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## Cryptocurrency Custody and Insolvency

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Cryptocurrency is known for raising a number of high profile, and in many cases novel, legal issues in comparison to more established financial assets. Custody, regulation of trading platforms, regulatory classification, for example, as a security or a commodity, and most recently, treatment in bankruptcy proceedings are among the most pressing.

From an investment and trading perspective, the volatility of cryptocurrencies is particularly well known. Since inception, the cryptocurrency market has experienced alternating cycles of growth and contraction. With each cycle, the cryptocurrency market has grown, reaching a peak of approximately US \$2.8 trillion in November 2021. Like the cycles of growth, the cycles of drawdown can be dramatic. The largest of these drawdowns, with respect to bitcoin, was approximately 93 percent in its early years. Since that time, drawdowns of approximately 55 percent to 85 percent have followed in later cycles. Since the peak in November 2021, bitcoin and ether, the largest cryptocurrencies by market capitalization, experienced drawdowns in 2022 of approximately 75 percent and 82 percent, respectively.

With the growth of the cryptocurrency market has come increased interest from retail and institutional investors. Increased growth also accompanied increased complexity, as market participants introduced new products, existing products such as

stablecoins grew in market size and demand, and the concept of decentralized finance or “DeFi” developed. As with all markets, with additional complexity comes additional risk.

In May 2022, TerraUSD (UST), an algorithmic stablecoin designed to maintain a valuation of \$1 through an issuance and burn mechanism with its sister asset Terra (LUNA), lost its peg to the \$1 valuation and collapsed to approximately \$0.12 in four days, further devaluing below \$0.01 within the following days. This collapse wiped approximately USD \$60 billion from the cryptocurrency market. Following the collapse of UST and LUNA, in July 2022, Voyager Digital Assets, Inc., a cryptocurrency brokerage and lending platform, and Celsius Network, a competing lending platform, filed for Chapter 11 bankruptcy protection in the Southern District of New York. These bankruptcy petitions have resulted in the assets of these platforms’ customers being tied up and unavailable for withdrawal, and have raised the industry-wide question as to how cryptocurrency is held by cryptocurrency exchanges, lenders and custodians; notably, whether cryptocurrencies on such platforms should be treated as assets of the debtor’s estate or as assets held for the benefit of the client and therefore not subject to creditor’s claims.

While the answer to this question will ultimately be fact-specific to each arrangement and likely

depend critically on the terms and conditions upon which each client agrees, the organizational form of the platform will likely play a role as to how the event of insolvency proceeds. As background, cryptocurrency platforms are typically organized either as operating companies under state law (for example, limited liability companies, corporations), or trusts or banks under state or federal banking laws. State-chartered limited purpose trust companies are commonly formed in New York, as well as in South Dakota and Washington. Wyoming has issued a Special Purpose Depository Institution Bank Charter for the custody of digital assets and US dollar deposits. Further, the Office of the Comptroller of the Currency (OCC), which charters national banks, permits national banks to provide cryptocurrency custody services. The OCC has also issued national nondeposit trust company charters for companies engaged in cryptocurrency custody services.

This article discusses issues for cryptocurrency platforms that may be subject to insolvency proceedings under the Bankruptcy Code, the Federal Deposit Insurance Act (FDIC), OCC regulations, and New York Banking Law.<sup>1</sup>

## Treatment Under the Bankruptcy Code

### Eligibility

The threshold issue of whether the insolvency of a cryptocurrency platform will be administered under applicable state and federal banking laws (Banking Law) or under the federal bankruptcy code (Bankruptcy Code) is largely shaped by the eligibility requirements for debtors under the Bankruptcy Code. Sections 109(b)(2) and 109(d) of the Bankruptcy Code dictate which kinds of legal entities may file petitions for bankruptcy as debtors under Chapter 7 or Chapter 11 of the Bankruptcy Code.<sup>2</sup> These provisions prohibit “banks” from filing for bankruptcy other than “uninsured State member banks” which may file at the direction of the Board of Governors of the Federal Reserve System.<sup>3</sup>

