Can Crypto Debtors Claw Back Pre-Bankruptcy Transfers?

January 23, 2023

On December 19, 2022, FTX Trading Ltd. issued a press release announcing a process for the voluntary return of avoidable pre-bankruptcy payments to "secure the prompt return of such funds to the FTX Estates for the benefit of customers and creditors."[1] Seeking to clawback or "avoid" pre-bankruptcy transfers is commonplace in bankruptcy. Such transfers may include customer withdrawals, payments to creditors, liquidations of DeFi loans, payments to insiders or charitable donations. However, as will be discussed in more detail below, there are several novel issues that could arise in crypto related chapter 11 cases that may implicate additional potential obstacles to avoid pre-bankruptcy transfers.

Background Law on Avoidance Actions

As background, chapter 5 of the Bankruptcy Code[2] provides a debtor (or a trustee) with the ability to recover certain pre-bankruptcy payments made by the debtor for the benefit of the debtor's entire estate, often referred to as avoidance actions or clawback actions.[3] "The principal policies underlying the Code's avoidance provisions are equal distribution to creditors and preserving the value of the estate through the discouragement of aggressive pre-petition tactics causing dismemberment of the debtor."[4] In particular, the Bankruptcy Code allows the trustee or debtor to avoid (i) preferential transfers under Section 547 or (ii) fraudulent transfers under Section 548.

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1 Press Release, FTX, FTX Debtors Announce Process for Voluntary Return of Avoidable Payments (Dec. 19, 2022), https://www.prnewswire.com/news-releases/ftx-debtors-announce-process-for-voluntary-return-of-avoidable-payments-301706546.html. *See also* https://www.wsj.com/articles/ftx-wants-to-claw-back-sam-bankman-frieds-donations-11671569675 (last visited Jan. 16, 2023).

2 The Bankruptcy Code is codified in Title 11 of the U.S. Code.

3 *See Merit Management Group v. FTI Consulting*, 138 S. Ct. 883, 888 (2018) ("Chapter 5 of the Bankruptcy Code affords bankruptcy trustees the authority to 'se[t] aside certain types of transfers … and … recaptur[e] the value of those avoided transfers for the benefit of the estate.'").

4 *In re Maxwell Communication Corp. plc by Homan*, 93 F.3d 1036, 1052 (2d Cir 1996).

Under the Bankruptcy Code, the trustee has the power to enlarge the bankruptcy estate by avoiding certain transfers to creditors that satisfied antecedent debt before the petition date.[5] Section 547 of the Bankruptcy Code provides that a debtor can avoid a prepetition "transfer of an interest of the debtor" to a creditor made within 90 days of the bankruptcy filing as a preference if certain requirements are satisfied.[6] The goal of the Bankruptcy Code's preferential transfer provision is to avoid depletion of the debtor's bankruptcy estate to certain creditors prior to the filing, and to promote equality of distribution among all similarly situated creditors.

Similarly, section 548 of the Bankruptcy Code empowers the debtor to avoid two categories of fraudulent transfers. Under section 548(a)(1)(A) of the Bankruptcy Code, a debtor may avoid any transfer of an interest of the debtor or any obligation incurred by the debtor, that was made or incurred within two years of the petition date if made with an actual intent to delay, hinder, or defraud creditors.[7] The more common scenario is section 548(a)(1)(B) which enables a debtor to avoid a transfer that was made or incurred within two years of the petition if the debtor (1) received less than reasonably equivalent value[8] and (2) was insolvent at the time of the transfer, was rendered insolvent by the transfer, was left with unreasonably small capital, or intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as such debts matured. This is generally referred to as a "constructive fraudulent transfer" and does not require any specific intent. Additionally, section 544 of the Bankruptcy Code also enables a debtor to rely upon, and pursue, state fraudulent transfer laws, which often have longer lookback periods.[9]

In addition to the traditional defenses available to defendants against preference and fraudulent transfer claims, avoidance actions involving digital assets may also turn on certain novel issues unique to cryptocurrencies and digital assets.

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5 11 U.S.C. § 547(b).

