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Defense Strategies for Depositors in Crypto Ch. 11 Litigation

WRITTEN BY

Deborah Kovsky-Apap

As multiple bankrupt cryptocurrency Chapter 11 cases begin to pick up steam, depositors of cryptocurrency on the bankrupt exchanges have many questions.

How much of a haircut will I have to take? If cryptocurrencies recover, is the amount of my claim still frozen at the petition date? Will I get any of my coins back, or just a pro rata distribution in fiat currency?

Within the next two years,[1] they may well be asking another question: Are you kidding me? Because they will just have received demand letters from the debtor's liquidation trustee,[2] informing them that the value of the cryptocurrency they withdrew in the 90 days before the bankruptcy petition date must be repaid to the estate.

Not only will the depositors not be made whole in the bankruptcy case in this all-too-likely scenario, they must give back what they did manage to pull out before the bankruptcy as a so-called preference.[3]

The policy behind the Bankruptcy Code's preference provision seeks to promote equal treatment of creditors by requiring preferred creditors, who were paid in full, to share their recovery with members of their cohort who weren't so lucky.

"But how can this be?" asks the outraged depositor. After all, the debtor didn't prefer the depositor. The debtor didn't pay the depositor. In fact, the debtor had no way of even knowing when or if the depositor would withdraw his coins.

The problem is that the preference provision of the Bankruptcy Code sweeps much more broadly than just sweetheart payments made to favored creditors on the eve of bankruptcy. Section 547(b) of the Bankruptcy Code allows a debtor-in-possession or trustee to "avoid any transfer of an interest of the debtor in property":

- That was made to or for the benefit of a creditor on account of an antecedent debt;
- While the debtor was insolvent;
- On or within 90 days before the filing of the petition;[4] and

- That gave the creditor more than it would get in a Chapter 7 liquidation.

This sets the bar to presenting a prima facie case for a preference clawback very low. Any prior loan or provision of credit to the debtor fulfills the antecedent debt requirement. The debtor is legally presumed to have been insolvent during the 90 days prior to its bankruptcy filing.[5]

And in most cases, a creditor that receives payment in full prior to the petition date has almost certainly received more than it would have gotten had the payment not been made, and the creditor instead had to settle for whatever distribution it might get in Chapter 7.

In the case of the cryptocurrency exchanges, to the extent that a deposit of coins on an exchange constituted a loan,[6] then the depositor's withdrawal of the coins would likely be deemed to be the repayment of the loan. Under this scenario, the depositor, in effect — and almost certainly unknowingly — preferred himself.

So is all lost for depositors who believed, however fleetingly, that they had gotten out in time? Probably not.

Affirmative Defenses

Section 547(c) of the Bankruptcy Code lists several affirmative defenses to avoidance of a preference, the best known of which is commonly called the ordinary course of business defense.

A trustee may not avoid a preferential transfer

to the extent that such transfer was in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was (1) made in the ordinary course of business or financial affairs of the debtor and the transferee or (2) made according to ordinary business terms.[7]

It may be difficult to establish the first prong of the ordinary course of business defense, particularly if a depositor did not have a long deposit-withdrawal history or a regular pattern of withdrawals. However, the second, objective prong of the ordinary course of business defense is somewhat broader and more flexible, going "beyond what is normal between the debtor and creditor," according the U.S. Bankruptcy Court for the District of Delaware's 2017 opinion in *In re: Powerwave Technologies Inc.*[8]

According to the U.S. Court of Appeals for the Third Circuit's 1994 decision in *In re: Molded Acoustical Products Inc.*, quoting prior precedent:

[O]rdinary business terms refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope [of the affirmative defense.][9]

Withdrawals made in accordance with the debtor's terms of service would arguably be ordinary in this sense.

Another common affirmative defense is the subsequent new value defense. Under Section 547(c)(4) of the

Bankruptcy Code, the trustee cannot claw back a preferential transfer to the extent that, after the transfer, the creditor gave unsecured new value to the debtor.

For a cryptocurrency exchange, subsequent new value could simply be the deposit of more coins after a withdrawal.

Safe Harbor

While the ordinary course of business and subsequent new value defenses may provide only partial protection from clawback, the safe harbor of Section 546(e) may shield withdrawals completely. That provision of the Bankruptcy Code provides that:

[T]he trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[10]

The stated legislative purpose of Section 546(e) is to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market," according to a 1981 U.S. House of Representatives bill.[11]

The safe harbor was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries," according to the bill, by ensuring the integrity and finality of commodities and securities transactions.[12]

While this policy goal seems as pertinent in the context of the burgeoning cryptocurrency market as in the securities and commodities markets, evaluating whether and how the safe harbor provision might apply to a cryptocurrency exchange requires chasing some definitions around the Bankruptcy Code.

