

# Turnarounds & Workouts

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## Crypto Winter Is Here

*By Christopher Patalinghug*

Three major crypto companies have sought bankruptcy protection following a recent financial crisis in the industry that investors are calling the “crypto winter.” These platforms’ collapse follows the crypto industry’s breakout years in 2020 and 2021 that saw Bitcoin reaching new all-time highs of more than \$20,000 in December 2020 and even hitting \$68,990 in November 2021.

As the economy continues to recover from the COVID-19 pandemic, the Federal Reserve early this year started to aggressively tighten monetary policy to curb high inflation. The move spooked many investors, triggering sharp sell-offs in cryptocurrencies and other risky assets. The sharp declines in crypto prices in early 2022 caused a liquidity crisis that led to the collapse of Three Arrows Capital Ltd., a \$10 billion crypto hedge fund, and the bankruptcy filings of crypto lenders Voyager Digital Holdings, Inc. and Celsius Network, LLC. The crypto market volatility also led to the \$60 billion collapse of Luna and its associated stablecoin Terra USD (UST) and caused the world’s largest

stablecoin Tether (USDT) to briefly lose its peg to the U.S. dollar in May 2022.

Three Arrows is the subject of insolvency proceedings in the British Virgin Islands and parallel Chapter 15 bankruptcy proceedings in the Southern District of New York. Voyager and Celsius commenced Chapter 11 proceedings also in the Southern District of New York.

### Uncharted Waters

**Robert Gayda**, a partner in law firm Seward & Kissel’s Corporate Restructuring and Bankruptcy group, and **Andrew J. Matott**, an associate in the firm’s Litigation and Corporate Restructuring & Bankruptcy groups, note that until Voyager’s bankruptcy filing, only one significant cryptoasset player had filed for bankruptcy protection in the U.S., which was Cred, Inc. in 2020. The Cred case, however, was precipitated more by fraud than any systemic issues related to the assets

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that it dealt in. Gayda and Matott anticipate that Voyager's filing, as well as any subsequent bankruptcy filings in the crypto space, will place untested issues front and center, including how cryptoassets held on behalf of customers of a bankrupt crypto platform are treated.

In May 2022, Coinbase, the largest U.S. crypto exchange, disclosed in an SEC filing that "in the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors." While the inclusion of this language in its SEC filing was the result of an accounting comment by the SEC staff, Gayda and Matott point out this highlighted the fact customer assets held in omnibus, non-segregated accounts — which generally include all assets held in client accounts — could, in the event of an insolvency, be treated as Coinbase's property (rather than property of customers). Ultimately, those assets could be liquidated and shared pro rata among all customers, subject to the priority scheme of the bankruptcy laws, with no guarantee that there would be assets sufficient to pay all customers in full.

"This disclosure sent Coinbase's

stock tumbling and forced their customers, and the customers of other crypto platforms, to contemplate a potential result that they had likely never considered. Although Coinbase's CEO soon after asserted that any bankruptcy risk is mitigated because its customer assets are held in segregated accounts, the public disclosure highlighted the uncharted waters that crypto-companies face in the event of a bankruptcy filing," Gayda says.

### Boom and Bust Cycle

Bracewell LLP's **Mark E. Dendinger**, **Anne M. Termine** and **Robert G. Burns** see the Voyager and Celsius filings could be the beginning of a series of bankruptcies by major cryptocurrency companies. They explain that as global financial markets worsen and investors withdraw their assets — particularly in the riskier field of cryptocurrency — more companies may be forced to seek refuge in bankruptcy. They also note that the "crypto winter" may linger for some time as companies may continue to be plagued by liquidity issues.

For **Tad Davidson** and **J.R. Smith** of Hunton Andrews Kurth, crypto currencies are another version of the boom and bust cycle attributable to any speculative investment. With virtually no rules, accountability

or transparency, corporate (and individual) failures and bankruptcies were inevitable and will persist until the industry achieves a better balance between innovation and transparency, the latter comprising of legal and regulatory certainty, Davidson says.

Dendinger is a managing partner of Bracewell's Connecticut office

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and a financial restructuring partner focusing on all aspects of corporate restructuring, bankruptcy and insolvency proceedings. Termine leads Bracewell's Cryptocurrency & Blockchain practice. Burns concentrates his practice on U.S. and international corporate restructurings and insolvency matters.

Davidson is the co-leader of Hunton Andrews Kurth's Bankruptcy/Restructuring practice group, and Smith is a restructuring and corporate

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finance attorney at the firm, and former managing partner of the firm's Tokyo office. Hunton Andrews Kurth is involved in a number of the crypto cases on behalf of creditors. "We are particularly involved in advising FinTech and other intermediaries on evolving blockchain technology and the related growing legal and regulatory framework in the U.S.," Smith shares.

### **Novel Issues**

According to Davidson and Smith, some of the gating issues involving crypto cases may include:

**(A) Property of the estate.** A fundamental question regarding customer crypto held in a crypto lender exchange that files for bankruptcy is whether such crypto is property of the debtor, and therefore subject to the debtor's bankruptcy, or is being held by such debtor as a custodian. Custodial property, assuming it can be traced, is not property of the estate subject to competing claims of creditors and should be returned to the customer. Non-custodial property is debtor-owned property subject to competing creditor claims and bankruptcy distribution hierarchy.

