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Crypto Meets Bankruptcy: Developments, Risks, and Concerns

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While perhaps inevitable that the largely unregulated cryptocurrency industry would become acquainted with the world of bankruptcy court, that intersection has certainly occurred. After facing a series of challenges and much scrutiny in recent years, the crypto industry experienced several high-profile bankruptcies in 2022. These bankruptcies have highlighted the unique risks faced by cryptocurrency holders and investors, as well as the importance of understanding bankruptcy procedures and priorities. Most of these cases were commenced within the past year, and thus there remain many issues unique to crypto that have not been resolved. Despite there being unanswered questions and lack of clear guidance from the courts on certain issues, this article discusses some of the legal issues and concerns that bankruptcy has brought to the fore and that anyone considering investing in cryptocurrency should be aware of.

Examples of Recent Crypto Bankruptcies

In 2019, QuadrigaCX, a Canadian cryptocurrency exchange, declared bankruptcy after its founder and CEO, Gerald Cotten, passed away unexpectedly. Cotten was the only individual with access to the exchange's cold wallets, which held the majority of Quadriga's crypto assets. With no access to the wallets, the exchange couldn't repay its customers, resulting in significant financial losses and the freezing of customer accounts.

The Spring of 2022 ushered in a bear market characterized by volatility in crypto prices, huge price drops, liquidity issues, panic selling, and margin calls. May 2022 saw the collapse of the popular stablecoin, terraUSD (UST). This led to the collapse of LUNA, the native asset of the Terra protocol, which led to the subsequent crash in Bitcoin and Ethereum prices. Three Arrows Capital, a prominent crypto hedge fund with heavy exposure to these failing stablecoins, faced a liquidity crisis after a deluge of margin calls, leading it into bankruptcy in June 2022. This had a ripple effect, impacting other crypto companies such as Blockchain.com, Genesis, and Voyager Digital.

In July 2022, Voyager Digital plunged into bankruptcy after Three Arrows could not repay loans of over $600 million from Voyager. That same month, Celsius Network, a popular crypto lender, followed Voyager into bankruptcy after a flood of withdrawals caused it to freeze accounts and halt withdrawals from hundreds of thousands of customers.

In November 2022, crypto exchange FTX and its affiliated hedge fund Alameda Research filed for bankruptcy. The 2022 crypto bear market posed severe challenges for FTX, one of the largest exchange platforms, and public reports regarding improprieties and financial issues with Alameda Research triggered a downward spiral for the company. Investors followed suit by attempting to withdraw billions of dollars, exacerbating the situation. Unable to meet the withdrawals, FTX joined the other once-thriving crypto players in bankruptcy, leaving a deficit of $9 billion and millions of customer/creditors whose recovery is anything but certain.

Since then, more crypto companies have continued the trend of bankruptcy filings, such as Blockfi, Genesis Global Capital, and Bittrex. It is not clear that the trend has subsided or will subside any time in the near future.

Limited Recourse for Cryptocurrency Holders

These bankruptcies highlight the unique risks faced by cryptocurrency holders and investors when trusting their funds with crypto firms. Regulatory protection does not yet exist. Unlike traditional banks that offer government-backed deposit insurance and professional oversight of business practices, cryptocurrency holdings are not protected by entities such as the Federal Deposit Insurance Corp. (FDIC). In the event of a crypto exchange going out of business, there is no government agency to compensate investors for their losses.

In addition, the Securities and Exchange Commission (SEC) has jumped into the fray, asserting regulatory jurisdiction and advancing the claim that some cryptocurrencies are not in fact currencies but instead bear characteristics more akin to securities, and the Commodity Futures Trading Commission (CFTC) has argued that crypto assets are more akin to commodities and thus it should have regulatory authority. Further, the FDIC, which does not protect crypto deposits, is deeply concerned about systemic risks caused by the failure of crypto companies and the lack of protection for depositors and currencyholders. But, for now, there is no federal regulatory scheme on the near horizon.

In the federal court decision in *SEC v. Ripple Labs, Inc*. it was held that the XRP token was, in some contexts, a security under the federal securities laws, and, in other contexts, not a security. On the other hand, in the *SEC v. Terraform Labs* case, Judge Jed Rakoff, of the U.S. District Court for the Southern District of New York, recently rejected that ruling. The SEC has already hinted that it may appeal the *Ripple Labs* ruling, and this case will have significant impacts on the industry and many court decisions will follow. Congress will likely act as well.