Settlement payment means

a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.[13]

Yes, this is as circular and uninformative as it sounds. Fortunately, the U.S. Court of Appeals for the Second Circuit helpfully clarified that a payment to settle a debt may fall within the meaning of "settlement payment" for safe harbor purposes in *Enron Creditors Recovery Corp. v. Alfa SAB de CV* in 2011.[14]

Financial participant means

[A]n entity that, at the time it enters into a securities contract … or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a)[15] with … any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with … any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition.[16]

Under this definition, provided that the definition of "securities contract" is also met, it appears likely that a multi-billion dollar exchange would be deemed to be a financial participant.

Securities contract means, among other things, "a contract for the purchase, sale, or loan of a security."[17]

Working backward, if interest-bearing cryptocurrency accounts are deemed to be securities — and a number of state regulators have asserted that they are, though it does not appear that any court has yet weighed in — then the agreement between the exchange and the depositor with respect to such an account arguably would be deemed to be a securities contract.

The debtor exchange would therefore be an entity that enters into a securities contract, and, given the total gross dollar value of all outstanding securities contracts, would likely be found to be a financial participant.

Putting all of the pieces together, a withdrawal of coins could thus be determined to be a settlement payment made by a financial participant or a transfer made by a "financial participant … in connection with a securities contract." In either case, the withdrawal would be shielded from clawback by the safe harbor.

Conclusion

Depositors who receive demand letters and are faced with the threat of preference litigation need not immediately reach for their checkbooks. A variety of potential defenses exist that may limit or completely eliminate their preference exposure.

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[1] Under Section 108 of the Bankruptcy Code, the debtor-in-possession or trustee has two years from the date of the bankruptcy petition to file avoidance actions.

[2] I use the term liquidation trustee here—that is, a post-confirmation trustee appointed under a chapter 11 plan of liquidation—because preferences are most likely to be pursued in a liquidation scenario. As a practical matter, a debtor that continues as a going concern, whether through a standalone reorganization or a sale under 11 U.S.C. § 363, will be reluctant to sow further ill will among the very creditors who are key to its future survival. This is why purchasers of assets in bankruptcy often include, among the acquired assets, all clawback claims against trade

vendors with whom they will continue to do business—they want to ensure the clawback claims are not pursued so that their relationship with their new supplier base is not poisoned.

[3] To the extent that the value of any crypto withdrawals is clawed back, the depositor will have a general unsecured claim against the estate in the same amount under section 502(h) of the Bankruptcy Code. Suppose, for example, that the trustee avoids and recovers $100,000 from the depositor, and that pro rata distributions on general unsecured claims are 30% (to be clear, that percentage is made up for illustrative purposes only). The depositor would be entitled to get back $30,000. In practice, when preference defendants settle clawback claims, section 502(h) claims are often factored in and netted out of the settlement amount.

[4] For payments to insiders, the lookback period is one year. 11 U.S.C. § 547(b)(4)(B).

[5] 11 U.S.C. § 547(f).

[6] The legal status of coins on cryptocurrency exchanges, including whether they constitute property of the bankruptcy estate, remains an open question.

[7] 11 U.S.C. § 547(c)(2). Note, however, that if a cryptocurrency exchange is found by a court to have been a Ponzi scheme—a charge that has been leveled at one of the debtors by some creditors—it may be difficult or impossible to establish an OCB defense. As one court put it, "because investment companies do not ordinarily pay fraudulent profits to early investors, the § 547(c)(2) defense is inapplicable to payments to investors in a Ponzi scheme." *Jobin v. McKay (In re M&L Business Machine Co., Inc.)*, 84 F.3d 1330, 1340 (10th Cir. 1996).

[8] *In re Powerwave Techs., Inc.*, No. 13019134 (MFW), 2017 WL 1373252, at *8 (Bankr. D. Del. Apr. 13, 2017).

[9] *In re Molded Acoustical Prod., Inc.*, 18 F.3d 217, 220 (3d Cir. 1994).

[10] 11 U.S.C § 546(e). The section 548(a)(1)(A) exception allows otherwise protected payments to be clawed back in the case of intentional fraud.

[11] H.R. Rep. No. 97-420, at 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583, 1982 WL 25042.

[12] Id.

[13] 11 U.S.C. § 741(8).

[14] *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011).

[15] Section 561(a)(1) refers to securities contracts, as defined in section 741(7).

[16] 11 U.S.C. § 101(22A)(A).

[17] 11 U.S.C. § 741(7)(A)(i).

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