
THE TREATMENT OF **CRYPTOCURRENCY ASSETS** IN BANKRUPTCY



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The continuing effects of the COVID-19 pandemic, the war in Ukraine, worsening inflation, and fears of a recession have roiled the world economy this year. The cryptocurrency market has not been immune to these forces and has experienced significant liquidity events, accelerating an industrywide sell-off, which has left the value of cryptocurrencies at historic lows—what many call a “crypto winter.” Bitcoin alone fell 60% during the first half of 2022.

The idea that participants in the cryptocurrency industry, namely exchanges that operate platforms that allow users to transact in cryptocurrency, may resort to Chapter 11 bankruptcy became widely sensationalized in the news media following the announcement in late March of a short disclosure required by the Securities and Exchange Commission (SEC) to be considered by publicly traded crypto exchanges in their SEC filings. The disclosure would note the risk that crypto assets

held by an exchange for its customers might be considered property of a bankruptcy estate, rather than the property of the applicable customer, in the event of a bankruptcy. See Securities and Exchange Commission Staff Accounting Bulletin No. 121 (March 31, 2022). If that were the case, then the customer might have only an unsecured claim against the bankrupt exchange.

Conditions only worsened in May with the collapse of algorithmic stablecoin TerraUSD, which fell from \$82.55 to \$0.000001 in one week. Bankruptcy fears crystallized when, on June 27, cryptocurrency hedge fund Three Arrows Capital commenced a liquidation proceeding in the British Virgin Islands, followed by a Chapter 15 bankruptcy in the Southern District of New York on July 1. The company cited the decline in value of many cryptocurrencies and other digital assets as the cause of its collapse.

continued on page 8



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continued from page 7

On July 5, cryptocurrency brokerage Voyager Digital filed for Chapter 11 bankruptcy in the Southern District of New York, citing a short-term “run on the bank” due to the downturn in the cryptocurrency industry generally and the default of a significant loan made to Three Arrows Capital as the reasons for its filing. Just over a week later, on July 13, the cryptocurrency lending platform Celsius Network, which had cited extreme market conditions in freezing withdrawals on June 12, filed for Chapter 11.

Notably, Voyager provides custodial services through which cryptocurrencies may be deposited by customers and stored on Voyager’s platform¹ rather than in individualized digital wallets of the customers. In turn, under its agreement with some of its customers, Voyager can lend cryptocurrency deposited on its platform to third parties.

Voyager’s and Celsius’ Chapter 11 bankruptcy filings highlight the question of whether crypto assets held in this manner may be considered property of a bankruptcy estate and therefore not recoverable by the customer, who instead would likely be an unsecured creditor of the debtor. While some commentators have suggested that crypto assets might be considered property of the bankruptcy estate, existing common law, current provisions of Uniform Commercial Code (UCC) Article 8, and proposed amendments to the UCC recognize that if the arrangement and relationship between the exchange

and its customers is one that is characterized as “custodial,” the crypto assets held by the exchange should remain property of the customers and, hence, not subject to dilution by general unsecured claim holders.

Cryptocurrency Exchanges and Digital Wallets

A cryptocurrency exchange is a digital platform that interfaces with cryptocurrency wallets and enables users to buy, sell, and, in many cases, store cryptocurrencies in digital wallets managed by the exchange operator for its customers. In general, there are two types of cryptocurrency exchanges: centralized and decentralized.

Centralized exchanges function similarly to a brokerage and are operated by an entity that maintains the exchange and facilitates trading. Unlike centralized exchanges, decentralized exchanges operate autonomously via smart contracts without a central authority or intermediary, instead enabling users to trade directly peer-to-peer or through trading pair liquidity pools that enable a user to trade one type of cryptocurrency in the pair for the other. An exchange usually generates its revenue by charging users transaction fees and/or a spread.

As a technical matter, to purchase, receive, send, and trade cryptocurrencies, a wallet is necessary. A cryptocurrency wallet is a software program that is associated with an address on a blockchain and a corresponding pair of keys, one public and one private. Anyone who has the private key for a cryptocurrency

wallet can access and control the cryptocurrency stored in that wallet.

A custodial wallet is one for which a third party, such as a centralized exchange operator, holds the private keys on behalf of the owners of the cryptocurrency stored in that wallet. Centralized exchanges that offer custodial wallets use a variety of operating models. Some provide each user with their own unique dedicated wallet address. Others provide users with accounts on the platform, which are not tied to a specific wallet address and instead represent only an entitlement to a certain quantity of cryptocurrency held in general use wallet addresses controlled by the exchange operator and in which cryptocurrencies of multiple users are held.

