

Recent Crypto Bankruptcy Filings May Provide Clarity to Critical Unresolved Questions

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One of the key unresolved questions surrounding crypto custodian bankruptcy proceedings under the U.S. Bankruptcy Code is whether or not digital assets that are held by a crypto exchange on behalf of platform users could be viewed as the exchange's corporate assets in the proceeding, which in turn could be used to satisfy debts of other creditors.¹ As we explained in a recent article, such determinations are fact specific and turn on various factors such as: 1) the intent of the parties, as reflected in, for example, the terms of any custodial or other agreements that exist between the customer and the crypto-exchange; 2) whether the assets are commingled with the debtor's assets or can be readily traced and identified; and 3) the debtor's control over such assets.² Were a bankruptcy court to characterize the digital assets held by exchanges or other custodians as corporate assets, customers could be treated as unsecured creditors and, thus, potentially stand to lose some or all of the value of their investment in the crypto-assets.³ Banks and other financial service providers contemplating or currently offering crypto-custody services through sub-custody arrangements with digital asset platforms may be impacted by this uncertainty to the extent that they hold their customers' digital assets in omnibus accounts at the exchange.

Recently, these risks have come to the limelight as two major crypto custodians have commenced bankruptcy proceedings and several others are facing financial difficulties. On July 1, 2022, Three Arrows Capital ("3AC"), a major cryptocurrency hedge fund, petitioned a New York bankruptcy court for recognition of its current liquidation proceedings in the British Virgin Islands under chapter 15 of the Bankruptcy Code to prevent creditors from seizing its U.S. assets.⁴ The filing followed a notice of default

¹ See Sidney P. Levinson et al, Recent Disclosure Guidance Highlight Growing Concern Surrounding the Risks of User Assets Held by Various Crypto Custodians, Debevoise & Plimpton (June 6, 2022) <https://www.debevoise.com/insights/publications/2022/06/recent-disclosure-guidance-highlights> ("Since most crypto-exchange platforms are not registered broker-dealers or members of a securities exchange, their bankruptcies would not be overseen by SIPC; instead those crypto-asset exchange platforms would be liquidated under the Bankruptcy Code.") .

² Id.

³ Id.

⁴ Jeremy Hill, Crypto Hedge Fund Three Arrows Files For Chapter 15 Bankruptcy, Bloomberg (July 1, 2022, 5:56 PM).

issued by Voyager Digital LLC (“Voyager”)—which owns a number of business lines, including online execution platform, lending platform, and custody business—to 3AC for 3AC’s failure to make the required payments on its previously disclosed loan of 15,250 Bitcoin (BTC) and \$350 million USD Coin (USDC).⁵

Shortly thereafter, on July 6, 2022, Voyager filed for Chapter 11 bankruptcy protection in New York, citing prolonged volatility in the crypto markets and the default of 3AC.⁶ Voyager disclosed that it held about \$1.3 billion of crypto assets on its platform as of its filing and is continuing to pursue over \$650 million of claims against 3AC.⁷

While both 3AC and Voyager have filed for bankruptcy, the proceedings for each will differ. 3AC filed for bankruptcy under chapter 15 of the Bankruptcy Code, which is an ancillary proceeding to a primary insolvency proceeding that is pending in another country, typically the debtor’s home country.⁸ (3AC is undergoing a court-ordered liquidation in the British Virgin Islands).⁹

Voyager, on the other hand, filed for chapter 11 bankruptcy.¹⁰ In a chapter 11 proceeding, or “reorganization” bankruptcy, the debtor’s management usually remains in place and may continue to operate the business.¹¹ The culmination of a chapter 11 bankruptcy is a plan of reorganization, which sets forth the treatment of creditors’ claims. Creditors whose rights are affected may vote on the plan and the plan may be confirmed by the bankruptcy court if it gets the required votes and satisfies certain legal requirements.¹² Voyager filed a proposed chapter 11 plan on the day it filed for bankruptcy and the plan (which is subject to ongoing discussions and court approval) contemplates that “customers with crypto in their account(s) will receive ... a combination of the crypto in their account(s), proceeds from the [3AC] recovery, common shares in the newly reorganized Company, and Voyager tokens.”

⁵ Shivani Kumaresan, Bitcoin-Related Voyager Digital Issues Default Notice to Three Arrows Capital, Yahoo Finance (June 27, 2022) <https://finance.yahoo.com/news/bitcoin-related-voyager-digital-issues-125315799.html>.

⁶ Suvashree Ghosh & Anna Irrera, Voyager Seeks Bankruptcy as Crypto Mogul’s Lifeline Fails, Bloomberg (July 6, 2022, 5:51 AM) <https://www.bloomberg.com/news/articles/2022-07-06/voyager-digital-holdings-files-for-chapter-11-bankruptcy>.

⁷ Id.

⁸ Chapter 15 – Bankruptcy Basics: Ancillary and Other Cross Border Cases, <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-15-bankruptcy-basics> (last visited July 7, 2022).

⁹ Jeremy Hill, Crypto Hedge Fund Three Arrows Files For Chapter 15 Bankruptcy, Bloomberg (July 1, 2022, 5:56 PM)

¹⁰ Id.

