

The Other Side of The Coin: Cryptocurrency Assets in Bankruptcy

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On July 5, 2022, cryptocurrency brokerage Voyager Digital filed for chapter 11 in the Southern District of New York Bankruptcy Court, citing a short-term “run on the bank” due to the “crypto winter” in the cryptocurrency industry generally and the default of a significant loan made to a third party as the reasons for its filing. At Voyager’s first day hearing on July 8, 2022, the Bankruptcy Court asked the critical question of whether the crypto assets on Voyager’s platform were property of the estate or its customers. Voyager asserted the crypto assets were assets of the estate pursuant to the terms of its customer agreements, but the question of ownership was more problematic in the context of a liquidation. In that context, Voyager’s plan of reorganization proposes to resolve any mystery of ownership by delivering the reorganized company to its customers.

On July 13, 2022, cryptocurrency lender Celsius Network filed for chapter 11 in the Southern District of New York Bankruptcy Court. Celsius had frozen customer withdrawals on June 12, 2022 and, at the time of its chapter 11 filing, indicated that it would not be requesting court authority to allow customer withdrawals. Celsius noted in a press release that customer claims would be addressed through the chapter 11 process.

Voyager’s and Celsius’ chapter 11 bankruptcy filings highlight the question of whether crypto assets held by an exchange, or similar platform, may be considered property of a bankruptcy estate and, therefore, not recoverable by the customer, who would then likely be an unsecured claimholder of the debtor.

While some commentators have suggested that crypto assets might be considered property of the exchange's bankruptcy estate, existing common law, existing provisions of Uniform Commercial Code (UCC) Article 8, and proposed amendments to the UCC recognize that if the arrangement and relationship between the exchange and its customers is one that is characterized as "custodial," the crypto assets held by the exchange should remain property of the customer and, hence, not subject to dilution by general unsecured claimholders.

Custodial Assets in the Bankruptcy of the Custodian

The common law. When assets are held by a "custodian" for the benefit of the customers of the custodian, the assets are owned by the customer and would not form part of the debtor's bankruptcy estate. The United States Court of Appeals for the Seventh Circuit determined in *In re Joliet-Will County Community Action Agency*^[1] that property held by the debtor as a custodian or other intermediary who then generally lacks beneficial ownership rights is not an asset of the bankruptcy estate.

The court then looked to see if the relationship between the debtor and those who transferred funds to the debtor was in fact "custodial." The court concluded the answer depends on "the terms under which the grants were made" and the "relationship" between the holder of the funds and its customer. In *Joliet-Will*, the agreement provided for controls on the holder's use of the funds and the holder was "in effect an agent to carry out specified tasks rather than a borrower, or an entrepreneur using invested funds." The court concluded the relationship was "custodial" and, thus, the funds were not property of the bankruptcy estate.

In the context of a cryptocurrency exchange bankruptcy, the same analysis should apply where the terms of the relationship between an exchange and its customer are comparable and, thus, "custodial". In that case, the customer would have a basis to assert that it should remain the beneficial owner of the assets, rather than become a general unsecured claimholder of the exchange.

The commingling of customer assets, or the contractual right of an exchange in possession or control of the customer's assets to grant a security interest in that property do not, of themselves, prevent the assets from remaining the property of the customer.

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Conversely, if the entity in possession or control of the property has extensive rights to use the property for its own benefit, a court is more likely to conclude that the relationship is not “custodial.” In that case, the customer “would have a contractual claim for the return of the money [it] had paid, but he would not have a property right in the money.”^[3]

However, even if a court was to determine the customer should remain the *beneficial owner* of assets held by a custodian in such capacity, notwithstanding any commingling and any right to pledge the cryptocurrency, any *contractual* rights of the custodian (for example, any rights under a staking arrangement) should become property of the estate. In such a case, while the customer remains the beneficial owner of its cryptocurrency, which would not be subject to distribution to general unsecured claimholders in the exchange’s bankruptcy, it could be tied up under the automatic stay preventing parties from exercising control over the exchange’s contractual rights (e.g., under a staking arrangement, the automatic stay might prevent a customer from recalling the cryptocurrency to its account).

Article 8 of the Uniform Commercial Code. Article 8 mirrors these rules for financial assets held by a securities intermediary. Under Article 8, a securities intermediary^[4] includes a “custodian” of a “financial asset”^[5] who otherwise meets the definition of a securities intermediary.^[6] Critically, existing language in Section 8-503(a) of the UCC outlines the ownership interest of a customer whose cryptocurrency is held by an intermediary such as an exchange, if the exchange is a “securities intermediary,” has agreed with the customer to treat the cryptocurrency as a “financial asset,”^[7] and has credited the financial asset to a securities account.^[8] This is true under Article 8 even though the securities intermediary holds the financial assets in “fungible” form (*i.e.*, they are commingled).^[9] Article 8 in effect codifies the common law custodian rules for transactions within the scope of Article 8—the customer of the custodian retains its property interest and has a pro rata interest in the commingled assets held by the custodian.

