

## Fintech

# Surviving the Crypto Winter: Tips for Limiting Counterparty Risk

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As crypto markets decline, businesses in the crypto industry face real risks of failure. Everyone in the industry is, or should be, thinking about counterparty risk. There has been a lot of focus on how crypto users can protect themselves (*i.e.*, “not your keys, not your crypto”), but less guidance to help crypto businesses protect themselves. If you work with any businesses in the crypto space, here’s some practical advice:

- **Act Now to Protect Yourself from Clawbacks.** If your business is being paid for goods or services, you should consider taking actions to protect yourself while you are still getting paid. If the company paying you later files for bankruptcy, payments you received within 90 days before the bankruptcy, or even longer in some cases, might be clawed back unless you take action to protect yourself. A “preference” lawsuit by the bankruptcy estate typically seeks the return of payments made by a bankrupt company within the 90 days before the bankruptcy filing.

There are several ways to protect against a future preference lawsuit; here are some of the best protections:

- **Seek Cash-In-Advance (CIA) Terms:** Advance payments are not subject to avoidance as preferences. If you are concerned about a company’s financial condition, seek advance payment before supplying goods or services.
  - **Consider Contemporaneous or COD. Payments:** These payments also are not subject to avoidance as preferences. However, if there is any material gap between when the goods or services were provided and the payment date, this defense may not be available.
  - **Ask for Security:** Secured creditors are often protected from preference lawsuits. However, it is often difficult or commercially impracticable to obtain a security interest on the crypto businesses’ assets. In addition, any lien granted during the preference period may itself be a preferential transfer, so the sooner you act, the better.
- **A letter of credit** is a form of security that can be strong protection against a preference claim, even if it is never drawn upon. To provide meaningful protection, the letter of credit should include a number of special provisions relating to draw conditions, expiration, and renewal, so you need to consult with a lawyer if you are relying on a letter of credit for payment or preference protection.

If you have received payment from a company that has filed bankruptcy or that you fear might soon file, and you do not have any of these protections, there are several other defenses that still might apply to a preference claim. You should consult with counsel if you have concerns about significant payments you are receiving from a company that is financial distress.

Payments made by a guarantor, affiliate or other third party are not preferences. However, if the third party files bankruptcy, the payments might be clawed back under a different legal theory, potentially with a much longer lookback period than 90 days. If you notice that the wire transfers or checks you are receiving are coming from someone other than the crypto business with which you have a contract or do business, you should consult with counsel to determine if you can and need to take action to protect yourself with respect to those payments. You should also consult with counsel if any payments are

being made under suspicious circumstances.

• **Review Long-Term Contracts.** Long-term contracts present unique risks in bankruptcy, because the Bankruptcy Code gives a debtor special powers when it comes to pre-petition executory contracts (contracts where substantial performance is still due and owing by both parties to the contract). Many standard service contracts are considered executory contracts.

- Once the company has filed for bankruptcy, the Bankruptcy Code's automatic stay typically prevents a contract counterparty from terminating an unexpired contract or lease. The debtor, meanwhile, has several options and typically has a significant amount of time to decide what to do with the contract. The debtor can:

- **Reject the contract.** Rejection will excuse any further performance by the service provider. The service provider will be left with a general unsecured claim for most pre-bankruptcy services provided to the debtor and for damages arising from the early termination of the contract. In many cases, general unsecured creditors receive pennies on the dollar, or worse. And to add insult to injury, a party to a rejected contract could also still be the subject of a preference lawsuit for payments made within 90 days before bankruptcy.

- **Assume the contract.** The debtor may seek to assume the contract or lease, but must cure all monetary defaults and provide adequate assurance of future performance. If the contract is assumed (typically because it has favorable pricing or the debtor cannot find an acceptable replacement service provider), the service provider may very well be made whole. The assumption of a contract also typically prevents a preference claim from later being asserted against the service provider.

If it would present a substantial problem for your business if any counterparty were to file for bankruptcy and exercise one of these options, consult with a lawyer concerning what you might do to avoid the problem before it happens.

• **Additional Considerations for Suppliers of Hardware and Other Goods.** Physical goods, such as mining processors or other hardware, are treated similarly to services in many respects but present additional considerations.

- **Adequate Assurance (Uniform Commercial Code (UCC) §2-609).** If you are a seller of goods to a crypto business and have reasonable grounds for insecurity regarding the crypto's businesses' ability to pay you, in some cases you can demand adequate assurance of performance before shipping any more goods. If the buyer fails to provide you with assurance, the contract may be deemed repudiated.

- **Reclamation (UCC §2-702).** A seller of goods generally has a right to reclaim goods delivered to an insolvent buyer (typically within 10 days under most state's laws) and also may stop goods in transit.

• If the crypto business files bankruptcy, the Bankruptcy Code expands the seller's right to reclaim to goods delivered within 45 days, but that right is "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof." As a result, in bankruptcy the strength of your reclamation rights will depend on whether the buyer has granted a lien on its assets to a lender or other secured party.

• The Bankruptcy Code also grants to suppliers an administrative priority claim for the value of goods the debtor receives within 20 days of its bankruptcy filing. However, in many bankruptcy cases even administrative priority claims can go unpaid, and so the value of this right will depend on the facts and circumstances of the case.

Diligence is rewarded when dealing with a distressed counterparty. If you have concerns about the financial condition of your counterparties:

- Be alert to the warning signs of distress. Look for bad press, slow or partial payments, payments being made by third parties, and other warning signs.
- Don't hesitate to exercise contractual and UCC rights pre-bankruptcy.
- Seek protection against preference claims—there is nothing wrong with demanding advance payments if available.

If you have significant exposure to a crypto business that is or may become distressed, you should be consulting with your lawyers now concerning how best to protect yourself.

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