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Crypto Bankruptcies Heat Up; Who Will Get Burned?

*By Kathleen M. St. John**

In this article, the author discusses a recent decision that provides some important insight as to courts' view of the ownership rights in digital assets.

A fundamental issue when assessing the prospects for reorganization or orderly liquidation of a Chapter 11 debtor is determining the scope and nature of the assets and liabilities of the debtor's estate. While Section 541 of the Bankruptcy Code is fairly expansive in defining "property of the estate," it is well established that the operative rights in property are generally determined by applicable state law.¹

With the proliferation of cryptocurrency exchanges and platforms seeking bankruptcy protection, bankruptcy courts are increasingly having to make determinations of first impression involving assets classes comprised of this cutting edge technology, all within a legal rubric that can, arguably, seem dated or even ill-suited to such an endeavor.² And this juxtaposition of innovative technological property interests and existing state law is creating contentious questions of ownership of digital assets that are posted to or held by virtual exchanges.

The issues are numerous and replete with complicating factors. Answers may vary widely and turn, in part, upon the particular terms of the contractual relationship between customer and exchange in any given scenario. The "First Day Declaration of Alex Mashinsky, Chief Executive Officer of Celsius Network LLC, In Support of Chapter 11 Petitions and First Day Motions" emphasized this position, stating at the outset:

The terms of use that form the basis of the contract between Celsius

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¹ See 11 U.S.C. § 541; *Butner v. United States*, 440 U.S. 48 (1979).

² The U.S. Trustee stated in its recent motion for the appointment of an examiner: "The market for cryptocurrency is relatively new, purposefully opaque, and, at best, loosely regulated. It also lacks transparency, which has resulted in widespread confusion among the Debtors' customers and other parties in interest. . . ." See Motion of the United States Trustee for Appointment of an Examiner at 2, *In re Celsius Network LLC*, No. 22-10964 (MG) (Bankr. S.D.N.Y. Aug. 18, 2022) (Dkt. No. 546).

and its users explicitly state that in exchange for the opportunity to earn rewards on assets, users transfer “all right and title” of their crypto assets to Celsius including “ownership rights” and the right to “pledge, re-pledge, hypothecate, rehypothecate, sell, lend, or otherwise transfer or use” any amount of such crypto, whether “separately or together with other property”, “for any period of time,” and “without retaining in Celsius’ possession and/or control a like amount of [crypto] or any other monies or assets, and to use or invest such [crypto] in Celsius’ full discretion.” A version of this statement has been in every version of Celsius’ “Terms of Use” since 2018.³

The results of such ownership disputes can have profound consequences for those directly impacted.⁴ Some clarity may soon be on the horizon, however, given the recent Chapter 11 filings of *In re Voyager Digital Holdings, Inc.*,⁵ *In re Celsius Network LLC*,⁶ and *In re FTX Trading Ltd.*,⁷ and related sale motions with respect to property ranging from bitcoin mined in the ordinary course, certain “de minimis assets,” and particular classes of assets such as “stablecoin.”⁸ It is anticipated that the resolution of those sale motions and related disputes about contested assets will provide some important insight as to the courts’ view of the ownership rights in the digital assets at stake.

This is not, however, the first time these questions have arisen in Chapter 11. The issue of competing ownership interests in cryptocurrency has come up at least once before in a Chapter 11 bankruptcy proceeding, and in spite of being fully briefed by both a creditor seeking relief from the stay to access its cryptocurrency, and by the objecting debtor and official committee of

³ First Day Declaration of Alex Mashinsky, Chief Executive Officer of Celsius Network LLC, In Support of Chapter 11 Petitions and First Day Motions at 3, *In re Celsius Network LLC*, No. 22-10964 (MG) (Bankr. S.D.N.Y.) (Dkt. No. 23). This issue has continued at the forefront of the various disputes in the *Celsius* case, with recent filings focusing on the changes implemented across versions of the Terms of Use, including the most recent amendment made in September 2022. See *In re Celsius Network LLC*, No. 22-10964 (MG) (Bankr. S.D.N.Y.) (Dkt. Nos. 393, 1325).

⁴ Indeed, in the *Celsius* Chapter 11 case alone, hundreds of letters from customers have been filed on the docket, many pleading with the Hon. Judge Glenn to allow the customers to access their cryptocurrency and ensure that it is deemed property of the customer.

⁵ *In re Voyager Digital Holdings, Inc.*, No. 22-10943 (MEW) (Bankr. S.D.N.Y.).

⁶ *In re Celsius Network LLC*, No. 22-10964 (MG) (Bankr. S.D.N.Y.).

⁷ *In re FTX Trading Ltd.*, No. 22-11068 (JTD) (Bankr. D. Del.).

⁸ *In re Celsius Network LLC*, No. 22-10964 (MG) (Bankr. S.D.N.Y.) (Dkt. Nos. 187, 188, 428, 430, 832, 1325, 1493, 1578); *In re Voyager Digital Holdings, Inc.*, No. 22-10943 (MEW) (Bankr. S.D.N.Y.) (Dkt. Nos. 126, 159, 160).

unsecured creditors who argued that such cryptocurrency was commingled and property of the estate, it was ultimately not determined by the court.