Proposed Amendments to the Uniform Commercial Code. Pending amendments to the UCC further implement the rule that custodially held crypto assets should not be property of the bankruptcy estate in a bankruptcy of a custodian-cryptocurrency exchange. The drafting of amendments to the UCC specifically to address certain cryptocurrencies and other digital assets is nearing completion and is expected to go to the States for consideration in the Fall of 2022. Under these amendments, cryptocurrencies would fit into a new category of collateral under the UCC, referred to as “controllable electronic records” (a form of general intangible) (CERs), which would generally include information stored in a nontangible medium that can be subjected to control. Under these amendments, CERs will have many characteristics of negotiability similar to negotiable instruments and securities; however, cryptocurrencies ordinarily will not be considered “money” for purposes of the UCC (that is, the amendment generally provides that cryptocurrencies generally are not considered “money,” but a cryptocurrency created and adopted by a government as an authorized medium of exchange could be “money” under the UCC).

Notably, the proposed amendments to the official comments to Article 8 of the UCC primarily serve to make clear that a securities intermediary and a customer of a securities intermediary can agree to treat a cryptocurrency as a “financial asset” and credit it to a securities account with the treatment described above.

The proposed amendments to the official comments in Section 8-501(d) note that assets such as CERs might also be controlled by a securities intermediary outside of a securities account for the benefit of a customer—similar to traditional securities, in which case the bankruptcy of the intermediary often times would not put in doubt the customer’s ownership of securities in in that circumstance held by the intermediary:

[A]ssets such as controllable electronic records, controllable accounts, and controllable payment intangibles also might be associated with an intermediary as well as with its customer under a similar direct holding arrangement. . . . As with conventional certificated securities, whether an intermediary has created a security entitlement in favor of an entitlement holder or is holding a financial asset directly for a customer depends on the nature of the relationship and the nature of the rights of the intermediary and the customer with respect to the financial asset.

In addition, revisions to Article 9 of the UCC will provide that a security interest in a CER can be perfected the old fashioned way—by filing a financing statement—or by obtaining “control” of the CER. Under current distributed ledger technology structures such as blockchain, a secured party normally would normally obtain “control” of a cryptocurrency that is a CER if the secured party has the private key. A secured party can have control through a custodian that has control for the benefit of a secured party. Where a securities intermediary and a customer of a securities intermediary agree to treat a cryptocurrency as a “financial asset”[\[10\]](#) and credit it to a securities account, the customer would have “security entitlement” related to the cryptocurrency, and the secured party could obtain and perfect a security interest in such security entitlement under existing procedures under Articles 8 and 9 of the UCC.

A new Article 12 to the UCC is being proposed that includes provisions addressing transactions in cryptocurrencies falling under the category of a CER, such as sales of the cryptocurrency. In these transactions, a buyer of a CER can take free of the property claims of others if the buyer obtains control of the CER (*e.g.*, holding the private key), gives value, and does not have notice of the property claims of others.

While the proposed amendments to the UCC have yet to be finalized and adopted by the States, many of the amendments to the UCC as they relate to the ownership interest of a cryptocurrency exchange customer in custodially held cryptocurrency are proposed as amendments to the official comments, without revision to the operative statutory provisions themselves because the existing statutory provisions already provide for the described results. Thus, a bankruptcy court could rely on the existing state UCC statute as a basis to determine that when cryptocurrency is held as a financial asset credited to customer accounts, the cryptocurrency is property of the customer, rather than bankruptcy estate. This is the same result outside of Article 8 as discussed above.

Conclusion

Crypto assets held custodially by an exchange or other entity for a customer should be treated as the property of the customer. The analysis of when a “custodial” relationship exists will depend on the agreements and other facts in a particular relationship.

[1] See *In re Joliet-Will Cnty. Community Action Agency*, 847 F.2d 430, 431 (7th Cir. 1988) (Posner, J) (“Did they constitute Joliet-Will a trustee, *custodian*, or other intermediary, who lacks beneficial title and is merely an agent for the disbursement of funds belonging to another? If so, the funds (and the personal property bought with them, cf. *In re Kaiser*, 791 F.2d 73, 77 (7th Cir.1986)) were not assets of the bankrupt estate.” (Emphasis added)).

[2] See also Restatement (Third) of Restitution and Unjust Enrichment § 59 (property interest in asset continues in commingled assets when the interests can be traced). See also Illustration 26 (400 customers of smelter deliver silver to smelter, who keeps records of the amount of silver delivered by each customer, refines the silver for a fee, and agrees to return a corresponding amount of silver to each customer; when smelter fails, each customer has a pro rata property interest in the refined silver, which is not the property of smelter); UCC § 9-207(c)(3).

[3] *Joliet-Will*, 847 F.2d at 432.

[4] “Securities intermediary” is defined in Section 8-102(a)(14) of the UCC.

[5] “Financial asset” is defined in Section 8-102(a)(9) of the UCC.

[6] UCC § 8-102(a)(14) and Comment 14.

[7] See Section 8-102(a)(9)(iii) of the UCC.

[8] Section 8-503(a) provides that “[t]o the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511.”

[9] This rule is the same as the smelting example described above from the Restatement (Third) of Restitution and Unjust Enrichment.

[\[10\]](#) A financial asset does not have to be a “security” (as defined in Article 8 of the UCC) to be a financial asset. As long as the relationship between the securities intermediary and the customer creates a “securities account” (UCC § 8-501, Comment 1), the securities intermediary and its customer (referred to as an “entitlement holder”) can agree to have any asset treated as a “financial asset”. UCC § 8-102(a)(9)(iii).

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