“Bank” is not defined in the Bankruptcy Code. Courts have utilized different approaches to determine whether an entity qualifies as a “bank” or other prohibited filer under 11 U.S.C. § 109(b)(2), including: (1) the “state classification” test based on the law of the state of incorporation, (2) the “independent classification” test based on the definition of the words of the Bankruptcy Code, and (3) the “alternative relief” test,<sup>4</sup> which examines “congressional intent and factors of practicality and policy” to determine whether, notwithstanding the existence of a state-law reorganization and liquidation scheme to wind up a particular entity, federal bankruptcy relief would nonetheless be a satisfactory alternative to the state procedure.<sup>5</sup>

Of these, the “state classification” test often carries substantial weight and courts have noted that once an entity’s status under state law is determined, state law should be overlooked only if there is good reason to conclude that following it will frustrate the full effectiveness of the Code.<sup>6</sup> Under the “state classification” test, the court will first look to the state statute under which the entity was formed and examine: (1) how the entity is classified under state law; (2) what powers are granted to the entity; and (3) what activities actually engaged in fell within the range of lawfully conferred powers.<sup>7</sup> If the state statute defines the corporation as one of the kind that the Bankruptcy Code excludes, the immediate inference should be that the corporation is not eligible to file under the Bankruptcy Code.<sup>8</sup> If state law does not classify the entity, the question then becomes whether the entity is the “substantial equivalent of those in the excluded class” through a comparison of the powers conferred upon or withheld from the entity with the powers conferred upon or withheld from entities excluded under Section 109(b)(2).<sup>9</sup> The court will also examine the relevant statute to determine whether the entity, like those in the excluded class, is subject to extensive state regulation; is subject to express statutory procedures for liquidation or rehabilitation; and conducts business of a public or quasi-public nature.<sup>10</sup> Courts are especially likely

to consider whether the state provides special process for the entity's liquidation.<sup>11</sup>

Under the “independent classification” test, a court would look to the specific language of Section 109 itself and construe its provisions using techniques of statutory construction.<sup>12</sup> Courts applying this test have declined to expand the list of entities excluded from being debtors under the Bankruptcy Code beyond those specifically enumerated in Section 109(b)(2).<sup>13</sup>

Under the “alternate relief” test, courts will allow entities not specifically prohibited under the Bankruptcy Code to file for bankruptcy as debtors irrespective of existing state level statutory provisions governing their liquidation or reorganization where “a bankruptcy proceeding is a satisfactory method, compared with available state and federal non-bankruptcy methods of reorganizing or liquidating a would-be debtor.”<sup>14</sup> This can occur for example, where the state's statutory scheme is limited, or the applicable regulator has failed to effectively employ such tools.<sup>15</sup>

### Property of the Bankruptcy Estate

Generally, a debtor initiates a Chapter 11 case with the filing of a petition with the bankruptcy court serving the area where the debtor has a domicile, residence, or principal place of business. Upon filing a voluntary petition for relief under Chapter 11 or, in an involuntary case, the entry of an order for relief, the debtor automatically assumes an additional identity as the “debtor in possession.”<sup>16</sup> A debtor will remain a debtor in possession until the debtor's plan of reorganization is confirmed, the debtor's case is dismissed or converted to Chapter 7, or a Chapter 11 trustee is appointed. Generally, the debtor, as “debtor in possession,” operates the business and performs many of the functions that a trustee performs in cases under other chapters.<sup>17</sup>

The bankruptcy filing also results in the creation of a bankruptcy estate, which is comprised of the debtor's property owned at the commencement of

the case. “Property of the estate” is defined as “all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>18</sup> The legislative history of Section 541(a)(1) demonstrates that this provision is construed broadly, including “all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified in” the Bankruptcy Code. Bankruptcy courts look to state law to ascertain the existence and scope of the debtor's “legal or equitable interests” for purposes of Section 541(a)(1).<sup>19</sup>

