcy: Overview).
- A constructive fraudulent transfer for less than fair consideration while the transferor is insolvent or is rendered insolvent.

Sales of assets can be subject to lookback provisions and clawback by a bankruptcy court up to two years (or in some cases, more) prior to the bankruptcy filing, depending on the cause of action. Bankruptcy court approval of a sale protects the buyer from collateral attack, which includes a transfer free and clear of any claims, liens, and encumbrances, among other things (see What are the benefits of purchasing distressed assets through bankruptcy?). However, a sale made while a company is in bankruptcy occurs in an auction format, and typically adds time and expenses to the deal. A buyer should weigh these factors against the advantages afforded to a buyer through a bankruptcy sale.

For a discussion of whether crypto withdrawals and loan repayments in the lead-up to a bankruptcy filing might avoided as preferences for the benefit of the estate, see Practice Note, Crypto Exchange Bankruptcies: Prepetition Crypto Withdrawals and Decentralized Finance (DeFi) Loan Repayments as Potential Avoidable Preferences.

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What are the benefits of purchasing distressed assets through bankruptcy?

Sales of assets that occur as part of a formal bankruptcy process can provide certain protections to the parties involved in the sale. Assets that are part of a bankruptcy estate can be sold by the estate under section 363 of the Bankruptcy Code or through a bankruptcy plan.

Section 363 sales:

- Do not include many of the risk-allocation provisions found in typical asset sales, such as indemnities and escrows.
- Provide a path for the seller and the buyer to complete the transaction without the risk of post-closing clawbacks and liability, which can be long-term and significant.
- Give the buyer a chance to extinguish all or substantially all liens and claims on the assets it is purchasing.
- Can be closed on a tight timeframe depending upon the particular facts and circumstances of the case.
- Are subject to higher and better offers.
- May also provide stalking horse status, which provides protections to the initial buyer, 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.

Many of the considerations for sellers and buyers in a section 363 sale are similar to those they face in the zone of insolvency.

For a complete discussion of section 363 sales in bankruptcy, see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview.

For an overview of issues arising in crypto exchange Chapter 11 cases more generally, see Practice Note, Crypto Chapter 11 Proceedings: Overview.

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