Conversely, a non-custodial or self-custody wallet, such as an off-chain hardware wallet, is one whose private key is held only by the owner of the cryptocurrency. The operator of any centralized exchange to which the user links their wallet has no control of the cryptocurrency stored in that wallet.

Custodial Assets in the Bankruptcy of the Custodian

As mentioned earlier, under existing common law and provisions of Uniform Commercial Code (UCC) Article 8, if the arrangement and relationship between the exchange and its customers is characterized as custodial, the crypto assets held by the exchange should remain property of the customers.

The Common Law. When assets are held by a “custodian” for the benefit

of its customers, the assets are owned by the customers and would not form part of the debtor's bankruptcy estate. The Seventh U.S. Circuit Court of Appeals determined in *In re Joliet-Will County Community Action Agency* that property held by the debtor as a custodian or other intermediary who then generally lacks beneficial ownership rights is not an asset of the bankruptcy estate. See *In re Joliet-Will Cnty. Community Action Agency*, 847 F.2d 430, 431 (7th Cir. 1988) (Posner, J) ("Did they constitute Joliet-Will a trustee, custodian, or other intermediary, who lacks beneficial title and is merely an agent for the disbursal of funds belonging to another? If so, the funds (and the personal property bought with them, cf. *In re Kaiser*, 791 F.2d 73, 77 (7th Cir.1986)) were not assets of the bankrupt estate.") (Emphasis added).

The court then looked to see if the relationship between the debtor and those who transferred funds to the debtor was in fact custodial. The court concluded the answer depends on "the terms under which the grants were made" and the "relationship"

between the holder of the funds and its customer. In *Joliet-Will*, the agreement provided for controls on the holder's use of the funds, and the holder was "in effect an agent to carry out specified tasks rather than a borrower, or an entrepreneur using invested funds." The court concluded the relationship was custodial and thus the funds were not property of the bankruptcy estate.

In the context of a cryptocurrency exchange bankruptcy, the same analysis should apply where the terms of the relationship between an exchange and its customer are comparable and thus custodial. In that case, the customer would have a basis to assert that it should remain the beneficial owner of the assets rather than be classified as a general unsecured claim holder of the exchange.

The commingling of customer assets, or the contractual right of an exchange in possession or control of the customer's assets to grant a security interest in that property, do not, of themselves, prevent the assets from remaining the property

of the customer. See Restatement (Third) of Restitution and Unjust Enrichment § 59 (property interest in asset continues in commingled assets when the interests can be traced). See also Illustration 26 (400 customers of smelter deliver silver to smelter, who keeps records of the amount of silver delivered by each customer, refines the silver for a fee, and agrees to return a corresponding amount of silver to each customer; when smelter fails, each customer has a pro rata property interest in the refined silver, which is not the property of smelter); UCC § 9-207(c)(3).

Conversely, if the entity in possession or control of the property has extensive rights to use the property for its own benefit, a court is more likely to conclude that the relationship is not custodial. In that case, the customer "would have a contractual claim for the return of the money [it] had paid, but he would not have a property right in the money." *Joliet-Will*, 847 F.2d at 432.

continued on page 10



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continued from page 9

However, even if a court were to determine the customer should remain the *beneficial owner* of assets held by a custodian in such capacity, notwithstanding any commingling and any right to pledge the cryptocurrency, any contractual rights of the custodian (for example, any rights under a staking arrangement) should become property of the estate. In such a case, while the customer remains the beneficial owner of its cryptocurrency, which would not be subject to distribution to general unsecured claim holders in the exchange's bankruptcy, it could be tied up under the automatic stay, preventing parties from exercising control over the exchange's contractual rights (e.g., under a staking arrangement, the automatic stay might prevent a customer from recalling the cryptocurrency to its account).

UCC Article 8. UCC Article 8 mirrors these rules for financial assets held by a securities intermediary. Under Article 8, a securities intermediary² includes a "custodian" of a "financial asset"³ who otherwise meets the definition of a securities intermediary. UCC § 8-102(a) (14) and Comment 14. Critically, existing language in Section 8-503(a) of the UCC outlines the ownership interest of a customer whose cryptocurrency is held by an intermediary such as an exchange if the exchange is a securities intermediary, has agreed with the customer to treat the cryptocurrency as a financial asset,⁴ and has credited the financial asset to a securities account.

Section 8-503(a) provides that "[t]o the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511."

This is true under Article 8 even though the securities intermediary holds the financial assets in "fungible" form (i.e., they are commingled). This rule is the same as that for the smelting example described earlier from the Restatement (Third) of Restitution and Unjust Enrichment. Article 8 in effect codifies the common law custodian rules for transactions within the scope of Article 8—the customer of the custodian retains its property interest and has a pro rata interest in the commingled assets held by the custodian.

