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## **CRYPTO EXCHANGE, S01 EP06, WHOSE CRYPTO IS IT ANYWAY? BANKRUPTCY AND CRYPTO**

### **Keith Barnett:**

Welcome to another episode of The Crypto Exchange, a Troutman Pepper podcast focusing on the world of digital assets and payments. As longtime leaders in the intersecting worlds of law, business, and government relations, our lawyers can go beyond the buzzwords and headlines to make sense of the emerging legal and regulatory frameworks for operating in the digital asset and payment industries.

My name is Keith Barnett. I am one of the hosts of the podcasts and a partner at Troutman Pepper. Before we jump into today's episode, let me remind you to visit and subscribe to our blog, [consumerfinancialserviceslawmonitor.com](http://consumerfinancialserviceslawmonitor.com). Don't forget to check out our other podcasts on [troutman.com/podcast](http://troutman.com/podcast). We have episodes that focus on trends that drive enforcement activity, consumer financial services, the Fair Credit Reporting Act, cybersecurity, hot-button labor and employment law issues, and more. Make sure to subscribe to hear the latest episodes. Today, I'm joined by my colleague Deborah Kovsky to discuss bankruptcies involving crypto exchanges. Deb, I'm looking forward to our discussion today.

### **Deborah Kovsky-Apap:**

Well, Keith, thanks so much for having me on. I really appreciate it and I think there is a lot of really interesting issues that are coming up and that are going to be coming out of these bankruptcies that have filed and probably new bankruptcy law and areas of law that are very unsettled currently.

### **Keith Barnett:**

Well, it seems like we have a new show on the horizons called instead of Whose Line is It, Anyway? it's going to be Whose Crypto is It, Anyway? That seems to be the trend. I say that because there's been a lot of attention paid recently to the question of who owns digital assets on a cryptocurrency exchange if the exchange files for bankruptcy.

For example, we know Coinbase filed a 10-Q for Q1 of this year, and Coinbase made the following disclosure, which it said was required by the SEC, and I'm quoting here, this is very interesting, "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."

In fact, we've seen in recent bankruptcy filings by cryptocurrency exchanges, that the debtors are taking the position that at least some of the digital assets on their platforms belong to them, and not their customers. Deb, how does this happen, and which customers and investors be aware of?

### **Deborah Kovsky-Apap:**

These are great questions, Keith. I want to back up for one second and just clarify what's meant by "property of the estate" and why does that matter because it's a little bit of a term of art that not everybody may be familiar with. A debtor goes into bankruptcy and all of its interest in property become part of this fictional legal entity called the "estate" and the estate is subject to the automatic stay, so creditors can't get at it. If the coins are determined to be property of the

debtor's estate, not only are they subject to the automatic state, but they could be used to satisfy the debtor's general creditors and not just the depositors who put the coins there.

If you imagine, let's say, I put a hundred coins on a crypto exchange and filed for bankruptcy, and they've got creditors that are owed thousands or millions of dollars, and those hundred coins are all the assets they have, if that's property of the estate, they can take my coins and divvy it up among all of the creditors, and I'm only going to get back a small fraction. This probably came as a pretty huge shock notwithstanding some public disclosures about it to most depositors on crypto exchanges.

How this happens is you really have to delve into and look at the specific terms of service, or terms of use for different accounts, and different services on these platforms. You may have a scenario where an exchange has terms of service. These are clickwrap agreements. These are the things that none of us ever read. We scroll down, we click the button, we go forward because this is a safe investment, right? Why do I have to read the detailed minutia of all of these terms of service, these terms and conditions?

But if you delve into them, they may say things like when you put your coins on this platform, you're making a loan of those coins to the crypto exchange, you are giving up all of your rights of ownership. The exchange has the right to trade those coins, stake them, hypothecate them, rehypothecate them, do all kinds of things with them, use them as collateral for loans in its own name, and you have all of these terms of service in terms and conditions that people have literally never read, or even thought about, and they usually don't matter until something goes seriously south, like in a bankruptcy case.