**(B) Secured/unsecured creditor status.** Some crypto lenders promote themselves as asset- or dollar-backed

— "stable" coins. That is, some exchanges claim to back such crypto with fiat or hard assets (such as gold or U.S. dollars) with the aim of reducing price volatility. This appeals to customers because it makes them feel like "stable" coin is less risky than other types of crypto currency. Yet asset-backed is different than legally having a security interest over collateral. Assuming customer crypto on deposit is "property of the estate," customers then have unsecured claims with payouts typically pennies on the dollar. Moreover, there is minimal transparency concerning "stable" coins. Customers have accused some exchanges of hiding losses or misleading customers about the extent of crypto actually backed by other assets. In the event of an insolvency, a trustee or other fiduciary would need to investigate such issues.

**(C) Valuation.** Many bankruptcy rules are keyed off of asset valuation as of a particular moment, often the bankruptcy petition date, to determine party rights. Reminiscent of the mark-to-market difficulties for financial assets during the Great Recession (2008), crypto has valuation issues on steroids. Crypto exchanges have emerged to promote valuations through trading and an indication of value, albeit imperfect due to the character of the asset. Unsurprisingly,

crypto valuations fluctuate wildly because it is a nascent asset class in an easily traded electronic form. In the event of substantial diminished liquidity, such assets could become difficult to accurately value.

**(D) Asset type.** Ubiquitously called "virtual currencies," a growing

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body of law and regulation treats crypto (and NFTs and other virtual assets) as securities or property. The *Diamond Fortress Technologies* case in the Delaware Chancery Court is a leading and informative case on this point, holding that crypto currencies are securities, subject to the Securities Act of 1933 and the Exchange Act of 1934 (i.e., Securities Exchange Commission and other regulatory oversight). Indeed, the Internal Revenue Service has issued a ruling following this approach, requiring reporting and imposing capital gains taxation on global profit realized from crypto assets.

**Matthew Gold and Dov Kleiner**, partners at Kleinberg, Kaplan, Wolff & Cohen, P.C., believe the integrity of

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individual currencies is an important topic in crypto bankruptcies. They note, “Will account holders/crypto creditors be treated as if they are holders of specific crypto currencies or coins, or will they receive a general unsecured claim based on the dollar value of their various crypto holdings computed at the time of the bankruptcy filing?” For Gold and Kleiner, the question is whether holders of a particular currency would try to have their claims and distributions tied to the particular currency or, alternatively, would all claims and assets be aggregated across coins and currencies (the norm in a bankruptcy).

Gold explains platforms like Celsius and Voyager, dealt in many different crypto assets for their customers but the losses were not evenly distributed among currencies. “So, for example, Voyager’s losses from its loans to Three Arrows Capital were primarily in Bitcoin and USD Coin, leaving other currency balances unaffected, in which case Ether depositors would likely push to have their claims paid out of available Ether, while Bitcoin depositors would want all assets aggregated before pro-rata distribution. Similarly, crypto currencies other than stablecoins,

while generally correlated with one another, do not move in lock-step, so fixing claim amounts at the time of the petition will be adverse to depositors of crypto assets that performed better since the petition date relative to other currencies.”

Kleiner notes Section 502 of the Bankruptcy Code says — “Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition.” “This would argue for having all claims aggregated and

*“It may be hard for platforms to continue as viable enterprises if deposits are treated as a single, commingled pool of currencies, and separate asset classification may be necessary for a successful reorganization.”*

fixed at their dollar value at the time of the bankruptcy and sharing pro-rata in the value of the debtor. But note also that in connection with a plan of reorganization, the debtor has significant leeway in how it classifies claims,” according to Kleiner.

Meanwhile, Section 1122(a) provides: “(a) Except as provided in

subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.” “A debtor may choose, therefore, to create separate classes of claims based on the crypto currency deposited. So, for example, there could be individual classes for Bitcoin deposits, for Ether deposits, for USDC deposits, etc. Then, assuming the other requirements of the bankruptcy code were met, assets could be distributed by class, so that Bitcoin class holders receive their pro-rata share of Bitcoin assets, Ether class holders receive their pro-rata share of Ether assets, USDC class holders receive their pro-rata share of USDC assets, and so on,” Kleiner continues.

At the Voyager first day hearing, the court questioned whether digital assets on the Voyager platform should be considered property of the estate, and thus subject to distribution to unsecured creditors, or property of Voyager customers themselves. An adversary proceeding was filed in Celsius addressing this same issue. According to Dendinger, Termine and Burns, the answer will impact how these companies can reorganize or sell their assets in the bankruptcy proceeding. They note that Voyager’s bankruptcy is “not a



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typical bankruptcy.” This case is about Voyager’s customers and the looming question of can customers recover their crypto assets without going through the bankruptcy proceeding, they say.

