By Brandon R. Wood

Pendulum of Deregulation Swings at Consumer Crypto Creditors

Brandon R. Wood
U.S. Bankruptcy Court (N.D. Ga.); Atlanta

Brandon Wood is a law clerk for Hon. Sage M. Sigler in the U.S. Bankruptcy Court for the Northern District of Georgia in Atlanta.

Philosopher George Santayana once said, "Those who cannot remember the past are condemned to repeat it."[1] This quote is apt when describing modern financial markets surrounding cryptocurrency. In 1933 and 1934, the Securities Act and the Securities Exchange Act were passed, respectively, to prevent high-risk investment strategies and low-to-no regulatory environments from creating financial chaos. Despite these regulations, cryptocurrency exchanges arose, avoided major regulatory hurdles, and offered high-risk investments to consumers with little to no oversight. Unsurprisingly, when cryptocurrency values began to crash, it exposed many of the same schemes, scams and sorely mismanaged businesses that the 1933 and 1934 Acts were designed to prevent.

Major exchanges such as FTX, BlockFi, Voyager and Celsius have all filed bankruptcy in the past year, with cryptocurrency markets in freefall. These bankruptcies have left millions of consumers in the lurch, with enormous sums of money tied up in entities that act like regulated financial institutions, but are anything but. This article shows how the restructuring process amplifies the risk from the lack of regulation in the cryptocurrency space, and how that impacts consumer creditors.

Unlike banks, cryptocurrency exchanges have no firm regulatory requirements that prevent them from making high-risk decisions that could imperil customer funds. For some people, this is enough to make them stay far, far away. For others, this is exactly the attraction to the space: a lack of regulation, allowing for high-risk, high-return investment strategies.

When banks fail, regulations step up to the plate. The Federal Deposit Insurance Corp. (FDIC) will take over the failed bank, liquidate its assets and pay insured account-holders up to the maximum of their coverage. A similar situation applies with the National Credit Union Administration. If you had $100,000 at Main Street Local Bank and the bank failed tomorrow, within the next few business days you would likely have all $100,000 of your money back. This policy grew out of the Great Depression to encourage people to trust depository institutions.

The obvious distinction for this article's purposes is that there is no federal agency in charge of insuring cryptocurrency exchanges. Since the exchanges themselves and the services they offer are so new, there are few rules in place to protect consumers who decide to leave their assets on a cryptocurrency exchange. Instead, many of these entities operate in what has basically become the financial wild west, where there are few rules and even fewer rule-enforcers.

This all brings us to the main problem. When the exchange that holds your assets looks, acts and markets itself like a bank and fails, you do not end up with a check from the FDIC; you end up in bankruptcy court. Furthering the problem, much of the law in cryptocurrency contexts has yet to be considered by courts or written by legislatures, leaving many of the rights of consumer creditors to be decided as a matter of first impression.

While there are a lot of facets to unpack, the underlying theme is that bankruptcy fails to treat consumer creditors fairly, potentially leaving them worse off through a chapter 11 process than through a chapter 7 liquidation. Nonetheless, absent all other forms of regulation, bankruptcy remains the only available forum capable of handling these matters when they arise.

Many Problems, Few Solutions

There are four major components to how consumers are getting harmed in recent crypto filings: (1) their status as unsecured creditors; (2) the (potential) role of clawbacks and fraudulent-transfer actions against those who made withdrawals; (3) the roles of committees in large restructuring operations, and how they might not always adequately represent the interests of the majority small-scale consumers who are the worst off in these cases; and (4) the undetermined status of "hold" or storage accounts, in which digital assets are merely held on behalf of a customer and not invested.

Unsecured Creditor Status

Creditors in bankruptcy play a sophisticated game of musical chairs. Money and claims move around, but eventually the music stops — the proposal of a plan — and many creditors might be left without a chair. In many of these crypto bankruptcies, consumer creditors are playing musical chairs with their legs tied together. While the exchanges may publicly state that their main desire is to make their consumer user whole through the bankruptcy

1 At least, this quote is commonly accredited to Jorge Agustin Nicolas Ruiz de Santayana y Borras, better known as George Santayana.

process, the steps needed to make that happen are fueled by mergers or infusions of new capital, which are presently unlikely in the rollercoaster cryptocurrency market.

