THREE CRITICAL ASPECTS TO UNDERSTAND IN DISPUTES INVOLVING CRYPTO ASSETS

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In recent years, cryptocurrency and blockchain technology have exploded in popularity and jettisoned down a path of perpetual innovation, experimentation, and growth. This has created diverse crypto assets, new financial products, and associated businesses, including loaning, lending, and investing in the crypto realm.

However, this has also led to major industry disputes resulting in ground-breaking litigation in the crypto ecosystem. In a major headline case this year of cryptocurrency brokerage firm Genesis' lawsuit against venture capital firm Digital Currency Group (DCG), for example, Genesis ultimately abandoned their pursuit of millions of dollars in compensation. They are reportedly planning for liquidation instead, possibly as a delay tactic as Genesis was part of an October 2023 complaint by the New York Attorney General's office involving Genesis and DCG, as well as cryptocurrency exchange Gemini.[1] This complex case traces its origins to the cataclysmic collapse of FTX and will be consequential in establishing precedent and norms in how these crypto investigations unfold and how the crypto community responds.

Crypto-centric disputes present new problems and new solutions. Understanding crypto-specific nuances when it comes to jurisdiction, asset storage, and price volatility is critical for practitioners in the crypto disputes space. Knowing the key points of divergence between disputes involving crypto versus traditional finance can clear investigative hurdles and proactively identify crypto-specific information to forward investigative pursuits in a timely manner through the use of legal process returns, identification of financial services used, assets involved, and aggrieved parties to name a few.

Of the three aspects we look at in this article, multiple jurisdictions and complications with asset storage are common to both crypto and traditional investigations, though the nature of the problem and solutions differ in the details. Volatility, however, is a much greater issue in crypto than traditional financial disputes.

1.Jurisdictions

The manner in which an individual or organization interfaces with the blockchain presents complex jurisdictional issues in disputes involving[4] crypto assets, as individuals may not be co-located with the devices or entities they use. Individuals may use a centralized service like a cryptocurrency exchange to interface with the blockchain, but that does not necessarily mean the user is in the same jurisdiction as the service. The combination of the speed of crypto transactions and the variety of regional financial rules can make crypto jurisdictional questions even more complicated. In the United States, demonstrating personal jurisdiction has been a key avenue to overcoming murky jurisdictional issues stemming from nebulously incorporated companies or unknown crypto services. Successful cases have met several standards, including the commitment of an intentional act, marketing or sales directed toward a specific location, and entanglement of US individuals.[2][3]

1.Crypto Storage

The crypto storage system is fundamentally different from traditional fiat currency services, as there are no assets physically sitting at location like a bank. Physical crypto is not stored in a cryptocurrency wallet, but on the blockchain as a calculated sum of transactions or debits and credits. To access or send the crypto, one needs the private key for the wallet. In cryptocurrency, there are two main types of wallets: custodial and non-custodial.

(1) https://www.wsj.com/articles/crypto-lender-genesis-prepares-to-liquidate-without-deal-with-parent-company-f442a932#:~:text=Genesis%20is%20now%20preparing%20to,exchange%20Gemini%20Trust's%20Earn%20program.
(2) https://www.law.com/nationallawjournal/2023/07/10/arguing-class-actions-class-actions-and-cryptocurrency-surviving-jurisdictional-challenges/
(3) https://blockchain.bakermckenzie.com/2023/02/21/personal-jurisdiction-analysis-as-applied-to-binance/

Custodial wallets, like wallets managed by Virtual Asset Service Providers (VASPs) such as Coinbase, Binance, and Kraken, have the private keys maintained by and in the custody of a VASP and transactions are facilitated through that service. For custodial wallets, the issue is similar to the jurisdictional challenges mentioned earlier. Should a user in New York use a UK-based crypto exchange, the individual and server with pertinent[6] investigative information would not be co-located. However, where a VASP is used, Know Your Customer (KYC) information, transaction details, and a host of other technical data are retrievable to help progress an investigation.

