Crypto Exchange: S01 Ep09 - Bankruptcy Filings Among Crypto Exchanges: Is This a Sign of the Future?
Host: Ethan Ostroff
Guest: Deborah Kovsky-Apap
Recorded November 2022

Ethan Ostroff:

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 regulations, 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.

I'm Ethan Ostroff, one of the hosts of the podcast at a partner Troutman Pepper. Before we jump into today's episode, let me remind you to visit and subscribe to our blog, consumerfinancialserviceslawmonitor.com. And don't forget to check out our other podcasts on 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 issues, and more. Make sure to subscribe to hear the latest episodes.

Today I'm thrilled to be joined by my colleague, Deb Kovsky, to discuss the recent FTX bankruptcy and other bankruptcy related developments in the crypto space.

Deb, the big news this past week, it's got the whole crypto world on fire, was the bankruptcy filing of FTX, all of these different related businesses, the third major cryptocurrency platform to go into chapter 11 this year. When FTX filed for bankruptcy protection, assets were frozen and almost everyone lost access to their accounts, including some very high-profile NFT projects that were built and lived on FTX's custodial NFT platform. Deb, is this series of bankruptcy filings by crypto exchanges a sign of things to come? And if so, what do you see as the drivers?

Deborah Kovsky-Apap:

Ethan, I am shocked by how fast everything is moving. It reminds me of the Detroit bankruptcy, which I worked on, where they said it happened suddenly and then quickly, or something to that effect. The dominoes are definitely falling. In just the last week, we've seen this contagion spreading. Platform after platform has halted trading or frozen withdrawals. BlockFi, which got rescue financing from FTX earlier this year, is very publicly preparing for its own bankruptcy filing. It may well have filed already by the time this podcast airs.

It's really shocking because FTX was really considered a blue-chip cryptocurrency platform. It was the one that everyone looked to as the model of what was going to be a safe place to trade, to put your crypto assets. And unfortunately, nothing there was what it looked like from the outside.

One of the key drivers in FTX's bankruptcy appear to have been a total lack of internal controls. If you look at John Ray's first day declaration that was filed in the bankruptcy case, he says he's never seen anything like it in 40 years. Now, when you have the guy who oversaw Enron's bankruptcy saying this is the worst thing he's ever seen, that's pretty bad.

Does that mean that all of the other crypto platforms that are experiencing freezes and withdrawals right now, are they all in the same boat? Are they just more FTX's waiting to happen? Obviously, there's a big difference between a liquidity crunch and an actual insolvency. But there is a tremendous lack of transparency in the industry, especially where platforms are incorporated offshore, they're operating outside of US jurisdiction, US regulations. And sure, when you look at them, everything looks good from the outside. But who's looking at proof of reserves? Who's auditing the proof of reserves? Who's actually matching assets to liabilities? Who's ensuring that coins that are supposed to be held in custody or in trust for customers, that they're actually being held that way, and they're not being deployed in risky betting strategies?

So there's a failure of internal controls, failure of regulation, failure of transparency. Of course, regulation cannot control for fraud because if it could, we wouldn't have had an Enron, we wouldn't have had an MF Global, we wouldn't have had a Bernie Madoff. But it seems to me that even where crypto platforms are in the US, regulators have really been remarkably slow to use existing tools that they do have, and Congress has been incredibly slow in catching up to the reality of a sector that really has just exploded in the last decade.

So those are some of the drivers that I'm seeing. Another factor in the FTX collapse, which has really been talked about and written about a lot, is FTX's proprietary FTT token, because when you've got the majority of the company's assets that consist of a token that the company itself just made up, that's not a good thing.

Ethan Ostroff:

You mentioned a couple of interesting things there that I think it might be helpful to break down for folks. First, you mentioned FTT. What's the difference between a cryptocurrency like Bitcoin and a token like FTT?

Deborah Kovsky-Apap:

That's a great question. All cryptocurrencies are tokens, but not all tokens are cryptocurrencies. It's sort of like how all lizards are reptiles, but not all reptiles are lizards, which used to confuse the heck out of me, but I think I've gotten it straight now.

