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TOP BANKRUPTCY LAWYERS 2022

THE CRYPTO CONTAGION

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Cryptocurrency had a market cap of $10 million in early 2011; it rocketed to nearly $3 trillion in February 2022 and is now down to about $1.1 trillion today. Some of this year's more notable gyrations in crypto's fall from grace include the following:

- In May there was a decline of billions of dollars in value related to TerraUSD, a purported stablecoin, and the crypto-currency it was linked to, Luna, causing TerraUSD to become de-linked from its peg and causing both TerraUSD and Luna to plummet. (A stablecoin is a cryptocurrency designed to have a relatively stable price, typically through being pegged to a commodity or currency or having its supply regulated by an algorithm.)
- On June 1 the U. S. Attorney for the Southern District of New York indicted a former product manager at Ozone Networks, Inc. d/b/a OpenSea, with wire fraud and money laundering in connection with a scheme to commit insider trading in Non-Fungible Tokens, or "NFTs."
- On June 2 the Commodity Futures Trading Commission filed a complaint against Gemini Trust Company, LLC, based in New York, N.Y., for making false or misleading statements in connection with the self-certification of a bitcoin futures product.
- On July 1 Three Arrows Capital (3AC), a Singapore-based crypto hedge fund that had managed $10 billion in assets, filed for liquidation in the British Virgin Islands with an attendant chapter 15 proceeding (an ancillary bankruptcy proceeding) in the United States. 3AC's woes started after the collapse of TerraUSD and Luna, which reportedly cost 3AC more than $200 million. 3AC also defaulted on a $670 million loan owed to Voyager Digital Ltd., a crypto brokerage and lending firm.
- On July 5 Voyager Digital Ltd, a publicly-traded crypto platform that advertised a 12% yield on various tokens, filed bankruptcy in New York. At its height, Voyager Digital claimed to have 3.5 million users and $5.9 billion in assets. The vast majority of Voyager's clients stored less than $10,000 on the platform.
- On July 13 U.S. based crypto lender Celsius Network filed for bankruptcy in New York. Celsius froze withdrawals, citing "extreme" market conditions, cutting off access to savings for individual investors. In a court filing, Celsius estimated its assets and liabilities as between $1 billion to $10 billion, with more than 100,000 creditors. (On August 5, the bankruptcy court authorized repatriation of some of the customer funds.)
- On July 21 a former Coinbase manager was hit with criminal charges of participating in an insider trading scheme that allegedly netted more than $1.5 million.
- On July 31 a class action lawsuit was filed for those who purchased Celsius Financial Products by way of the company's so-called native "CEL Tokens."
- On August 8 Cryptocurrency exchange CoinFlex said it has filed for restructuring in a Seychelles court, seeking to resolve a shortfall due to a counterparty failing to make a margin call.
- On August 10 Nuri, a crypto-focused digital banking platform filed insolvency in a Berlin court, saying the move was "necessary to ensure the safest path forward for all our customers."

Crypto institutions generate interest on deposits usually by loaning crypto assets out to traders and institutions. Investment firms and hedge funds like 3AC rely on these loans to make big trades. They take in capital from lenders, go long or short on risky assets, and if all goes well, earn huge returns relatively quick. But in an industry where counterparties are tightly bound together, dominoes we see can fall fast and hard.

This fall in value has come with bankruptcies, lawsuits, regulatory claims and a host of pending laws and legislation on multiple Federal and State fronts.

At the Federal level, some of the efforts have been to rein in the excessive energy usage by crypto miners. Most cryptocurrency organizations use a "proof-of-work" process to validate transactions. Proof-of-work is a competition between miners to solve the cryptographic algorithms or equations and validate the transactions to earn blockchain rewards. This process takes enormous amounts of energy. The Biden administration has made policy recommendations to lower cryptocurrency mining's energy consumption and emissions footprint.

In a similar effort to moderate energy consumption, proposed Federal regulatory actions are also coming from Congress. Senate Bill S6486D, introduced in the 2021-2022 legislative session, establishes a moratorium on cryptocurrency mining operations that use proof-of-work authentication methods to validate blockchain transactions.

In response to these and other pressures, the industry is slowly moving to a proof-of-stake verification process. In a proof-of-stake process, randomly chosen validators make sure the transaction is reliable, compensating them in return with crypto.

On other fronts at the Federal level, the Financial Crimes Enforcement Network (FinCEN) issued a proposed rule regarding certain transactions involving convertible virtual currency or digital assets with legal tender status. Under the proposed rule, banks and money services businesses would be required to submit reports, keep records, and verify the identity of customers in relation to transactions above certain thresholds involving wallets not hosted by a financial institution.

On March 8, the US Treasury Department stated that all US crypto exchanges must register with FinCEN. The Treasury urged all virtual asset service providers (VASPs), including crypto exchanges, to follow Bank Secrecy Act rules. The Bank Secrecy Act requires financial service providers to implement strict anti-money laundering protocols and report suspicious activity.

In June, Wyoming Republican Sen. Cynthia Lummis and New York Democrat Sen. Kirsten Gillibrand introduced the Responsible Financial Innovation Act that would generally assume that cryptocurrencies are commodities, and apply existing statutes on commodity broker liquidation to digital assets. The bill would expand the law to protect digital assets in customer accounts, shielding them from other creditors. The bill would require the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission to develop within 18 months "comprehensive, principles-based" cybersecurity guidance for a broad range of entities that create, store or transfer digital currencies. The guidance would also address the "potential for digital asset intermediaries to be used to facilitate illicit activities," including those seeking to use digital assets to avoid sanctions against them.

