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Digital Assets Alert

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Hold on for dear life: How a bankruptcy of a cryptocurrency exchange may affect holders

By Christopher Fong

Can a cryptocurrency exchange file for bankruptcy under the United States Bankruptcy Code, and if so, what are the ramifications for cryptocurrency holders?

What's the Impact?

- Exchanges offer a convenient way to buy, sell, and trade cryptocurrencies, but owners should be aware that they are not protected like traditional brokerage accounts
- Some states are beginning to allow banks to house digital currencies—and in turn, become subject to different insolvency rules
- Customers may face difficulties trying to withdraw cryptocurrencies from exchanges involved in bankruptcy proceedings

On May 10, 2022, Coinbase Global, Inc. ("Coinbase"), one of the most used US-based cryptocurrency exchanges and brokers, released its quarterly Form 10-Q. Besides its reported quarterly loss of $430 million, the 10-Q also contained information that Coinbase users may find alarming: As of March 31, 2022, Coinbase held $256 billion in custodial fiat currencies and cryptocurrencies on behalf of customers and "because custodially held crypto assets may be considered to be the property of a bankruptcy estate, 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."[1]

This article examines whether a cryptocurrency exchange could file for bankruptcy under the United States Bankruptcy Code and the ramification to users who hold cryptocurrency on an exchange.

Cryptocurrency exchanges

In the United States, popular cryptocurrency exchanges include Coinbase, Gemini, and Kraken. These exchanges offer users the ability to buy, sell, trade, and hold their crypto currency on the exchange. A third-party cryptocurrency exchange like Coinbase can securely hold a customer's cryptocurrency in a custodial capacity. Coinbase alone holds $256 billion in custodial fiat currencies and cryptocurrencies on behalf of customers. In addition, exchanges like Coinbase can hold a user's digital keys so that the account holding a customer's cryptocurrency cannot be lost, forgotten, or rendered inaccessible.

Exchange customers also have the ability to transfer their cryptocurrencies and digital assets to their own "cold" wallet, which is held separately from an exchange. In a personal wallet (i.e., a cold storage wallet), the owner gets a private digital key to control that digital wallet and only the holder can make withdrawals and activate payments. Anyone can send cryptocurrency to a cold wallet address, but only the owner can transfer cryptocurrency from his or her own address. However, if the owner loses the password or the device, the digital assets are lost as well.

Exchanges like Coinbase offer the convenience of maintaining a cryptocurrency account that cannot be forgotten or lost. In addition, an exchange can also use the customer's digital information to facilitate transactions on the customer's behalf. For example, Coinbase provides a procedure to exchange cryptocurrency for traditional fiat currency at current market value. The customer can liquidate all or part of a Coinbase account and receive fiat currency.

However, people who use exchanges to buy, hold, and trade cryptocurrency may not be aware that cryptocurrency accounts on exchanges are not like traditional brokerage accounts protected by the Securities Investor Protection Corporation ("SIPC") and are not FDIC insured. Thus, customers may not be aware of the ramifications if one of these cryptocurrency exchanges collapses. SIPC was created to protect customers from the loss of cash and securities in the event of member brokerage firm bankruptcy. No such government program exists for cryptocurrency exchanges (though an exchange may purchase liability insurance on behalf of its client accounts).

Although a US-based cryptocurrency exchange has never filed for bankruptcy, several foreign exchanges have collapsed and /or filed for insolvency proceedings:

[1] Coinbase Global, Inc., Form 10-Q (May 10, 2022), at ___.

- Mt. Gox—In February 2014, Mt. Gox, the then-largest crypto asset platform worldwide, filed for bankruptcy protection in Japan after an estimated 700,000 Bitcoins were stolen from its wallets.
- QuadrigaCX—Canada's largest exchange, collapsed when its founder died without any succession plan for the keys needed to access the hundreds of millions he controlled.
- Cryptopia—a company registered in New Zealand, operated a digital exchange that allowed its approximately two million users to trade digital assets, including Bitcoin and Ethereum. Cryptopia was placed into liquidation in New Zealand on May 14, 2019. The liquidators are focused on collecting and distributing Cryptopia's property to the entitled parties.

Can a US-based crypto exchange file for bankruptcy protection under the bankruptcy code?

The Bankruptcy Code sets a specific list of entities that are *not* eligible for relief (i.e., banks, insurance companies, *see* 11 U.S.C. § 109). An exchange that is not a bank can ostensibly file for bankruptcy protection. For example, following its parent filing for liquidation in New Zealand, Cryptopia's foreign representative filed a chapter 15 petition for recognition of its New Zealand liquidation proceedings in the United States Bankruptcy Court for the Southern District of New York. On June 24, 2019, the Bankruptcy Court issued an order granting recognition of the foreign proceeding, thus allowing the foreign representative to avail itself of the powers of US courts.

However, in 2020 the state of Wyoming began approving digital banks under its Special Purpose Depository Institution Bank Charter ("SPDI"). The SPDI allows approved banks to house digital currencies alongside fiat currencies under Wyoming law. SPDI banks in Wyoming must hold reserves backing 100 percent of the cryptocurrencies on deposit. So if a client seeks to withdraw funds, the bank will have the assets on hand to cover the request.