So FTT is what would be considered an alt coin, and there's actually another term that's commonly used that's probably more accurate but not appropriate for this podcast. So basically, it's just an ERC-20 token that's proprietary to FTX. And just to give a little context, ERC-20, it's a way to standardize tokens that are created on the Ethereum blockchain, and it enables different tokens to be easily used in exchange without having to convert them back and forth between different apps. Probably the most well-known ERC-20 token would be USDC, which is a stable coin. It essentially functions pretty much like cash in the crypto world.

It's really easy to create an ERC-20 token. So Celsius created the CEL token, FTX created the FTT token, and they're just these things that were sort of invented out of thin air using a widely standardized protocol.

So then what gives value to the tokens? One driver of value could be utility. If you can do cool stuff with a token, like you can get discounted trades on the issuer's platform, then as more trades get done, the token gets more valuable. It actually has a use. It's a little bit of a circular use, but it's a use.

Another driver is really just perception. If Celsius is perceived as valuable, if FTX is perceived as valuable, then the value of their proprietary tokens goes up in tandem with that perception.

A lot of ERC-20 tokens are what you could characterize as being mixed use, so they kind of function like currency, or at least like house money that can be used on the platform. And at the same time, they share a lot of attributes of stocks because they go up in value with the value of the issuer.

And here's where gets really sticky. If the issuer holds back most of its tokens for itself, so it only floats a little fraction of the tokens that it's minted and it keeps the rest, they call it, in treasury... Not really in treasury, but that's sort of the concept. So now, it's holding back most of its token. Now, all of a sudden it has this really spectacular-looking net equity because, gosh, look how valuable all these tokens that they hold are. So then, the issuer can raise capital based on that value. They could borrow money based on that value.

And all of the time, all of that is premise. All of that collateral just consists of tokens that the issuer itself created out of thin air. So as soon as there's a liquidity crunch, the whole house of cards just comes tumbling down.

Bitcoin is a little bit similar to alt coins in the sense it has value just because a lot of people got together and consensually agreed, like, okay, this thing has value. But that, in a sense, is not all that different from something like gold, which everyone got together and agreed, yeah, we like this bright, shiny metal, and we're going to deem it to be really valuable.

And the crucial difference between Bitcoin and these alt coins that are proprietary tokens to different platforms is that Bitcoin is really decentralized, so it's not tied to the value or the perceived value of any particular company or platform. If Celsius tanks, if FTX tanks, and any one particular platform goes under, because it affects the industry broadly, Bitcoin may be impacted somewhat, but it's not going to have the same kind of one-to-one ratio where FTX goes under, FTT could go to zero. That's not going to happen with Bitcoin because it is decentralized.

Ethan Ostroff:

Interesting, I think, and a very important distinction to draw between alt coins and Bitcoin.

You also mentioned MF Global. I'm curious if you can draw any similarities or differences to the MF Global bankruptcy. There you had, this was back in 2011, a $6.7 billion shortfall, a multinational commodities brokerage firm that was supposed to have held customer funds and custodial accounts in which customers retained title. They weren't supposed to be using those funds for proprietary purposes. But then there were unexpected losses at the trading desk, gave rise to a cycle of customer withdrawals and margin calls, overwhelmed the company. And then on the way down, as it were, MF Global misappropriated customer funds in an attempt to cover certain of the losses at its proprietary trading desk.

Do you see parallels between what we're seeing, particularly with FTS, with MF Global?

Deborah Kovsky-Apap:

You know the saying, there's nothing new under the sun? The crypto firms are just doing all over again what TradFi did 10, 15, 20 years ago. Anyone who went through MF Global is going to be having deja vu right now. Absolutely there are similarities. And that's why I said before, regulation is not a cure for fraud. Bad actors are going to be bad actors regardless of regulation. But when you have entities that are insured, where there's a source and a way for customers to recover, they're likely to be better off than if they're just operating the wild, wild west. But the concepts are completely the same. What FTX was doing appears, at least based on the allegations that have been made, to be a very familiar story.