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7 *See e.g.*, *ACLI Gov't Sec., Inc. v. Rhoades*, 653 F. Supp. 1388, 1394 (S.D.N.Y. 1987), *aff'd sub nom. ACLI Gov. v. Rhoades*, 842 F.2d 1287 (2d Cir. 1988) ("Actual fraudulent intent, by its very nature, is rarely susceptible to direct proof, and normally is established by inference from the circumstances surrounding the allegedly fraudulent act."). *But see In re Bernard L. Madoff Investment Securities LLC*, 12 F.4th 171, 181 (2d Cir 2021) ("Under the so-called 'Ponzi scheme presumption,' the existence of a Ponzi scheme demonstrates actual intent as [a] matter of law because transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors.").

8 "Reasonably equivalent value" is not defined in the Bankruptcy Code, but has been determined by courts on a case-by-case basis, considering various factors, including (1) the good faith of the parties; (2) the difference between the amount paid and fair market value; (3) the percentage of fair market value paid; and (4) whether the transaction was arm's length. *See, e.g., Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs., Inc.)*, 299 B.R. 732, 748 (Bankr. D. Del. 2003).

9 11 U.S.C. § 544.

Are Crypto Withdrawals "Property" of the Debtor?

A threshold question in considering the application of these avoidance actions is whether cryptocurrency held on a crypto exchange platform is considered an "interest of the debtor in property." This question is crucial because if withdrawn crypto assets are not the debtor's property, then the transfer of those assets could not be avoided by the debtor (i.e., it was merely the return of a customer's own property that was not part of the debtor's property). As explained by the Supreme Court, "if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated."[10]

The answer to whether crypto assets are property of the debtor's estate is highly fact specific and may depend on a number of factors, such as the specific terms of the applicable customer agreement.[11] Among other factors, the outcome may be different depending on whether the crypto assets are held in trust for the customer or if the agreement provides for the transfer of ownership to the crypto exchange; whether the assets are commingled with the debtor's assets or can be readily traced and identified; and the debtor's control over such assets.[12] Additionally, because the Bankruptcy Code looks to state law to determine property rights, parties may look to applicable state law to determine whether the digital assets are excluded from the bankruptcy estate. This has been one of the key disputes in the pending crypto chapter 11 cases. By way of example, on January 4, 2023, the bankruptcy judge overseeing Celsius Network's chapter 11 case found that digital assets that account holders deposited into "Earn" program accounts were property of the debtor, basing the conclusion on the applicable terms of use.[13] In particular, the court found that the terms of use formed "a valid, enforceable contract" between Celsius and its account holders that "unambiguously transfer title and ownership of Earn assets deposited into Earn accounts from accounts holders to the debtors."[14] Conversely, the Celsius court previously entered an order after trial finding

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10 *Begier v. IRS*, 496 U.S. 53, 58 (1990).

11 *See* Sidney P. Levinson, *et al.*, *Recent Crypto Bankruptcy Filings May Provide Clarity to Critical Unresolved Questions*, Debevoise and Plimpton FinTech Blog (Jul. 13, 2022), https://www.debevoisefintechblog.com/2022/07/13/recent-crypto-bankruptcy-filings-may-provide-clarity-to-critical-unresolved-questions.

12 11 U.S.C. § 541(d) explicitly excludes from a debtor's bankruptcy estate any property in which a debtor holds only legal title and not an equitable interest, such as assets held by the debtor under trust, escrow, agency, or bailment arrangements. The Supreme Court has commented that Section 541(d) showed congressional intent to exclude property held by the debtor in trust at the time of the filing of the petition. United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.10 (1983).

13 Memorandum Opinion and Order Regarding Ownership of Earn Account Assets, *In re Celsius Network LLC et al.*, Case No. 22-10964 (MG) (Bankr. S.D.N.Y. Jan. 4, 2023), Docket No. 1822.

14 *Id.*

that digital assets in the Custody Wallets and certain Withhold Accounts were not property of the Debtors' estates under section 541 of the Bankruptcy Code.[15]

Does the Safe Harbor Provision Apply?

