Decoding The Digital Asset Landscape In Bankruptcy

By **David Castleman and Anthony Facciano** (November 8, 2023)

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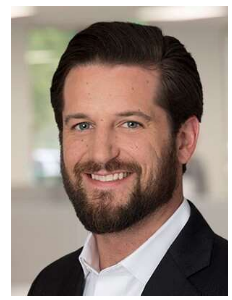

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The explosion of cryptocurrency as an asset class has created new challenges for debtors-in-possession, bankruptcy trustees, and federal and state receivers that find themselves in possession of these assets and have to decide what to do with them.

Although much attention has been paid to the bankruptcies of cryptocurrency exchanges and lenders — such as Celsius Network LLC, Voyager Digital and FTX Trading Ltd. — we are beginning to see additional cases where digital assets come into different kinds of estates.

In some cases, the underlying business in bankruptcy — or potentially fraudulent scheme in a receivership — may have been operated using cryptocurrency transactions, leaving large account balances of bitcoin, ethereum or a variety of tokens in the accounts of the company.

In other cases, a company or even an individual may have a substantial position of digital assets that becomes part of the bankruptcy or receivership estate.

The question then becomes, what next?

Once a fiduciary comes into possession of a digital asset, the fiduciary in charge of the estate — whether the DIP, trustee, receiver or the like — will have to maintain and manage custody of that digital asset, decide whether to sell such digital asset, and potentially deal with claimants who want their claim to be satisfied in whole or in part with a portion of that digital asset.

Each of these issues will present challenges to a fiduciary under the U.S. Bankruptcy Code, the federal securities laws and other applicable law.

Maintaining Digital Assets

Once digital assets become part of an estate, the fiduciary will first have to decide how to manage custody of such assets, which is a nontrivial question.

Perhaps the most significant decision will be whether to maintain such assets on an exchange, in a hot wallet or in cold storage. For assets held on an exchange, the bankruptcy remoteness of the holdings will likely be a critical issue.

In the Celsius case in the U.S. Bankruptcy Court for the Southern District of New York, U.S. Bankruptcy Judge Martin Glenn held in January that certain digital asset accounts — generally those earning yield — were the property of the bankruptcy estate, whereas other accounts were not, based on the contract in effect for those accounts.[1]

Although there are risks in using any third party to maintain custody of estate assets, including cash in a bank, Judge Glenn's decision highlights the importance of careful review and negotiation of any post-petition contract between the estate and the exchange.

Storing digital assets in a separate wallet may have appeal given the lack of counterparty risk, whether that wallet is hot (connected to the internet) or cold (not connected). In either situation, the digital asset is stored on the blockchain, accessible only by a digital private key — a complex string of numbers and letters.

However, there may be more risk than meets the eye, as a fiduciary remains exposed to the risk of the digital private key falling into the wrong hands. If a wrongdoer with that private key transfers the digital asset, it could be gone forever.

As such, storing in any wallet — hot or cold — is not without some risk.

Measuring Claims and Value

In general, the Bankruptcy Code requires that claims be dollarized as of the date of the filing of the petition — meaning that the court is required to "determine the amount of such claim in lawful currency of the United States."[2]

Thus, to the extent that the claims of stakeholders are based on digital assets owed to them, the value of those claims may be fixed at the time of the petition. This is especially challenging where the price of the applicable digital asset rises.

Some claimants may be disappointed to find that their claims are valued at the price at the time of petition, depending on their situation.

Further, the blockchain's reputation for allowing the tracing of all digital assets along the blockchain can, in some circumstances, be somewhat oversold. This is especially so when digital assets are transferred to and from an exchange where the debtor holds an account, and such exchange maintains its own internal off-chain records identifying which account holders hold which digital assets.

At that point, if the digital assets are commingled legitimately, what remains in the debtor's account may be a readily identifiable amount of a digital asset, but not necessarily traceable on-chain to any one claimant. The tracing required for the creation of a constructive trust or similar vehicle may, in some cases, not exist.

Distributing Digital Assets in Kind

At some point, a fiduciary may and likely will want to effect a distribution of assets or money to claimants or creditors.

Even if the claims are dollarized under Section 502(b) of the Bankruptcy Code, a fiduciary may still choose to distribute assets in kind, which may involve the fiduciary weighing a number of fact-specific issues in any particular case.

The Bankruptcy Code requires that the confirmation of any plan of reorganization be consistent with the applicable law,[3] such that a plan cannot violate the federal securities laws. As such, a plan that requires the distribution of digital assets may run into trouble if the transfer of such digital assets to claimants does not comply with federal securities law.

Whether a digital asset is a security can be, in today's climate, an uncertain question as even judges in the recent digital asset cases from the Southern District of New York did not agree with each other on whether certain similar secondary market transactions constituted securities transactions, as discussed below.[4]

Is the Digital Asset a Security or Not?

This is often the $64,000 (or 2 bitcoin) question that remains unsettled in the law today.