Ethan Ostroff:

Interesting. Another thing you mentioned was regulatory activity, government regulatory activity. Do you have a sense of how governmental, state, and federal regulatory activity might impact creditors in the FTX bankruptcy case?

Deborah Kovsky-Apap:

Well, I think there can be pluses and minuses. At this point, I think it's too late for any regulatory activity to help customers because the damage has already been done. The point of regulation is to try to prevent these types of things from happening. And I think that there may actually be challenges to reorganizing, whether it's FTX or other similar entities, because you already have lots of government investigations. I think someone from the company said that when they were asked whether the SEC of the CFTC had come knocking, they said it would be easier to list the agencies that hadn't come by.

There's going to be a tremendous amount of money spent. Even when you're cooperating, complying with the government investigation, as you know, is very expensive. Where's that money going to come from? Whatever they're sitting on right now, most of which came from customers. So there's going to be the cost of complying with investigations, fines that may be levied, all kinds of additional costs that the estate's going to have to bear because of these regulations. So then even if there were a way to reorganize the business, there's such an outcry right now for this either needs to be regulated under a new type of commodities act, these are going to be regulated as securities, whatever it is, any company that is in bankruptcy right now that previously was sort of operating on the fringes, sort of skirting the edges of regulation, not really being regulated, they're going to be emerging into a very different regulatory environment that's going to be much more difficult, much more expensive, probably better for consumers, but harder for these companies to survive and make a go of it, to be honest.

And to the extent that any of these entities in bankruptcy were going to be looking to their own proprietary coins, their own tokens, to be part of their ticket out of bankruptcy, as it were, this is how we're going to help pay customers and help make them whole with these coins that we're, again, going to mince out of thin air, I think that plan is on shaky grounds.

Ethan Ostroff:

You mentioned BlockFi, and the freeze that has occurred at BlockFi, and the expectation and anticipation that BlockFi will also likely seek bankruptcy protection. What should someone who is caught up in this be thinking about? Like, I'm not an FTX customer. I'm storing Bitcoin or Ether with BlockFi. BlockFi's frozen client withdrawals as a result of all this fallout with FTX. If I'm in that situation, what should I be thinking about? What are my options? What can I expect? And what kind of time period do you think I should be thinking about to get some sort of clarity?

Deborah Kovsky-Apap:

There aren't a lot of options, unfortunately. It's really more about level setting expectations. And one of the things just to be real realistic about is BlockFi and these other platforms that have frozen customer withdrawals probably aren't freezing them because they're just nervous about volatility in the market, they just think it's better for everybody to take a breather and a timeout. It's most likely because they don't have the assets to cover the liabilities that they would need to cover in the event of a run on the bank, which is what we're seeing over and over. So just be realistic that there's a good chance that wherever you've put your coins, there's not enough assets there to make you whole, even if withdrawals were unfrozen.

Something else really important is to document everything. Take screenshots of everything that you do on the platform. Take a screenshot of your account. There have been reports that different platforms have deleted or lost customer data, and it's unclear when or how those records can get reconstructed. If you have the ability to go onto the platform and download a CSV file showing your entire transaction history, do it now while it's still available, if it's still available, because at some point in a bankruptcy, you're going to actually have to be able to prove what you held. And if the debtor has no idea, whatever documentation you're saving now may be the only source of information.

You may want to consider retaining counsel if a bankruptcy files. Chances are that an official committee of unsecured creditors will get appointed, but that doesn't mean that they're going to represent your interests. The goal of a creditor's committee as a fiduciary to the entire estate is to try to increase the size of the debtor's estate. That means pulling in all of the assets that it can, putting them in a big pot, and then divvying them up pro rata. Now if you have, for example, a personal wallet on BlockFi versus money in an interest account, you may have a basis to say that your coins should be treated differently. A creditor's committee may not see it that way, and you may need to have your own counsel to fight for your particular rights in the bankruptcy case.