Kraken, which operates a cryptocurrency exchange, was the first digital asset company to receive the SPDI charter in Wyoming. Thus, if Kraken were to attempt to file for bankruptcy, it would be a question whether it was eligible for relief as a debtor under 11 U.S.C. § 109 and whether its cryptocurrency exchange arm could be separated from its SPDI bank arm. To the extent that a crypto exchange has a bank arm—*i.e.*, a state-chartered non-deposit trust company, a national non-deposit trust company, or an FDIC insured bank or trust company—the insolvency rules governing that entity will be the insolvency regime applicable under either state banking laws or an FDIC receivership, rather than the Bankruptcy Code.

What happens to cryptocurrency held in an exchange?

In Cryptopia, the New Zealand court decided that the cryptocurrency remaining in Cryptopia's accounts was held in trust for the account holders. In reaching this conclusion, the court looked at the operating practices of Cryptopia, how it had marketed itself to account holders, and the terms and conditions in place at various times. Of particular importance was the fact that account holders brought their own currency onto the platform to make it available for exchange.

Cryptopia acted as a platform for the exchanges but did not hold the currency as part of its assets (apart from the currency traded on its own account).

If a domestic exchange files for bankruptcy protection, it is likely that all cryptocurrency held by the exchange in a custodial capacity will be considered property of the debtor's bankruptcy estate. Upon the filing of a bankruptcy, there is a new legal entity created—the debtor's estate—which accedes to all of the debtor's property rights, and those include, at the very least, the exchange's possessory interest in the cryptocurrency. In a US bankruptcy, the cryptocurrency exchange has, at the minimum, a possessory interest in the digital assets and the automatic stay will prevent customers from immediately withdrawing or trading their cryptocurrency.

Can customers get their cryptocurrency back?

When a debtor files for bankruptcy protection, there is an automatic stay that arises under section 362 of the Bankruptcy Code that stops all actions to exert control over property of the bankruptcy estate. The automatic stay's protections are broad and are intended to provide the debtor a breathing spell. It is likely that the automatic stay would prevent exchange customers from withdrawing their cryptocurrency from their account since the exchange would have a possessory interest in any cryptocurrency held on the exchange. Parties can move to lift the automatic stay for "cause." However, that comes with the cost of hiring counsel and the risk that the court might not grant the motion. Moreover, one of the difficulties in lifting the stay to withdraw or trade cryptocurrency is demonstrating that any customer has an ownership interest in a specific coin (i.e., Bitcoin #45679), rather than one Bitcoin in general. Without showing a specific ownership interest in a specific coin, it might be exceedingly difficult to lift the stay to withdraw or trade a cryptocurrency.

In addition to the difficulty of withdrawing or trading cryptocurrency held in an exchange that has filed for bankruptcy, in a bankruptcy case, general unsecured creditors of the debtor usually have to wait to get paid under a confirmed bankruptcy plan, which may take years to formulate and confirm (especially if the bankruptcy case is contentious). It is likely that customers who hold their cryptocurrency on an exchange are likely general unsecured creditors. Indeed, Coinbase suggested as much in its May 2022 Form10-Q. General unsecured creditors (unless they have some basis for a priority claim) are generally last to get paid (assuming there is no value for equity holders). Moreover, general unsecured creditors are often not fully compensated and typically only share on a *pro rata* basis (i.e., pennies on the dollar) with (i) whatever assets are left (if any) after the secured creditors and the priority creditors (including the expenses of running the bankruptcy) get paid, and (ii) recoveries from lawsuits that the estate may bring to clawback money into the bankruptcy estate (although, as explained below, customers could be the targets of those lawsuits. Accordingly, payments to general unsecured creditors might not occur for some time, especially if recoveries are based on the success of the estate's avoidance actions and other lawsuits.

Claims of the exchange estate against customers

In addition to not having immediate access to cryptocurrency and having to wait to get repaid, customers using exchanges should also be aware that once in bankruptcy, the cryptocurrency exchange has certain powers under the Bankruptcy Code to clawback certain pre-bankruptcy transfers.

For example, once a customer decides to hold cryptocurrency on an exchange, that customer becomes a creditor of the exchange for the amount of crypto held. If that customer redeems its custodially held crypto within 90 days of the bankruptcy filing, that transaction could be avoided as a preference, unless one of the defenses apply. If an exchange declares bankruptcy, it can legally claw back many of the withdrawals its depositors made over the 90 days before the bankruptcy and the burden would shift to the customer to provide a defense.

In addition, like the transfer of any other asset, transfers of cryptocurrency within two years of a bankruptcy filing could be deemed fraudulent if the elements of fraud are satisfied. More specifically, a transfer is deemed fraudulent if a debtor voluntarily or involuntarily makes a transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was indebted. Similarly, a transfer is also deemed fraudulent if a debtor received less than a reasonably equivalent value in exchange for such transfer or obligation and was also insolvent at the time of the transfer. For these reasons, valuation is an important issue in determining the "reasonably equivalent value" of cryptocurrency.

What's next?

Cryptocurrency brokers and owners benefit from seeking guidance on how to plan ahead for the impact of rapidly changing regulatory developments surrounding digital currencies and include bankruptcy protection strategies in their approach.

Nixon Peabody's Financial Restructuring & Bankruptcy team helps businesses protect existing capital and unlock new value in distressed assets, and our Blockchain and Digital Assets team can further assist you in conducting business in this rapidly changing marketplace.

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