Many judges and commentators have expressed the opinion that bitcoin is a commodity, but even that determination is far from certain. The oft-cited Howey test, based on the 1946 U.S. Supreme Court case U.S. Securities and Exchange Commission v. Howey involving orange groves, finds that an investment contract exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[5]

Although the SEC has published guidance on the framework of an investment contract analysis for digital assets,[6] at this point there is an ever-present risk that the SEC will claim that any digital asset is a security — with the possible exception of bitcoin.

Other agencies, including the Commodity Futures Trading Commission, may take a different view, and there are a number of bills working their way through Congress to provide additional guidance.

In the SEC v. Coinbase case currently before the U.S. District Court for the Southern District of New York, Sen. Cynthia Lummis, R-Wyo. — the author of one of the primary bills under consideration[7] — filed an amicus brief arguing that the SEC should defer to Congress given that legislation is underway.[8] However, the success or timing of legislation is generally uncertain, perhaps more so in today's political climate.

Recent decisions have not necessarily shed any further light on this question.

As noted above, in the Southern District of New York, two judges recently disagreed as to how to characterize certain digital asset sales as securities transactions.

In the Ripple case, U.S. District Judge Analisa Torres held in July that sales of Ripple's native token, XRP, through its trading platform were not securities transactions, although sales directly to institutional investors were securities transactions.[9]

Expressly rejecting that distinction, U.S. District Judge Jed Rakoff held in SEC v. Terraform Labs Pte Ltd. in July that all sales of digital assets were securities transactions.[10]

The question of whether there will be a regulatory consequence to a transaction in a plan remains unanswered and was a subject of concern raised expressly in the Voyager case in March where the SEC declined to take a formal position.[11]

The distribution of digital assets can have additional challenges.

Unlike in other payment processing methods, where a check can be stopped or even a wire can be reversed by the receiving bank, once a digital asset has been transferred, there may be no practical way to reverse the transaction if such an asset is sent to a wallet outside anyone's jurisdiction.

A fiduciary may attempt to ameliorate the risk, for example by distributing digital assets only to a handful of exchanges, or possibly by using a specialized distribution agent.

Distributing Cash Instead of Digital Assets

In light of the valuation, dollarization and securities laws challenges above, the fiduciary may decide that it is better to liquidate the digital assets and distribute only cash to claimants. This too may present challenges, not the least of which is compliance with the securities laws.

The recent decisions in Ripple and Terraform, in addition to the Coinbase action, highlight the need to ensure that the sale of any digital asset complies with applicable law.

Other challenges may be present as well. A sale of any asset generally requires that there is a market to purchase that asset — for some digital assets like bitcoin, the existence of a somewhat efficient market is to be expected.

Other less common digital assets may have far less liquid markets that result in a substantial illiquidity discount for any sale.

Although no fiduciary has a crystal ball, any sale of an asset also exposes the fiduciary to price risk, especially in cases where a sale is made before a large price increase or a sale is not made before a large price decrease.

Digital assets remain highly volatile, and such volatility shows no real signs of abating. There may be strategies a fiduciary can take to lessen that volatility, such as dollar-cost averaging over a lengthier sale period, but even those strategies cannot avoid taking any price risk.

Conclusion

As insolvencies involving cryptocurrency continue to occur in the coming months and years, the increasing prevalence of digital assets increases the likelihood that a fiduciary will have to handle their existence in the estate.

As cases may begin to show a wide variety of digital asset issues, fiduciaries will have to consider a number of legal and practical considerations when determining how to manage and ultimately resolve these assets in insolvency proceedings.

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[1] In re Celsius Network LLC, Case No. 22-10964 (Dkt. 1822) (S.D.N.Y. Jan. 4, 2023).

[2] 11 U.S.C. § 502(b).

[3] 11 U.S.C. § 1129(a)(3).

[4] SEC v. Ripple Labs, Inc., No. 20 Civ. 10832 (S.D.N.Y.); SEC v. Terraform Labs Pte. Ltd., No. 23 Civ. 01346 (S.D.N.Y.).

[5] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[6] See https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[7] Lummis Gillibrand Responsible Financial Innovation Act (proposed), available at https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-2023.pdf.

[8] Amicus Brief of Senator Cynthia Lummis, SEC v. Coinbase Inc. et al., Case No. 23 Civ. 4738 (S.D.N.Y. filed Aug. 11, 2023), available at https://www.jenner.com/a/web/28X9k8T5he7oXkAgNGj4LY/84AadY/lummis-amicus.pdf.

[9] SEC v. Ripple Labs, Inc., No. 20 Civ. 10832 (Dkt. 874) (S.D.N.Y. July 13, 2023).

[10] SEC v. Terraform Labs Pte. Ltd., No. 23 Civ. 01346 (Dkt. 51) (S.D.N.Y. July 31, 2023).

[11] See https://www.coindesk.com/policy/2023/03/02/voyager-bankruptcy-judge-says-he-is-absolutely-shocked-by-sec-objection-to-binance-us-deal/.