A defining characteristic of these bankruptcies is the sheer drop in crypto prices. Many of these entities appeared solvent when prices were at all-time highs, but the incredible price crash left their balance sheets with significant gaps. As with any large chapter 11, large balance sheet gaps mean that unsecured creditors need to brace for significant losses. For example, unlike major oil bankruptcies, the creditors taking on these losses are not banks or hedge funds but rather are ordinary consumers with ordinary jobs. The people taking on these losses cannot simply write them off as bad investments. For many of them, these losses are their entire savings.[2]

The bankruptcy process is currently placing millions of consumers in the lurch where they cannot access their assets and do not know when, if ever, they will be able to. They are left unable to realize and harvest their losses in the short term, and are left waiting on the bankruptcy process to resolve itself. For many small-time investors, being left waiting for an answer is almost worse than just finding out you lost 70 percent of your cryptocurrency. If you have a fixed loss, you can take what you have left and move on. If you do not have fixed losses and are waiting for the bankruptcy process to play out — and literally create the law on how your claim will be treated — you wind up financially paralyzed.

Fraudulent Transfers, Clawbacks and Ponzi Schemes

A second major risk to crypto investors is that when these exchanges fail, they are exposed to the risk that the debtor may attempt to claw back pre-petition withdrawals. Amplifying this risk is how quickly the crypto markets imploded. When the markets were churning along, there was little reason for most average investors to bail on the crypto markets. Consequently, they stayed in until the markets collapsed suddenly. With the markets collapsing, many exchanges stopped allowing withdrawals from their platforms, effectively dragging consumers into bankruptcy.[3] If you thought you were one of the lucky few who got out before withdrawals were paused, you might be even worse off.

While not yet proposed in any case publicly, it is well within the power of the debtor in possession (DIP) or another trustee under § 548 to pursue these "lucky" consumers who got out and take back any withdrawals they made. Consumers in the crypto space are uniquely the most worried about the clawbacks[4] because they might not have that money available in liquid form. Many consumers might have taken their assets into cold storage (personal, off-platform digital wallets), or they might have re-invested them in some other location. Either way, they do not "have the money" to pay back the DIP or trustee, which means they must liquidate assets or investment positions.

Of course, this liquidation creates tax liability. Even worse, this liquidation could result in further losses if the performance of their new investments has not been strong since they pulled out of the crypto exchange in question. This creates compounding losses. They lose money on the exchange from the collapse in crypto prices, they lose money from having to liquidate assets and pay taxes on their investments (where applicable), then they must liquidate their investment positions early and likely with little warning. No part of the Bankruptcy Code accounts for these compounding losses for consumers; they are merely left to deal with them.

Even worse, some of these exchanges might turn out to be Ponzi schemes. As with any Ponzi scheme, any alleged "profits" must be pulled back into the pool to distribute losses evenly among all investors. In the cases of entities such as FTX and Celsius, allegations of fraud and Ponzi-schemery abound, and might play a crucial role in how those cases play out.[5] If you were invested in FTX or Celsius and you thought you got out before the company imploded and filed for bankruptcy, you might find yourself needing to write a check to the DIP account for the value of the assets that you withdrew — even when you made the withdrawals well outside of the § 548 preference period.

When facing either clawbacks by the debtor, trustee or through a Ponzi scheme reconciliation process, there are defenses available to fight back. However, these preference battles can quickly become very expensive for both parties. Many attorneys would suggest to their consumer creditor clients that they should seek out a settlement, as they may end up spending substantially on a defense only to have to lose and write the check anyway. Simply put, even if you were a consumer who got out in time, you are far from safe from the consequences of the bankruptcy filings.

Committees and Their Duties

Another risk to consumers comes from the appointment of committees in large cases. Ideally, committees are meant to represent large classes of creditors collectively to amplify their interests and prevent disorganization. Unfortunately, because committees represent so many individual parties, the interests of the small consumers might get washed out.

Committee representation can also fail to account for the degree of harm suffered by consumers. Committees do well for creditors based on the absolute value of their claims. The person with $10 million invested might be represented in the same group as the person with $10,000 invested. The difference between these two claims is several orders of magnitude in terms of absolute value, and it appears that the smaller claimholder is getting good value for his claim; they could not afford to bring the same type of claims that the holder of a $10 million consumer claim could.