Proposed UCC Amendments.

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. The drafting of amendments to the UCC specifically to address certain cryptocurrencies and other digital assets is nearing completion and is expected to go to the states for consideration this fall. Under these amendments, cryptocurrencies would fit into a new category of collateral under the UCC, referred to as "controllable electronic records" (CERs) (a form of general intangible), which would generally include information stored in a nontangible medium that can be subjected to control.

Under these amendments, CERs would have many characteristics of

negotiability similar to negotiable instruments and securities; however, cryptocurrencies ordinarily would not be considered "money" for purposes of the UCC (that is, the amendment provides that cryptocurrencies generally would not be considered money, but a cryptocurrency created and adopted by a government as an authorized medium of exchange could be considered money under the UCC).

Notably, the proposed amendments to the official comments to Article 8 of the UCC primarily serve to make clear that a securities intermediary and a customer of a securities intermediary can agree to treat a cryptocurrency as a financial asset and credit it to a securities account with the treatment described.

The proposed amendments to the official comments in Section 8-501(d) note that assets such as CERs might also be controlled by a securities intermediary outside of a securities account for the benefit of a customer—similar to traditional securities—in which case the bankruptcy of the intermediary usually would not put in doubt the customer's ownership of securities held by the intermediary: "[A]ssets such as controllable electronic records, controllable accounts, and controllable payment intangibles also might be associated with an intermediary as well as with its customer under a similar direct holding arrangement. . . . As with conventional certificated securities, whether an intermediary has created a security entitlement in favor of an entitlement holder or its customer is holding a financial asset directly depends on the nature of the relationship and the nature of the rights of the intermediary and the customer with respect to the financial asset."

In addition, revisions to Article 9 of the UCC would provide that a security interest in a CER could be perfected



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the old-fashioned way—by filing a financing statement—or by obtaining control of the CER. Under current distributed ledger technology structures such as blockchain, a secured party would normally obtain control of a cryptocurrency that is a CER if the secured party has the private key. A secured party can have control through a custodian that has control for the benefit of a secured party. Where a securities intermediary and a customer of a securities intermediary agree to treat a cryptocurrency as a financial asset⁵ and credit it to a securities account, the customer would have a "security entitlement" related to the cryptocurrency, and the secured party could obtain and perfect a security interest in such security entitlement under existing procedures under Articles 8 and 9 of the UCC.

A proposed new UCC Article 12 includes provisions addressing transactions in cryptocurrencies falling under the category of a CER, such as sales of the cryptocurrency. In these transactions, a buyer of a CER could take free of the property claims of others if the buyer obtains control of the CER (e.g., holds

the private key), gives value, and does not have notice of the property claims of others. Because a CER is intangible, it is not possible to take possession of it.

The proposed amendments to the UCC have yet to be finalized and adopted by the states. However, as they relate to the ownership interest of a cryptocurrency exchange customer in custodially held cryptocurrency, many of the changes are proposed as amendments to the official comments, without revision to the operative statutory provisions themselves, because the existing statutory provisions already provide for the described results. Thus, a Bankruptcy Court could rely on the existing state UCC statute as a basis to determine that when cryptocurrency is held as a financial asset credited to customer accounts, it is property of the customer rather than the bankruptcy estate. This is the same result outside of Article 8 as discussed earlier.

Conclusion

Crypto assets held custodially by an exchange or other entity for a customer should be treated as the property of the customer. The analysis of when

a custodial relationship exists will depend on the agreements and other facts in a particular relationship. ■

Also contributing to the preparation of this article was Steve Y. Ma, an associate at Proskauer Rose LLP.

¹ Voyager utilizes "self-custody" and "third-party custody" solutions and internal "hot wallets" to hold crypto assets. The "self-custody" solutions include use of the Fireblocks platform to securely store, transfer, and stake a material portion of Voyager's crypto assets. The "third-party custody" solutions use institutional-grade, third-party custodians (such as Anchorage Digital Bank N.A. and Coinbase Custody Trust Company LLC) to hold crypto assets.

² "Securities intermediary" is defined in Section 8-102(a)(14) of the UCC.

³ "Financial asset" is defined in Section 8-102(a)(9) of the UCC.

⁴ See Section 8-102(a)(9)(iii) of the UCC.

⁵ A financial asset does not have to be a "security" (as defined in Article 8 of the UCC) to be a financial asset. As long as the relationship between the securities intermediary and the customer creates a "securities account" (UCC § 8-501, Comment 1), the securities intermediary and its customer (referred to as an "entitlement holder") can agree to have any asset treated as a "financial asset." UCC § 8-102(a)(9)(iii).