Then they go into a bankruptcy, and all of a sudden, they're taking the position based on, and I'm not suggesting right now that I have any position or any insight into whether these types of terms of service would be enforceable, but they certainly give the debtor an argument that, in fact, coins that are subject to these types of contractual arrangements have been given over to the debtor and are no longer the property of the depositor, and the depositor just has a general unsecured claim, which is not a very highly ranked priority claim.

**Keith Barnett:**

It seems to me, at least in the banking industry, you have FDIC insurance, and in the securities industry, you have SIPC. Is there any type of crypto insurance that the crypto exchanges have?

**Deborah Kovsky-Apap:**

Certainly not anything that's regularized and broadly used. Making the analogy to banks is a really good analogy because if I deposit that my money in a bank, I'm really lending my dollars to the bank, the bank is going to go out and do whatever it does with my dollars to generate returns, I might earn a little bit of interest in exchange, and when I go to withdraw my money, I'm not withdrawing my same dollars, I'm withdrawing a like amount from the bank, and the difference is if the bank goes into some kind of a dissolution or liquidation, I have FDIC insurance to cover me, I get made whole, at least up to the limits. Same thing with stockbrokers that are insured under SIPC, you have protections in regulated industries that you don't have with crypto.

What's really interesting is three months ago, if you went on social media and any of the spaces where people who invest in crypto congregate, you would see all kinds of statements about, "The government needs to stay out of this. Regulation is bad. The SEC is bad. The Fed is bad." They're all bad until something goes seriously, seriously sideways, and you realize, gosh, maybe some form of regulation is needed to protect people from what's otherwise the Wild, Wild West.

**Keith Barnett:**

That makes sense because I know in some states they require crypto exchanges. If they are holding consumer wallets that have cryptocurrencies or virtual funds, they will require them to register as money transmitters, and go through the license and bonding and insurance requirements there and that can sometimes protect the consumers.

But let's move on. Let's talk about bankruptcy eligibility. We have some questions about that. How can cryptocurrency exchanges file for chapter 11? Because if exchanges are effectively buying and selling securities, wouldn't they be required to liquidate under chapter seven?

**Deborah Kovsky-Apap:**

Really good question and one that I think is going to be debated as more of these exchanges are likely to face the pressures of potentially trying to reorganize. You're absolutely correct, if a cryptocurrency exchange is deemed to be a commodities broker or a stockbroker, there are specific provisions under the bankruptcy code that borrow them from accessing chapter 11 and instead force them to liquidate under specific subsections of chapter seven.

One of the questions is... Let's take the stockbroker example just to talk about it theoretically. In order to be deemed a stock broker, an entity would have to be active in effectuating the trades of securities, and would have to have customers and think that customers would be a really intuitive thing to have. If you're buying and selling and effectuating trades of securities, certainly, there must be a customer on the other side, but it's actually a pretty specialized bankruptcy term, and a lot of the litigation in prior cases over whether various entities outside of the crypto universe were really functioning as stockbrokers has revolved less around whether is the product they're trading a security versus do they have somebody that qualifies as a customer under the specialized bankruptcy definition. It's not clear whether these cryptocurrency exchanges would qualify.

Certainly, there have been state regulatory actions that have indicated that at least some of the products that these exchanges are offering, if not the actual crypto itself, but the way that the exchanges are packaging products and enabling cryptocurrency to earn rewards on their platform, so that type of account, that product itself is the security that's being offered or sold. If there's the argument that, okay, at least something that they're doing is effectuating trades of securities, and if there is an argument that the individual retail depositors qualify as creditors for buying and selling and trading these securities. It's one of those, if it walks like a duck, quacks like a duck, at some point, you're going to have to conclude it's a duck. Then these exchanges may not have an option to reorganize, their only option may be to liquidate, and unfortunately, the liquidation under the bankruptcy code is different from a CPA liquidation because there's no SIPC insurance, so the holders of these securities have no insurance to look to make them whole, they just have whatever assets are left on the platform.