However, this is a dichotomy between the appearance of value and the receipt of value. The person who invested their whole life savings of $10,000 is at far more risk in the process

2 Khristopher J. Brooks, "Customers of Bankrupt FTX May Never Get Their Crypto Back, Experts Say," CBS News (Nov. 14, 2022), *available at* cbsnews.com/news/ftx-bankruptcy-funds-returned-sam-bankman-fried (unless otherwise specified, all links in this article were last visited on Jan. 18, 2023).

3 Tracy Wang, "FTX Exchange Halts All Crypto Withdrawals," *CoinDesk* (Nov. 8, 2022), *available at* coindesk.com/business/2022/11/08/ftx-exchange-halts-all-crypto-withdrawals.

4 Individuals in many online consumer groups just refer to potential § 548 actions as "clawbacks" in the same way that Ponzi scheme reconciliation actions are clawbacks of fake profits.

5 Arjun Kharpal, "Embattled Crypto Lender Celsius Is a 'Fraud' and 'Ponzi Scheme,' Lawsuit Alleges," CNBC (July 8, 2022), *available at* cnbc.com/2022/07/08/crypto-lender-celsius-is-a-fraud-and-ponzi-scheme-law-suit-claims.html; David Yaffe-Bellany, William K. Rashbaum & Matthew Goldstein, "FTX's Sam Bankman-Fried Is Arrested in the Bahamas," *N.Y. Times* (Dec. 12, 2022), *available at* nytimes.com/2022/12/12/business/ftx-sam-bankman-fried-bahamas.html (subscription required to view article).

continued on page 51

than the sophisticated investor who can weather a $10 million loss on a high-risk investment — but they are still part of the same group of creditors. Even if a consumer committee is formed, the unequal footing still perpetuates the same issue.

Furthermore, there is no consensus among consumers as to how the committees should proceed. Many consumers want these cases converted to chapter 7 to (hopefully) quickly pay out their claims. Others want the case to play out in chapter 11 to maximize their potential return on their claims, while others still are more focused on holding officers and directors responsible for the lack of oversight. No matter how they are constructed, committees will struggle to adequately represent consumers due to the myriad risks taken on and the myriad views on how to recuperate on their claims.

Holding Account Uncertainty

Very little law in the cryptocurrency space has been settled. Furthermore, there are multiple cases happening simultaneously, with each court capable of reaching different decisions on the same issues. One such issue is that of "hold" or "storage" accounts. Think of these as crypto safety deposit boxes. Instead of holding your currency in your own digital wallet and running the risk of losing your password or being hacked, you give the currency over to the exchange, which holds it in a non-interest-bearing account.

Recently, interest-earning accounts were ruled to be property of the estate, likely wiping out the holdings of many consumers.[6] This consequently raises the question of what happens to the "hold" accounts. When a bank fails, the contents of safety deposit boxes are turned over to the owner, but the same is not guaranteed in cryptocurrency bankruptcies. Furthermore, treatment of these accounts will have an outsized impact on the centralized finance market in cryptocurrency.

Interestingly, it might be more beneficial to the exchanges, in the long term, to lose on custody or fight any assertions by creditors that they own the "hold" assets. The long-term business of exchanges functions around being crypto banks, even if they are not "banks" and specifically avoid calling themselves such. Consumers will not be handing over their "keys" to their coins[7] if they are at risk of losing them all the same as if they had saved their password to their wallet on a flash drive and stored it in a drawer. If the exchanges can lose all your assets and leave you with no recourse, why would you ever trust them? In this case, if "hold" accounts fall into the estate, then the business model — as currently construed — fails. Without regulations protecting the customer's assets, nothing would stop bankruptcy courts from turning over never-risked "hold" assets to the estate, leaving consumers even worse off.

Where to Next?

Cryptocurrency's wild west symphony is playing out its final strings. Prior to these cases reaching confirmation, more blood will be spilled in the battles over possession of consumers' funds. This is the reality of cryptocurrency, deregulation and their impact on the consumer. There were no rules, and no one cared, because everyone was profiting. Now the money has dried up, customers want their money back, and creditors want to get paid. It is now up to the bankruptcy courts to determine the law surrounding ownership of intangible digital assets worth billions of dollars, and to monitor and direct the process of payment to significantly unequally footed creditors. abi

6 *In re Celsius Network LLC*, 2023 Bankr. LEXIS 2 (Bankr. S.D.N.Y Jan. 4, 2023).

7 A common phrase is "not your keys, not your coins" when it comes to utilizing cryptocurrency exchange "hold" accounts.