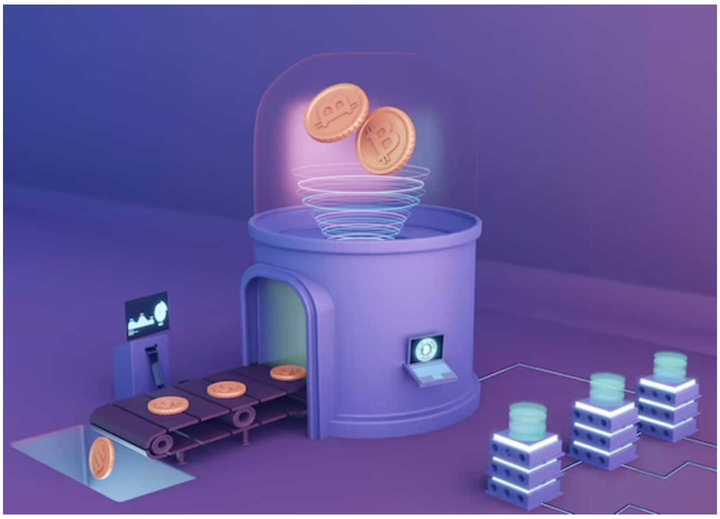
A non-custodial wallet is a wallet software or hardware in which the user retains total control of the private keys, seed phrases, and wallet activity. To access funds for any purpose, be it to spend, send, seize, or freeze assets, an individual needs access to the private keys. As the user controls the wallet and all data themselves, there is little information retrieval authority to identify jurisdiction.

This lack of KYC for non-custodial wallets is an endemic issue within the crypto world, as one can engage in crypto transactions entirely through non-custodial wallets, forgoing any modicum of KYC and leading investigators to a dead end.

To compound matters, privacy enhanced measures like mixers or usage of privacy coins could further obfuscate asset tracing to identify key sources of KYC data. These measures have no clear equivalent in the traditional fiat currency world, as the steps to launder fiat currency typically are more complex. In the case of crypto, an individual can transfer to and from privacy enhanced coins or use a mixing service oftentimes with the same wallet software they use to engage in any other crypto transaction.

3.Volatility

Unlike traditional financial disputes in stable government currencies, cryptocurrencies constantly fluctuate in value and are at the mercy of a volatile market. In 2023 alone, the price of Bitcoin has fluctuated between about $16,500 to nearly $36,900.[4] This instability is not unique to Bitcoin, as other cryptocurrencies similarly fluctuate in their native governmental currency. This applies equally to Non-Fungible Tokens (NFTs), which can be likened to digital art or collectibles.



Returning to the example of Genesis and DCG, one of the crypto loans at the heart of the dispute was agreed in June 2019 for approximately 18,697.7431 BTC, with the remaining balance of 4,550.4517 BTC maturing in May 2023.[5] At the onset of this loan, the remaining balance would have been worth almost US$43,416,000, whereas this balance is almost US$168,740,000 as of November 13, 2023.

Remediation when such vast volatility differences occur are subject to negotiation, both in terms of quantum and currency. The initial agreement between Genesis and DCG, subsequently abandoned in late August 2023, proposed estimated recoveries of 70%-90% for unsecured creditors. This would have had huge implications for parties evaluating if they would prefer to be made whole in cryptocurrency or fiat currency.

Conclusion

Investigating or advising on a crypto or digital asset dispute poses a variety of challenges unique to the crypto sector. The technology itself implicates different regions with different laws and regulations with a variety of means to interface with the crypto ecosystem, all subject to an incredibly volatile market. These cases may take more specialized resources to investigate than their traditional financial counterparts, and it is critical to understand what expertise is needed early in the investigation. That being said, the ability to trace assets using the permanent and unalterable nature of the blockchain alleviates these challenges and can provide valuable information to advance a crypto investigation.

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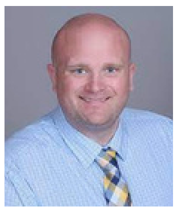

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(4) https://coinmarketcap.com/currencies/bitcoin/
(5) https://storage.courtlistener.com/recap/gov.uscourts.nysb.314889/gov.uscourts.nysb.314889.681.0.pdf