**Keith Barnett:**

Wow.

**Deborah Kovsky-Apap:**

Again, a question about whether there should be more regulation in this space, or if we're going to end up seeing a lot of chapter seven liquidations.

**Keith Barnett:**

It seems like that is something that, I guess, as a matter of first impression, in some instances, the courts are going to have to work through.

**Deborah Kovsky-Apap:**

Interesting point. Yes, if somebody brings it up, because there may be broad consensus, at least with the exchanges that have filed right now. Maybe we don't touch this with a 10-foot pole before we see whether there is an ability to effectively reorganize because if that's going to get creditors a better return, then everybody's just going to leave it alone. If at the end of the day, it looks like, "Gosh, we just spent a hundred million dollars on professional fees and chapter 11."

By the way, chapter 11's really expensive and maybe a hundred million is a high estimate, but it's not completely out of the ballpark of what might be reasonable in a very large case. You're going to spend tens of millions, or even a hundred million dollars on professional fees, you get to the end of the day, and you haven't achieved any better of an outcome for the depositors who put their money on the exchange, or other creditors, folks in the next case might look at it and say, "You know what? We think that we'd be better off financially at the end of the day, if we actually said, 'You know what, let's not even try to go down that route because it's too uncertain, too expensive, and at the end of the day, we're not even going to do any better. Let's just liquidate right now at the front end.'" Then somebody will bring this argument up and will push it in front of a court and we'll see how it comes out.

**Keith Barnett:**

Speaking of depositors, what are clawbacks? Should depositors on crypto exchanges be worried?

**Deborah Kovsky-Apap:**

I would say yes, they should be worried, and here's why. "Clawback" is sort of a colloquial term for chapter five causes of action, so avoidance and recovery claims that can be brought under chapter five of the bankruptcy code. These are typically preference actions and fraudulent transfer actions. Fraudulent transfer, don't get confused by the name, often has absolutely nothing to do with fraud, it's a type of transfer that often is just constructively fraudulent, or is voidable because the recipient got something and didn't give reasonably equivalent value in exchange. These are the kinds of claims where it's like the bankruptcy code is rubbing salt in the wounds of creditors.

Take a preference claim. If a depositor got coins out of a cryptocurrency exchange within the 90 days before its bankruptcy filing and that enabled them to do better, and they got more out of it than they would have gotten, had they not taken those coins out, and instead the crypto exchange had liquidated under chapter seven, very low bar to meet, then that is potentially a preference, and that can be potentially clawed back.

In fact, there was a cryptocurrency exchange that filed two years ago, and now is just about the time that the post-confirmation liquidating trustee is sending out demand letters to the depositors, the ordinary folks who put their coins on the exchange, and then took them off in the 90 days before the bankruptcy. They're getting demand letters from the trustees saying, "Hey, remember when you withdrew your coins and you thought you were so lucky to get out in time? Actually, we want back the value of those coins at the time." Remember, crypto was doing much better two years ago.

**Keith Barnett:**

Wow.

**Deborah Kovsky-Apap:**

It's definitely a cost for concern, but I also don't want to be too dire here because there's also defenses. I think the defense that is most likely to get litigated in these cryptocurrency bankruptcies is the 546(e) Safe Harbor defense, because if these things are securities, and again, some state regulators have said, "Yeah, these look like securities. They act like securities. We deem them to be securities." Okay, fine. Well, section 5456(e) of the bankruptcy code protects the settlement of securities transactions from being clawed back by the debtor in possession or trustee.

The whole point, the public policy behind it is to protect the integrity of these markets, and it's really, the commodities markets and the securities markets, but you know what? The cryptocurrency market is one of the emerging markets that really functions very much like a securities market or a commodities market and the same public policy implications, I think, are invoked here as well, where there could be a defense to say, look, this was in effect the settlement of a securities transaction, and in order to protect the integrity of this market, this is really safe harbor under 546(e), so sorry, you can't claw any of it back.

**Keith Barnett:**

That's interesting. Another question I have is how are security interests in cryptocurrency perfected and why does that matter in a bankruptcy?