Understanding Bankruptcy Procedures and Priorities

For those cryptocurrency holders, creditors, or debtors who find themselves dealing with bankruptcy court issues, there are many applicable rules that govern the bankruptcy process. The Bankruptcy Code gives preference to secured creditors by allowing them to recover the assets owed from the proceeds of their collateral, while typically relegating unsecured creditors to splitting up the assets remaining after secured creditors and other priority claims have been paid off. Due to the varied processes by which currencies are acquired and handled, the courts are being called upon to sort out whether an account holder is actually a secured creditor. Because there is no uniformity of arrangements between the various crypto companies and their customers, these battles will most likely have to be fought out individually as the cases are administered.

Recovering Funds from Bankrupt Crypto Companies

If a cryptocurrency company goes bankrupt, customers who have adhered to know your customer (KYC) requirements should be contacted promptly regarding fund recovery. Companies will likely establish their own procedures for distributing funds, requiring customers to complete forms, providing necessary documentation, and verifying payment information. While there is a risk of recovering nothing or only a portion of the initial investment, investors may still receive some assets or cash.

Understanding Cryptocurrency Characteristics

Cryptocurrencies vary in their features and underlying assets. Stablecoins, for example, are designed to maintain a stable value relative to an underlying asset, such as the U.S. dollar or physical gold. Some stablecoins are backed by assets, while others use algorithms to maintain their pegged value. As examples in various cases have shown, however, stablecoins do not always live up to their name. Other types of coins are generally built on their own blockchain, the most popular being Bitcoin, and are intended to function like currency. Tokens are generally created on an existing blockchain and are intended to serve as currency, and can also be used as programmable assets for smart contracts and can represent units of value.

Legal Issues in Cryptocurrency Bankruptcy cases

Several common threads have emerged in the bankruptcy cases. The ownership of digital assets deposited with a crypto firm depends on the contractual relationship between the customers and the firm. While bankruptcy proceedings generally fix the value of a claim on the date of filing, if customers own their assets, they may receive them back in kind, allowing them to benefit from any increase in value during the bankruptcy.

A recent ruling in the *Celsius* case by the Southern District of New York Bankruptcy Court determined that customer deposits constituted property of the bankruptcy estate, rather than customer property, based on the terms of use. But, as noted above, every crypto firm has developed (and frequently altered) its own customer contracts, and so the *Celsius* ruling, while providing some analytical guidance, does not necessarily predict the outcome when this issue arises (as it assuredly will) in other cases.

Even if digital assets are considered customer property, bankrupt crypto firms may struggle to return those assets in kind. Assets are often commingled in centralized wallets, making it difficult to trace ownership. Additionally, crypto firms may hold only a fraction of the assets they manage, creating further challenges for customers seeking recovery.

Recent disclosures by FTX and the court-appointed examiner in the *Celsius* bankruptcy reveal discrepancies between customer deposits and the available assets. Allegations of fraud and mismanagement have emerged, complicating the recovery process for customers. These issues are likely to take years to fully sort out.

Customers attempting to recover their assets may face a long battle, particularly if there are insufficient digital assets to cover all claims. Moreover, bankruptcies involving fraud or Ponzi schemes can result in government forfeiture or restitution orders, further complicating customer recoveries.

The insolvencies in the crypto sector shed light on the ownership and disposition of distressed crypto assets. Establishing ownership is only the first step, as risk management failures and fraudulent activities hinder the recovery process. As these insolvencies progress, the landscape for distressed crypto assets may become clearer.

Navigating Cryptocurrency Bankruptcies

Experiencing a failure of any financial institution can be daunting, but since traditional banks are not eligible for bankruptcy but instead are supervised by federal and state regulators, there are well-established procedures that minimize the uncertainties of account holders (the recent failure and rescue of Silicon Valley Bank and Signature Bank are prime examples). In the cryptocurrency industry, by contrast, confusion reigns precisely because this represents uncharted territory. Nevertheless, investors should allow the bankruptcy process to unfold and determine the extent of asset recovery.

Conclusion

By staying informed and understanding the risks associated with cryptocurrency investments, investors can make more informed decisions and mitigate potential losses. Those with specific questions about issues and legal developments in bankruptcy court, or who need assistance in navigating the bankruptcy process as a debtor or creditor, should seek advice of legal counsel.

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