### Custodial Assets as Property of the Estate

Section 541 further identifies certain limitations to the scope of the “property of the estate,” as well as certain assets and interests, which are outside the scope of the “property of the estate” as defined in Section 541(a). Under Section 541(d), “Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's *legal* title to such property, but not to the extent of any *equitable* interest in such property that the debtor does not hold.”<sup>20</sup> Further, property of the estate does not include “any power that the debtor may exercise solely for the benefit of an entity other than the debtor.”<sup>21</sup> As such, property held by the debtor as a custodian or other intermediary who generally lacks beneficial ownership rights is not an asset of the bankruptcy estate.<sup>22</sup>

Courts have employed various factors to distinguish assets held in custody for third parties from estate assets, focusing broadly on the terms of the agreement between the debtor and the account holder and the nature of the relationship. For example, in the trust context, where client assets are deposited with a debtor for the benefit of the client, courts may apply principles of state or federal law regarding trusts to exclude such assets from the debtors' estate.<sup>23</sup> Where applicable state or federal law is unclear on the nature of the client-debtor relationship, courts may analogize it to other “common

modes of analysis” to determine whether the debtor “lacked an equitable interest” in the property it holds for others’ benefit such that the property is excluded from the debtors’ estate.<sup>24</sup> Some of the specific factors that courts have employed in this analysis include: (1) “the role that the debtor was intended to play;” (2) the “degree and intensity of regulatory control over the property in control;” (3) the “extent to which recognizing a greater ownership interest . . . would thwart the overall purpose of the regulatory scheme.”<sup>25</sup>

Whether cryptocurrency assets that are held by a cryptocurrency platform on behalf of platform users constitute the platform’s assets and part of the platform’s bankruptcy estate in a bankruptcy case has not yet been addressed by courts. Based on existing case law in respect of fiat currency assets which addressed the factors distinguishing custodial accounts from estate assets, it is likely that courts analyzing such issues would engage in a fact specific inquiry and examine, *inter alia*: (1) the intent of the parties, as reflected in, for example, the terms of any custodial or other agreements that exist between the customer and the cryptocurrency platform; (2) whether the assets are commingled with the debtor’s assets or can be readily traced and identified; and (3) the debtor’s control over such assets. It is therefore crucial that customers carefully review the agreements under which they contract with their cryptocurrency trading and custody provider, as these contracts play a critical role in establishing whether the provider or the customer owns the assets.

### Access Issues

Regardless of whether clients’ assets are excluded from the bankruptcy estate, access to these assets could remain limited, at least temporarily, upon a bankruptcy filing. Upon such a filing, the debtor becomes a debtor in possession and subject to fiduciary obligations of trustees under the Bankruptcy Code which would obligate them to, among other things, collect and be accountable for all property

of the estate and to evaluate and potentially assert claims held by their estate against client assets.<sup>26</sup> Under such circumstances, it is likely that the debtor may impose a pause on clients’ withdrawal of their assets in order to permit the debtor to confirm that such assets are not in fact property of the estate (or subject to claims held by the estate). Clients seeking to withdraw their assets would have limited options due to the automatic stay imposed by Section 362 of the Bankruptcy Code and would need to bring a motion to lift the stay in order to compel the debtors to return their assets.

This is similar under Banking Laws. For example, Section 619(1)(d) of the New York Banking Law establishes a broad automatic stay whenever the New York Department of Financial Services takes possession of a banking organization. The Federal Deposit Insurance Corporation (FDIC), if appointed as receiver, has the authority under Section 11(d)(12) of the Federal Deposit Insurance Act,<sup>27</sup> to request a stay for up to 90 days of any legal proceeding in which the failed bank is or may become involved, but the stay is not automatic. While the OCC’s receivership regulations do not explicitly grant the receiver such authority it is likely the OCC’s receiver would attempt to seek a stay through the exercise of its equitable powers.