You should also think about where might the bankruptcy be filed. We just saw that there was a Bahamian insolvency proceeding started with respect to FTX Digital, whereas the rest of the FTX entities filed in Delaware, here in the US. The Bahamian provisional liquidator then filed a Chapter 15 case in New York, and now there's a whole jurisdictional fight going on over where the case should be administered and who should administer it.

Ethan Ostroff:

And a potentially adversarial relationship between that entity that filed for protection in The Bahamas and the US FTX debtors, right?

Deborah Kovsky-Apap:

Exactly. There are reports that the huge amount of coins that went missing suddenly right after the bankruptcy filed, that was actually a movement that was directed by the provisional liquidator and those coins are now in government-controlled accounts in The Bahamas. What could very well end up happening, particularly because a lot of these platforms are incorporated offshore, is you'll have an insolvency proceeding in another country that may have different standards, different rules, different regulations, fewer customer protections, your rights are going to be potentially quite different in that insolvency proceeding. But they can file what's called a Chapter 15 here in the US and then get all of those foreign rulings approved and enforced here. So that's just another risk to consider, that you may not even have the ability to stand up in a Chapter 11 here in the US and assert your rights. All of the action could be in The Bahamas or in Cayman or in Singapore or wherever else they might be.

You should also be prepared for a lengthy wait. It is likely to be months or even years before issues of who owns what crypto, whether it belongs to customers or the debtor; if it belongs to the debtors, to which debtor; what other assets and liabilities are there at the various different companies and what clawback claims may exist... Crypto's got to be traced and followed and figure out where it all actually went and whether or not some of it can come back. And that takes a really long time.

Just to give you an example, Lehman Brothers filed in 2008. Madoff filed in 2008, also. MF Global was a couple of years after that. All of those cases, I'm on the ECF notice list from the courts because I represented various different clients in each of the cases, and I am still daily getting ECF notices from those cases. There is still stuff going on, issues being litigated, well over a decade later. Might there be some kind of interim distributions earlier on? Sure. If you can convince the court that your coins should be treated differently than the general undifferentiated masses, you might be able to get out earlier and with a better result. But the time to protect yourself is really before all of this happens. Once it happens, you're really looking at a lot of litigation and a lot of time before you see a recovery.

Ethan Ostroff:

So in other words, take steps immediately right now to do everything you can to protect yourself, to make sure that you have everything you can get to establish what your activity has been on a particular platform, and then expect a very long runway while you're waiting for these things to be sorted out.

Deborah Kovsky-Apap:

Correct. And if the bankruptcy is filed in the US, which I imagine BlockFi should be because I believe it's a US company, but many of the other platforms out there are not, but if a Chapter 11 is filed in the US, it may be worth retaining counsel or forming an ad hoc group with other similarly situated customers to press for your rights, because your particular interest may not be adequately represented in the case otherwise.

Ethan Ostroff:

Interesting. Another thing that's happened recently, although overshadowed by the FTX bankruptcy filing, was a decision out of a federal court in New Hampshire in an SEC case against LBRY. And that stemmed from LBRY's offering of its proprietary LBC token, which the SEC said was an unregistered security. And the court in that case thought it wasn't even a close question that the tokens are in fact securities under the Howey test. So it was a pretty definitive win for the SEC. Do you see the ruling in that case having an impact in bankruptcy cases like FTX, Celsius, and Voyager?

Deborah Kovsky-Apap:

Well, as I said before, to the extent that coins are regulated as securities, you're going to see enforcement actions. And I have to be honest, right now, it seems like the SEC is regulating by enforcement. The big case, obviously, is the Ripple case, which has been pending in the southern district of New York since 2020, I believe, where a lot of the same issues are being litigated that the SEC just won on in the LBRY case, which by the way is going up on appeal.

Just to back up, one of the really interesting things that came out of the LBRY case is that was a coin that had never been offered in an ICO, in an initial coin offering, and yet the court said it's absolutely clear, and not only is it clear that it was a security, there was no fair notice exception or defense where the issuer saying, "but how was I supposed to know that you were going to treat this as a security? There's no regulation that says this coin is a security. What am I supposed to point to? How am I supposed to know that I was violating something?" and the court did not buy that at all.