¹¹ Chapter 11 – Bankruptcy Basics, <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics> (last visited July 7, 2022).

¹² Id.

Notably, during Voyager's first court appearance before Bankruptcy Judge Michael E. Wiles, Voyager's counsel acknowledged that there will be several legal issues of first impression. The Court specifically raised the question of whether the crypto-assets on Voyager's platform are property held in trust for the customers or property of the debtor's estate. Voyager's counsel offered their view that the crypto assets held on its platform are "assets of the estate" pursuant to the terms of the customer agreements, which authorizes Voyager to hold crypto assets in commingled accounts and to use them on the customer's behalf.¹³ This unresolved issue will likely become critical as Voyager's bankruptcy case proceeds.

Shortly after Voyager's announcement, the Federal Deposit Insurance Corporation ("FDIC") announced that the agency is investigating how Voyager marketed itself to customers. Voyager had previously claimed that, due to Voyager's partnership with Metropolitan Commercial Bank ("Metropolitan"), U.S. dollars deposited with the firm's business lines are covered by FDIC deposit insurance. In an email to the press, a FDIC spokesperson emphasized that, while Metropolitan is FDIC-insured, Voyager is not; deposit insurance therefore does not protect customers against a default or bankruptcy by Voyager.¹⁴ The Consumer Financial Protection Bureau ("CFPB"), which exercises jurisdiction over certain financial institutions and larger participants in consumer financial markets (including some crypto-asset firms), had previously issued an enforcement memorandum regarding claims about FDIC insurance in May 2022.¹⁵ We

¹³ Notably, section 5(c) of Voyager's Customer Agreements specifically provides: "Customer and Voyager understand that the legal treatment of Cryptocurrency is unsettled and disparate across different jurisdictions. In the event that Customer, Voyager or a Custodian become subject to an insolvency proceeding it is unclear how Customer Cryptocurrency would be treated and what rights Customer would have to such Cryptocurrency. How an insolvency court would categorize and treat Customer Cryptocurrency is a highly fact-dependent inquiry that necessarily depends upon the circumstances of each individual case. In addition, within the U.S. there is notably little case law addressing insolvency proceedings involving Cryptocurrency. As such, the law governing the likely treatment of Customer Cryptocurrency in the event of a Customer, Voyager or Custodian insolvency proceeding remains largely unsettled. Voyager does not make any representation as to the likely treatment of Customer Cryptocurrency in the event of a Customer, Voyager, or Custodian insolvency proceeding whether in the U.S. or in any other jurisdiction. Customer explicitly understands and acknowledges that the treatment of Customer Cryptocurrency in the event of a Customer, Voyager, or Custodian insolvency proceeding is unsettled, not guaranteed, and may result in a number of outcomes that are impossible to predict, including but not limited to Customer being treated as an unsecured creditor and/or the total loss of all Customer Cryptocurrency." <https://www.investvoyager.com/useragreement/> (July 11, 2022, 9:50 pm).

¹⁴ Allyson Versprille, FDIC Probing How Bankrupt Crypto Broker Voyager Marketed Itself, Bloomberg (July 7, 2022, 2:39 PM), <https://www.bloomberg.com/news/articles/2022-07-07/fdic-probing-how-bankrupt-crypto-broker-voyager-marketed-itself>.

¹⁵ "CFPB Takes Action to Protect Depositors from False Claims About FDIC Insurance," Consumer Financial Protection Bureau (May 17, 2022), [https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-to-protect-depositors-from-false-claims-about-fdic-insurance/#:~:text=Misrepresenting%20the%20FDIC%20logo%20or,insurance%20will%20typically%20be%20material](https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-to-protect-depositors-from-false-claims-about-fdic-insurance/#:~:text=Misrepresenting%20the%20FDIC%20logo%20or,insurance%20will%20typically%20be%20material.).

expect that future bankruptcy cases involving crypto-asset firms may similarly be followed by regulatory scrutiny from financial regulators such as the FDIC and CFPB.

It is worth noting that several other crypto exchanges have also announced substantial losses in the wake of 3AC's bankruptcy, leading to concerns of more bankruptcy filings to come. One notable crypto exchange platform, Genesis Trading, announced that it too had suffered losses due to 3AC's bankruptcy, but managed to mitigate its losses with its parent company, Digital Currency Group, assuming certain liabilities related to 3AC.¹⁶ Other crypto exchanges have announced they have hired restructuring advisors and are considering all of their legal options. The bankruptcy cases involving 3AC and Voyager could establish important precedent for how crypto assets are treated in future bankruptcy proceedings, as well as other legal issues that have not yet been tested, and are treated by financial regulators. Accordingly, it is prudent that other crypto custodian platforms and those with substantial investments in such digital assets monitor the ongoing proceedings.

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¹⁶ Crypto exchange Genesis discloses exposure to bankrupt Three Arrows Capital, Reuters (July 6, 2022, 5:15 PM), <https://www.reuters.com/technology/crypto-exchange-genesis-discloses-exposure-bankrupt-three-arrows-capital-2022-07-06/>.

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