The debtors in each of the recent bankruptcy filings by cryptocurrency companies Voyager Digital Holdings Inc. (Voyager) and Celsius Network LLC (Celsius) imposed such pauses on the withdrawal of assets they held in custody for clients, though in each case the debtors have subsequently sought court approval to release certain of these assets. In the Voyager cases, the debtors implemented a pause on asset withdrawals shortly before their bankruptcy filing.<sup>28</sup> Subsequently, the Voyager debtors sought and received authority from the bankruptcy court to release fiat currency held for the benefit of their clients with the Metropolitan Commercial Bank.<sup>29</sup> Voyager has not yet sought to release cryptocurrency assets to customers which, under the Voyager

platform's terms of use are maintained in Voyager's name and which Voyager maintains are property of its estate and to which clients only hold unsecured claims.

Similarly, the Celsius debtors paused withdrawals on their platform in June 2022, roughly a month before filing for bankruptcy.<sup>30</sup> Nearly two months after their petition, on September 1, 2022, the Celsius debtors filed a motion seeking authority to return a portion of the cryptocurrency assets held in "Custody Wallets" for their clients.<sup>31</sup> Notably the debtors only sought to return those cryptocurrency assets held in custody for the benefit of their clients and which a review of their records confirmed were not subject to avoidance as preference claims (or if subject to such avoidance, the amount of the claims fell below applicable statutory caps).

### Avoidance Claims Implications

The Bankruptcy Code as well as Banking Laws empower debtors to avoid and recover certain transfers of estate assets made prior to a bankruptcy filing as either preferences or fraudulent transfers.<sup>32</sup> Preference transfers generally include any transfer that a debtor made to creditors in the 90-day period prior to the filing of a bankruptcy petition.<sup>33</sup> Fraudulent transfers include both transfers made by debtors for the purposes of defrauding creditors and transfers made by debtors for which the insolvent entity did not receive reasonably equivalent value in return.<sup>34</sup>

While the existence of potential avoidance claims should not impact the customers' ownership of their assets, the recent experience in the Celsius case shows that they might impact the customers' access to their assets. The Celsius debtors maintained that they hold colorable preference claims that may permit them to avoid transfers of cryptocurrency assets made into their clients' custody accounts as payment under Celsius's cryptocurrency lending and rewards programs and thus deduct these amounts from the cryptocurrency assets to be released to the custodial customers.<sup>35</sup>

## Insolvency under Banking Laws

### Overview

Since the FDIC was established in 1933, most bank insolvencies have been governed by the Federal Deposit Insurance Act, which contemplates that the FDIC would be appointed by the chartering authority (OCC or state bank regulator) as receiver for any FDIC-insured depository institution. During the course of the ensuing almost 90 years, the FDIC's experience with insolvent banks has grown considerably and Congress expanded and clarified the FDIC's authority as receiver or conservator of an insolvent bank on numerous occasions including with the 1989 adoption of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

There has not been similar growth, however, in bank regulators' experience with insolvent banking organizations, the deposits of which are not insured by the FDIC. Relatively recently, however, the OCC in 2016 adopted regulations at 12 CFR Part 51 specifically to provide clarity with respect to how it would handle the receivership of uninsured national banks. Of particular interest, the OCC also believes that this guidance might influence how other regulators approach similar situations.<sup>36</sup>

### Proprietary versus Custody Accounts

The FDIC has consistently recognized that fiduciary accounts (including custody accounts) are not part of an insolvent bank's receivership estate.<sup>37</sup> General assets of a failed bank are subject to claims of the failed bank's creditors, while "trust assets" are fully recoverable by the customer.

The OCC in its regulations governing the receivership of uninsured national banks similarly provides at 12 CFR 51.8(b) that:

***Fiduciary and custodial assets.*** Assets held by an uninsured bank in a fiduciary or custodial capacity, as designated on the bank's

books and records, will not be considered as part of the bank's general assets and liabilities held in connection with its other business, and will not be considered a source for payment of unrelated claims of creditors and other claimants.