And that's a big issue that's also being litigated in the Ripple case. I believe it's Judge Torres has the Ripple case. I don't know if she's going to be looking at the New Hampshire cases being persuasive at all. It's clearly not precedential, but that may have an impact on her thinking, for what it's worth.

And to the extent that these coins are regulated as securities, that changes the landscape in which these companies are going to be operating. It exposes them to enforcement actions. It exposes them to increased costs, which bankrupt entities cannot afford. It's going to potentially expose them to fines, penalties, and to a new regulatory regime that they're going to be facing as they emerge from bankruptcy.

It may also tip other companies into bankruptcy. One of the things that Celsius had been struggling with a little bit is they had what was called an earned rewards program, which is similar to BlockFi's interest account, and they got dinged by a lot of state court regulators who were saying, "Hey, these are unregistered securities, and you're selling them to non-accredited investors, and you need to stop." So they created custody accounts, but they grandfathered in a lot of people into the earned rewards account who, had they been starting out on the platform and making new deposits, they couldn't have gotten into earned rewards because they weren't accredited investors. It became a non-sustainable business model, in some regards.

Yeah, I do think that increased regulation and treating not just interest earning products but also the coins themselves as securities is going to potentially have a very significant impact on any entity that one, offers interest bearing accounts, and two, offers its own proprietary coins as an item of value that help drive their business model.

Ethan Ostroff:

Yeah, I mean, this whole situation is, at the same time, fascinating, but to some extent, I think for a lot of people, potentially a source of a lot of anxiety and angst about what's going to happen next in the situation they've been left in, thinking they've been holding onto some very valuable token, but now they're learning that that token or that alt coin may or may not really have any true value.

We've talked a lot about a number of different risks. As a takeaway, what are some final thoughts about things that investors and customers should be thinking about?

Deborah Kovsky-Apap:

They should be thinking about doing their diligence, looking at proof of reserve, looking at the terms of use. Don't get surprised when you put coins onto a platform, if the terms of use say you are lending this coin to company X, and company X is allowed to hypothecate it, stake it, do whatever they want with it and exercise all rights of ownership, do not expect that when that company goes into bankruptcy, you're going to be able to get your coin back. It is most likely to be deemed or at least argued to be property of the debtor and not property of the customer. So actually read the fine print. It's a pain in the neck, but look at what it actually says.

And then do some diligence as to whether the platform that you're using is actually following its own terms of use. If they say, "These are your coins and we're not going to lend them, stake them, rehypothecate them, et cetera. We're going to keep them safely in this custodial account, and here's the entity that we use for custodial services," call up the entity that they're using for custodial services and ask some questions. Because this is your money in an unregulated, uninsured industry, and you have no other way of protecting yourself than asking as many questions as you can.

Ethan Ostroff:

To me, I would also add, there's the old saying, not your keys, not your coins, right? And so if your private keys are not in your own digital wallet, and preferably a hardware wallet, there's a real question about whether you actually own your cryptocurrency or NFTs or any other asset stored on a blockchain that you believe you own. And so that's another thing to consider is not just who your custodian is, but do you want to have a third party be your custodian?

Deborah Kovsky-Apap:

Yeah. I'm not quite ready to write off all third-party custodial services completely because I have a healthy dose of skepticism and cynicism. But I do believe that there are responsible actors in the market. The key is finding them, asking questions, doing the diligence, and during periods of high volatility like this, having the option and having the ability and the infrastructure in place to move everything to a hard wallet. Not a bad idea.

Ethan Ostroff:

Totally agree. Well, Deb, thank you again for joining us today. I thought this was great and highly informative. Thank you to our audience for listening to today's episode. Don't forget to visit our blog, consumerfinancialserviceslawmonitor.com, and subscribe so you can get the latest updates. And we look forward to you all joining us again in our next episode of *The Crypto Exchange*.