In *In re Cred Inc.*,⁹ a customer of debtor Cred Inc. (“Cred”) that had pledged 478.17 Bitcoins (purportedly valued at approximately \$7.3 million as of the November 9, 2020 petition date) to secure a \$2 million prepetition line of credit issued by Cred had sought to repay the line of credit to obtain the return of its Bitcoin collateral, and when the debtor was unwilling to do so, filed a motion for relief from stay, arguing that the subject Bitcoins were not property of the estate. Both Cred and the official committee of unsecured creditors objected, arguing that because such property was commingled with Bitcoin deposited by other Cred customers and was not traceable, it was property of the estate, and the movant was merely an aggrieved unsecured creditor.

In a hearing on November 5, 2020, the court questioned, “If these bitcoins belong to these creditors and are only being held by the debtors for their benefit, what basis is there for me to say they’re not allowed to reach out to these exchanges and ask that those exchanges be frozen?”¹⁰ Cred’s counsel responded:

Your Honor, that’s actually not the case. The bitcoin are—it’s borrowed capital between the debtor and the customer. We think its property of the estate. . . . But, you know, I disagree with the premise that this is [the customers’] property. It was property—you know, it was an asset that was transferred to the debtors to use in the ordinary course of the debtors’ business.¹¹

Ultimately, when it became clear that Cred no longer held the bitcoin at issue, the movant revised its argument to seek authority to assert direct causes of action against non-debtor third parties. Given that the focus of the dispute had shifted from the determination of whether the pledged bitcoin was property of the estate, Judge Dorsey noted in a memorandum opinion dated February 26, 2021 that “[t]hrough the issues of whether the Debtors had a contractual or legal obligation to hold the pledged Bitcoin and whether the Bitcoin became property of the Debtors once it was commingled were extensively briefed and argued, the Motion does not require me to decide them, and I decline to do so.”¹²

⁹ *In re Cred Inc.*, No. 20-12836 (JTD) (Bankr. D. Del.).

¹⁰ Transcript of Hearing at 19:16–19, *In re Cred Inc.*, No. 20-12836 (JTD) (Bankr. D. Del. Dec. 1, 2020) (Dkt. No. 93).

¹¹ *Id.* at 19:20–23, 20:1–4.

¹² See Memorandum Opinion at 2, *In re Cred Inc.*, No. 20-12836 (JTD) (Bankr. D. Del. Feb. 26, 2021) (Dkt. No. 565). Indeed, potentially conflicting regulatory approaches may even

A framework to navigate this uncharted territory may be forthcoming, although whether it will be enacted into law in time to provide guidance for the courts grappling with these issues now or in the near future remains to be seen.¹³ In July 2022, a Joint Committee of the American Law Institute and Uniform Laws Commission (“Joint Committee”) approved and recommended for adoption in all states the 2022 amendments to the Uniform Commercial Code (the “Proposed UCC Amendments”), which modernize the UCC by addressing digital assets primarily through amendments to the Official Comments and a new Article 12 titled “Controllable Electronic Records.”

Specifically, the Proposed UCC Amendments address ownership interests of the customers of cryptocurrency exchanges in custodially held cryptocurrency.¹⁴ The prefatory note to new Article 12 states that “Article 12 creates a legal regime that is meant to apply more broadly than to electronic (intangible) assets” such as “distributed ledger technology (DLT), including blockchain technology, which powers transactions in bitcoin and other digital assets” and that Article 12 “aspires to apply to electronic assets that may be created using technologies that have yet to be developed, or even imagined.”¹⁵

CONCLUSION

Whether the Proposed UCC Amendments and new Article 12 will be uniformly adopted remains to be seen, however, and with some state legislatures attempting to modernize their state UCCs to address emerging technology and digital assets, the potential for conflict among state laws, in addition to continued uncertainty, looms large.

create further ambiguity. Compare SEC Staff Accounting Bulletin No. 121, 17 C.F.R. 211 (Apr. 11, 2022) (requiring, among other things, that crypto assets held on behalf of customers to be treated as assets and liabilities on the custodian’s balance sheet) *with Responsible Financial Innovation Act*, S. 4356, 117th Cong. (2022) (proposed legislation that would, if enacted, clarify that the Commodity Futures Trading Commission has jurisdiction over cryptocurrency regulation, impose increased disclosure requirements to prevent consumer confusion, and determine treatment of certain digital assets in the bankruptcy context).

¹³ Notably, certain state legislatures have endeavored to enact provisions of state commercial codes addressing digital assets. *See* IDAHO CODE ANN. § 28-5302 *et seq.* (addressing the “legal status of digital assets”); WYO.STAT. § 34-29-102 (specifying digital assets as property within the Uniform Commercial Code).

¹⁴ *See* Unif. Com. Code & Emerging Techs. (Unif. L. Comm’n & Am. L. Inst. 2022), *available at*: <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=67fe571b-e8ad-caf8-4530-d8b59bdca805&forceDialog=1>.

¹⁵ *See* Reporter’s Prefatory Note preceding U.C.C. Art. 12, *available at*: <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=c7232d9c-6f39-0576-935e-8ad76333240f&forceDialog=0>.

In any event, it appears that the stage is set for new law to be made in the *Celsius* and *Voyager* Chapter 11 proceedings which will provide much needed precedent in the new and constantly evolving space of digital assets and currency.