Although less specific than the OCC's regulations, the New York Banking Law's provisions governing the dissolution of New York chartered banking organizations also recognize that property held by a banking organization as a bailee would not be considered assets of the banking organization. In this respect, Section 617 of the New York Banking Law provides for notice to be provided to "the owner of any personal property in the custody or possession of such banking organization as bailee or depository for hire or otherwise," which phrase is defined to include "without limitation, securities, whether held in custody directly or in book-entry form by such banking organization, its nominee, subcustodian, clearing corporation or similar entity."

Regardless of whether one evaluates the question under FDIC receivership of an insured bank, an OCC receivership of an uninsured national bank, or a New York Banking Law insolvency proceeding, key factors for determining whether assets in an account are held in custody or another fiduciary capacity are (1) whether the account is identified on the bank's books and records as a custody or fiduciary account and (2) if so, whether the bank has maintained the assets consistent with that characterization (that is, the bank has not commingled assets it holds in a fiduciary or custodial capacity with its own proprietary assets).<sup>38</sup>

## Conclusion

For an asset category that peaked at \$2.8 trillion, one would expect a well-advanced legal framework. Unfortunately, such is not the case. There is a host of issues resulting in significant uncertainty under the securities laws, Uniform Commercial Code and bankruptcy law. Regulators and lawmakers around the

world are paying close attention and working on laws and rules designed to govern the treatment of cryptocurrencies. In the United States, it is yet to be seen how the pending cryptocurrency bankruptcy cases will be resolved. While each case will necessarily be based on the facts and circumstances at hand, general principles of bankruptcy laws should apply to disputes involving ownership and entitlements to cryptocurrencies and assets designated and properly treated as custodial assets should not be included in the debtor's estate.

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## NOTES

- <sup>1</sup> Other state laws should be consulted when dealing with a cryptocurrency platform that is organized and governed by the law of another state and is not subject to the Bankruptcy Code or Federal Banking Laws.
- <sup>2</sup> See 11 U.S.C. §§ 109(b)(2), 109(d).
- <sup>3</sup> "[U]ninsured State member bank" is defined by reference to the Federal Deposit Insurance Act and includes "a member of the Federal Reserve System" that is a "bank, banking association, trust company, savings bank, industrial bank (or similar depository institution which the Board of Directors finds to be operating substantially in the same manner as an industrial bank), or other banking institution which (A) is engaged in the business of receiving deposits, other than trust funds (as defined in this section); and (B) is incorporated under the laws of any State." See 11 U.S.C. § 101(54A); 12 U.S.C. §§ 1813(a)(2), 1813(d).
- <sup>4</sup> The majority of courts refer to the third test as the "alternate relief" test; however, at least one court has referred to the test as the "alternative relief" test. Compare *In re Republic Trust & Sav. Co.*, 59 B.R. 606, 616 (Bankr. N.D. Okla. 1986) (using "alternate relief" test) with *In re First Assured Warranty Corp.*,