**Deborah Kovsky-Apap:**

That's something that's definitely going to matter a lot to the debtors themselves and more derivatively to creditors because it's a way that the debtor may be able to go out and look for clawbacks against other entities where it can bring money back into the estate that can then help satisfy its ordinary retail creditors.

What does that mean? Let's say that you have a cryptocurrency exchange that one of the ways that it was generating returns, it was taking out loans, and it was going to use those loans for other purposes. But in order to get a loan, they changed the want to sell the crypto that it was holding so it collateralized the loan. The crypto exchange sends a hundred Bitcoin over to lender and lender lends say a hundred USDC to crypto exchange. Now, that collateral sitting over there, and that lender says, "Hey, I'm a fully secured lender here. I've got this collateral. I'm totally protected," because also the Bitcoin's worth quite a bit more. But then Bitcoin drops and it falls below the LTV that was required for the loan and the lender says, "You know what? I'm just going to go ahead and liquidate the collateral. I'm going to pay myself off, and you, crypto exchange, are going to take a loss."

What if it turns out that that lender didn't properly perfect security and trust in the collateral? If that were true, then the debtor, which has the rights of a trustee under the bankruptcy code, and the trustee has the rights of a hypothetical lien creditor, the debtor can go and try to avoid that transaction and say, "You know what? Give that all back." Now, instead of being a secured creditor, you're just going to be a general unsecured creditor, and you're going to have to get in line with everybody else, and instead of getting paid a hundred cents on the dollar out of what you thought was your collateral, in fact, you're only going to get paid 60 cents on the dollar, 20 cents on the dollar, whatever the rest of the unsecured creditors get.

The question is, how was that supposedly secured lender supposed to perfect its security interest in crypto? The reality is there was no clear answer under the UCC. Cryptocurrency just, if you look at article nine of the UCC, which governs secured transactions, it just doesn't work. The only category that seems to apply is the catchall bucket for general intangibles. A security interest in general intangibles are perfected by filing a UCC-1 financing statement. They are not perfected by possession and I am pretty sure that almost everybody who has taken crypto and had possession of it as a "secured creditor" has believed they were properly perfected because they had possession.

How can you possibly be better off than actually having this stuff in your control? You got the keys. It's your keys, it's your crypto, and yet, if you look at the Uniform Law Commission, which just passed their new article 12, which deals with digital assets and their amending article nine, none of which has been adopted in any state yet, but there's some really interesting comments that they made in their overview to the 2022 amendments to the UCC for emerging technologies. One of the things that they said with respect to security interest in digital assets, they said, "Under the prior version of article nine, there was no effective way for a lender to perfect a security and digital assets except by filing a financing statement."

I think that's a really interesting statement for them to make, because on the one hand you could make the argument, it wasn't clear under the prior article nine, so we're going to look to the new amended article nine that comes out in 2022, and we're going to argue to courts to say, "Look, judge, you should really look at it the way that it's going to be under the amended article nine, where possession would be the way that you perfect in digital assets," or alternatively, you can say, "No, no, no, judge, clearly this is a sea change in the law, and that prior to 2022, the only way that you could perfect in digital assets was by filing a UCC-1 financing statement, and if you didn't do it, then you didn't perfect," and that could have huge, billion-dollar implications in these bankruptcy cases.

**Keith Barnett:**

Wow. This is all very, very interesting. You gave us a lot to think about a lot of things to unpack here. This has been great. Deb, thank you for joining us today.

**Deborah Kovsky-Apap:**

Oh, totally my pleasure.

**Keith Barnett:**

No, this was very excellent discussion. Also, thank you to our audience for listening to today's episode. Don't forget to visit our blog, [consumerfinancialserviceslawmonitor.com](http://consumerfinancialserviceslawmonitor.com), and subscribe so you can get the latest updates. Please make sure to also subscribe to this podcast via Apple Podcast, Google Play, Stitcher or whatever platform you use. We look forward to the next time. Thank you.

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