“At the moment, it appears that the debtor platforms would like to maintain the integrity of the depositors specific crypto asset claims. As a business matter, it may be hard for platforms to continue as viable enterprises if deposits are treated as a single, commingled pool of currencies, and separate asset classification may be necessary for a successful reorganization. But if liquidation appears more likely, then the pressure to aggregate assets and claims may push towards treating depositors as a single class that shares recovery on an overall, aggregated basis,” Kleiner adds.

### **Treatment of Borrowers**

Another interesting issue that is likely to emerge from the Celsius case is the treatment of borrowers, according to Gold and Kleiner. Gold explains Celsius had a lending program, whereby it would lend depositors USDC against “collateral” deposited with Celsius by the borrower. Celsius then took the collateral into its own

account and lent or staked it, earning a return which Celsius kept. Prior to the bankruptcy and following the sharp drop in crypto prices, Celsius demanded that borrowers post additional collateral or face liquidation of their collateral. Since Celsius was freezing withdrawals, many borrowers elected to have their positions liquidated rather than deposit additional collateral that might become frozen (as has now happened, given the bankruptcy filing). Since the bankruptcy filing, the status of the loan program is uncertain, with depositors unsure of how to proceed on their loans. Because the loans are significantly “over-secured,” many depositors would like to pay off the loan balance and get the return of their collateral. But, given the freeze on Celsius accounts, there is no mechanism to do that. Moreover, there will be a legal question as to whether the “collateral” is property of the borrower/depositor or simply property of Celsius with borrowers having only an unsecured claim to receive back their posted collateral.

### **Safe Harbor, Other Issues**

Gold and Kleiner further note that one issue that may critically affect preference and fraudulent conveyance actions that may be brought in the

Voyager and Celsius cases is the applicability of the Safe Harbor. The Safe Harbor provides significant protection to defendants in bankruptcy clawback actions with regard to transactions that involve securities or commodities. Accordingly, the currently unresolved questions of whether the coins involved in Voyager and Celsius can be considered securities or commodities can affect the applicability of the Safe Harbor, Kleiner says.

He adds, “The Voyager and Celsius debtors have not yet revealed whether and to what extent they will be bringing clawback actions. Indeed, the statute of limitations allows such actions to be timely brought as much as two years after the bankruptcy petition is filed, and it is common for a debtor in possession to defer the filing of clawback complaints until after a plan of reorganization has been confirmed. Accordingly, it may be some time before Safe Harbor issues are litigated.”

For Dendinger, Termine and Burns, the handling of private keys of crypto wallets has become a novel issue in these bankruptcy proceedings. Private key is an important element of blockchain. It may also be the key for Voyager customers to protect themselves through the court-approved sale process that is ongoing,

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they explain.

Davidson and Smith believe that figuring out how to jam the crypto peg into existing legal/regulatory squares will simply take time for courts to work through. Ultimately new law, regulations, and case law likely will provide transparency and predictability. “But crypto was created, in part, to exist above traditional borders and related legal and regulatory regimes. Resolving this tension will take time,” they add.

### **Need for Clarity**

Dendinger, Termine and Burns observe the crypto industry has been asking for regulatory clarity and the lack of it may be causing some businesses and innovation to move offshore to other countries who are moving swiftly to enact regulation specific to the industry. The *Voyager* case is the perfect example of trying to apply old law to new products and finding it is an imperfect fit, at best. They note: “We are finally seeing movement in Congress to address this issue through multiple bills that have been introduced over the past few months to create a regulatory framework for digital assets. The overarching concern for members of Congress is consumer

protection when dealing with risky assets such as cryptocurrency or NFTs. Cases like *Voyager*’s only heightens the urgency in Congress. Given the building urgency to act amount members of Congress, it is likely that some sort of legislation will be passed within the next year. How such legislation will define the assets, whether as commodities or securities or something else, will have significant impact on the potential growth here in the US.”

“We have been urging clients to engage with members of Congress now to be able to shape the future of the industry as opposed to having the future shaped for them. Until there is

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*“We are finally seeing movement in Congress to address this issue through multiple bills that have been introduced over the past few months to create a regulatory framework for digital assets.”*

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regulatory certainty, it is possible that the courts may be the ones to define digital assets and provide some clarity on a case-by-case basis. This will only further entrench the patchwork regulatory framework that currently exists.”

Davidson and Smith note: “[Crypto] assets form only part of

blockchain and other distributed ledger technologies, including smart contracts. Recent reporting identifies more than 12,000 different types of crypto currencies alone. While these asset classes are growing exponentially through innovations across all industries, time is needed to bridge the gap between physical and virtual assets for mainstream consumers.”

The *Voyager* bankruptcy will be closely watched and likely precedential in the marketplace, Gayda and Matott add. “How will customer assets be treated? The preliminary view seems to be customer crypto that is held in omnibus accounts and not segregated would likely be “estate property” (i.e., property of the bankrupt entity), leaving those customers with a shortfall,” Gayda says. “Different cases could have disparate results, depending on the underlying loan or customer custody agreements. On a macro scale, it will be interesting to see if this is simply contagion related to a specific collapse working through certain industry players, and if it can be contained, or if this is an indictment of the broader crypto marketplace. We will continue to monitor the situation closely and report on significant updates.” ▢