- 383 B.R. 502, 519 (Bankr. D. Colo. 2008) (using “alternative relief” test). The terms “alternate” and “alternative” in this context are interchangeable. For the avoidance of doubt, will refer to the test as the “alternate relief” test.
- <sup>5</sup> See 2 Collier on Bankruptcy ¶ 109.03(3)(b) (2022); Matter of Est. of Medicare HMO, 998 F.2d 436, 439 (7th Cir. 1993).
- <sup>6</sup> *Medicare HMO*, 998 F.2d at 442.
- <sup>7</sup> First Am. Bank & Trust Co. v. George, 540 F.2d 343, 346 (8th Cir. 1976).
- <sup>8</sup> See *Medicare HMO*, 998 F.2d at 438; Kansas ex rel. Roynton v. Hayes, 62 F.2d 597, 600-01 (10th Cir. 1932).
- <sup>9</sup> Matter of Cash Currency Exchange, Inc., 762 F.2d 542, 548 (7th Cir. 1985).
- <sup>10</sup> *Id.*
- <sup>11</sup> In re Prudence Co., 79 F.2d 77, 79 (2d Cir. 1935).
- <sup>12</sup> *Medicare HMO*, 998 F.2d at 438.
- <sup>13</sup> See *Cash Currency Exchange, Inc.*, 762 F.2d at 551-52.
- <sup>14</sup> In re Bankwest Boulder Indus. Bank, 82 B.R. 559, 566 (Bankr. D. Colo. 1988) (*citing* Republic Trust & Savings Co., 59 B.R. at 614).
- <sup>15</sup> See *id.* at 567.
- <sup>16</sup> 11 U.S.C. § 1101.
- <sup>17</sup> 11 U.S.C. § 1107(a).
- <sup>18</sup> 11 U.S.C. § 541(a)(1).
- <sup>19</sup> Butner v. United States, 440 U.S. 48 (1979).
- <sup>20</sup> 11 U.S.C. § 541(d) (emphasis added).
- <sup>21</sup> 11 U.S.C. § 541(b)(1).
- <sup>22</sup> In re Joliet-Will Cnty. Cmty. Action Agency, 847 F.2d 430, 432 (7th Cir. 1988).
- <sup>23</sup> See In re Catholic Diocese of Wilmington Inc., 432 B.R. 135, 148-50 (Bankr. D. Del. 2022).
- <sup>24</sup> In re LAN Tamers, Inc., 329 F.3d 204, 211-14 (1st Cir. 2003).
- <sup>25</sup> See *id.*; see also In re Columbia Gas Systems, Inc., 997 F.2d 1039, 1055 (3d Cir. 1993).
- <sup>26</sup> See 11 U.S.C. §§ 704(a), 1106, 1107.
- <sup>27</sup> 12 USC § 1821(d)(12).
- <sup>28</sup> See In re Voyager Digital Holdings, Inc., No. 22-10943, Dkt. No. 73 ¶ 7 (Bankr. S.D.N.Y. Jul. 14, 2022).
- <sup>29</sup> See generally In re Voyager Digital Holdings, Inc., No. 22-10943, Dkt. No. 250 (Bankr. S.D.N.Y. Aug. 5, 2022).
- <sup>30</sup> See In re Celsius Network LLC, No. 22-10964, Dkt. No. 23 ¶ 14 (Bankr. S.D.N.Y. Jul. 14, 2022).
- <sup>31</sup> See In re Celsius Network LLC, No. 22-10964, Dkt. No. 670 (Bankr. S.D.N.Y. Sep. 1, 2022).
- <sup>32</sup> See e.g., 11 U.S.C. §§ 547, 548.
- <sup>33</sup> See *id.*
- <sup>34</sup> See *id.*
- <sup>35</sup> See *supra* n.30.
- <sup>36</sup> See 81 Fed. Reg. 92594 at 92595 (2016) (“The OCC believes it would nevertheless be beneficial to financial market participants and the broader community of regulators for the OCC to clarify the receivership framework for uninsured banks. Although the OCC conducted 2,762 receiverships pursuant to this framework in the years prior to the creation of the FDIC, and the associated legal issues are the subject of a robust body of published judicial precedents, the details have not been widely articulated in recent jurisprudence or legal commentary. This final rule may also facilitate synergies with the ongoing efforts of U.S. and international financial regulators since the financial crisis to enhance our readiness to respond effectively to the different critical financial distresses that could manifest themselves unexpectedly in the diverse types of financial firms presently operating in the market.”) (footnote omitted).
- <sup>37</sup> See *FDIC Advisory Opinion* No. 03-01 (Jan. 3, 2003).
- <sup>38</sup> See e.g., *FDIC Advisory Opinion* No. 03-01 (emphasizing the importance of both documenting the relationship and holding trust assets separate and apart from general assets); 12 CFR § 51.8(b) (designation of assets on bank’s books and records determinative); 12 CFR § 9.13(b) (national bank required to keep fiduciary assets separate from bank’s assets) and Section 11-1.6 of the New York Estates, Powers and Trusts Law (fiduciary assets must be kept separate from bank’s assets).

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