Bipartisan legislation to establish a regulatory regime for stablecoins in the U.S. was introduced into the House of Representatives (H.R. 7328). The bill requires stablecoin issuers to maintain 1:1 reserves of their stablecoins in circulation and to limit the types of assets that could back these stablecoins. The bill has recently been pushed back to after the August congressional recess.

On Aug. 3, Senate Agriculture Committee Chairwoman Debbie Stabenow (D., Mich.) and Republican John Boozman (R., Arkansas) unveiled a plan that would empower the Commodity Futures Trading Commission to regulate spot markets for digital commodities, a newly created asset class.

At a State level on May 4, Governor Gavin Newsom issued Executive Order N-9-22 to set a process that, among other things, would harmonize federal and state laws relating to companies operating in blockchain, including crypto assets and related financial technologies. The order requires the state agencies to provide a report to the Governor's Office on the relationship of crypto assets to priorities in energy, climate and preventing criminal activity.

Similarly on June 7, California Assembly Bill 2269 – titled the Digital Financial Assets Law – was introduced under which businesses would need a license to offer crypto financial services in California. The legislation aims to give the cryptocurrency industry regulatory clarity and consumer protections by licensing and regulating the activities of cryptocurrency exchanges. The bill would require companies "engaging in digital financial asset business activity," including investing, lending, or trading cryptocurrencies, to register with the state's Department of Financial Protection and Innovation ("DPFI").

Unless signed into law, the DPFI does not currently seem to assert jurisdiction over crypto. In a Request for Interpretive Opinion dated April 8, the DPFI evaluated a company that allowed customers to deposit fiat currency to a company account and then draw down that balance to purchase virtual currency from the company. The purchased virtual currency was transferred to the customer's virtual currency wallet issued by the company, and then held there, transferred to an external wallet, or sold for fiat currency. The company then purchased a corresponding amount of virtual currency from a third party. On these facts the DPFI found that the company's purchase and sale of digital assets with customers did not require a California Money Transmission Act license because it did not involve the sale or issuance of stored value or receiving money for transmission. The DPFI concluded that it does not currently require Money Transmission Act licensure for the Company to provide customers with a virtual currency wallet.

Much of the pending legislation and legal changes arise out of the uncertainty of who owns the crypto assets at a crypto exchange, particularly if a bankruptcy ensues. What status will be given to customers of a cryptocurrency platform? Will they be treated as investors, unsecured creditors or trust beneficiaries? Each classification comes with different protections and different rights under the bankruptcy code. Secured creditors have the highest priority for repayment, while unsecured creditors would fall below them. Securities holders come last and often receive no recovery in a Chapter 11 case.

On May 10, Coinbase Global, Inc. filed its first quarter report with the SEC disclosing that, in case of bankruptcy, cryptocurrencies and other digital assets that Coinbase holds for its customers' accounts potentially could become property of its bankruptcy estate, with the result that its customers would be treated as general unsecured creditors. This created a massive wave of concern driving down Coinbase's value.

Section 541 of the Bankruptcy Code provides that upon commencement of a bankruptcy case, an estate is created that is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." What constitutes property of the estate is determined by reference to applicable non-bankruptcy law – usually state law. The governing state law may significantly alter the outcome of whether crypto assets constitute property of the bankruptcy estate, or belong to the holder of the crypto account. Under Bankruptcy Code section 541(b)(1), the estate does not include "any power that the debtor may exercise solely for the benefit of an entity other than the debtor." This includes the "power" to distribute assets of a trust that must be distributed to the trust's beneficiaries. As a result, property held in trust is excluded from the debtor's bankruptcy estate.

Customer agreements range widely among cryptocurrency platforms. Depending on the company, the terms could specify that digital assets will be held in trust or that they'll be segregated from the company's funds.

For example, Coinbase's standard User Agreement with U.S.-based customers provides that California law governs. The custodial trust agreements for Coinbase Custody which is a New York limited purpose trust company that provides crypto custodial services for institutional investors, provides for New York law to govern and states that "Digital Assets in Client's Custodial Account are not treated as general assets of [Coinbase].

Existing Article 8 of the Uniform Commercial Code (UCC) recognizes that if the contractual relationship between the exchange and its customers is defined as one that is "custodial," the crypto assets held by the exchange should remain property of the customer and, hence, not subject to dilution by general unsecured claimholders.

Pending amendments to the UCC further implement the rule that custodially held crypto assets should not be property of the bankruptcy estate in a bankruptcy of a custodian-cryptocurrency exchange. Under these amendments, cryptocurrencies would fit into a new category of collateral under the UCC, referred to as "controllable electronic records" (CERs). The amendments to the UCC to address certain cryptocurrencies and other digital assets are nearing completion and are expected to go to the States for consideration in the Fall of 2022.

Changes to Article 9 of the UCC provide that a security interest in a CER can be perfected by filing a financing statement, or by obtaining "control" of the CER. Under current blockchain technology, a secured party would normally obtain "control" of a cryptocurrency that is a CER if the secured party has the private key.

A new Article 12 to the UCC is also being proposed that includes provisions addressing transactions in cryptocurrencies falling under the category of a CER. In these transactions, a buyer of a CER can take free of the property claims of others if the buyer obtains control of the CER (e.g., holding the private key), gives value, and does not have notice of the property claims of others.

The laws applicable to crypto are uncertain and incomplete. Bankruptcy judges will be making rulings that will have long-lasting effects. Until there is some certainty, customers should take at least one minimal precaution: instead of giving the crypto company custody of a private key, customers should hold the crypto in a "cold" or "hardware wallet." A cold or hardware wallet is a device that the owner connects to the internet only when effecting a crypto transaction. Also carefully determine what state law applies, and carefully review the custodial agreement.