As is widely known, classification of cryptocurrencies and other digital assets is not only an existential question with big regulatory implications, but could also affect the availability of potential defenses to avoidance actions under the Bankruptcy Code. The Bankruptcy Code's securities safe harbor includes a provision that provides a defense to avoidance actions (both preference actions and constructive fraudulent transfer actions) for certain transactions involving securities contracts, securities or commodities.[16] Courts have explained that the rationale behind such safe harbor provisions is that "transactions made through these financial intermediaries promotes stability in their respective markets and ensures that otherwise avoidable transfers are made out in the open, reducing the risk that they were made to defraud creditors."[17] As previewed in a recent blog post, whether certain digital asset transactions could qualify for the safe harbor provisions and obtain a complete defense to such complaints is an unsettled question.[18]

In particular, section 546(e) of the Bankruptcy Code exempts a transfer from avoidance if, among other things, the transfer is either a "settlement payment"[19] or a "transfer . . . in connection with a securities contract,"[20] in each case "made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant."[21] A "financial participant" is defined by the Bankruptcy code as "an entity that . . . enter[ed] into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract . . . with the

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15 Order (I) Authorizing the Debtors to Reopen Withdrawals for Certain Customers With Respect to Certain Assets held in the Custody Program and Withhold Accounts and (II) Granting Related Relief, *In re Celsius Network LLC et al.*, Case No. 22-10964 (MG) Bankr. S.D.N.Y. Dec. 20, 2022), Docket No. 1767.

16 11 U.S.C. § 546(e).

17 *In re Quebecor World (USA) Inc*, 719 F.3d 94, 100 (2d Cir. 2013). *See* also *In re Tribune Company Fraudulent Conveyance* Litigation, 946 F.3d 66, 81 (2d Cir. 2019)(noting "Congress's intent to 'minimiz[e] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries'").

18 *See also* Andrew Bab, *et al.*, *FTX Collapse Causes SEC to Request Additional Crypto Asset Disclosures*, Debevoise and Plimpton FinTech Blog (Dec. 12, 2022), https://www.debevoisefintechblog.com/2022/12/12/ftx-collapse-causes-sec-to-request-additional-crypto-asset-disclosures/

19 Section 741(8) of the Bankruptcy Code defines "settlement payment" as 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."

20 Section 741(7) of the Bankruptcy Code defines a "securities contract" as a "contract for the purchase, sale, or loan of a security . . . including any repurchase or reverse repurchase transaction on any such security."

21 11 U.S.C. § 546(e).

debtor or any other entity (other than an affiliate) [for a certain qualifying amount]."[22] Although drafted in very technical defined terms, courts have consistently interpreted these provisions broadly.[23] By way of example, payments to creditors to redeem notes have been found to be "settlement payments" and protected by section 546(e) because they are "the transfer of cash or securities made to complete [a] securities transaction."[24] If crypto and other digital assets are classified as securities, then the associated contracts could constitute "securities contracts" or "settlement payments" and the securities safe harbor provision may apply, protecting certain prepetition transfers of digital assets to customers under such agreements from being clawed back.

Similarly, Section 546(g) of the Bankruptcy Code protects transfers made by or to a swap participant in connection with any swap agreement before the commencement of the bankruptcy case.[25] If classified as a currency, cryptocurrencies may be categorized as swap agreements, or contracts where parties exchange currency for another form of currency.[26]

On the other hand, if cryptocurrencies and other digital assets are classified as commodities, the analysis is less clear. While section 546(e) also protects payments made under a commodities contract, the Bankruptcy Code does not provide a bankruptcy-specific definition of commodity to determine the scope of a commodity contract. Rather, section 761(8) of the Bankruptcy Code incorporates the definition from the Commodities Exchange Act (the "CEA"), which lists specific examples of commodities but also includes "all services, rights, and interests . . . in which contracts

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22 11 U.S.C. § 101(22A)(A).

23 *See, e.g.*, *Picard v. Ida Fishman Revocable Trust (In re Bernard L. Madoff Inv. Sec. LLC),* 773 F.3d 411, 417-18 (2d Cir. 2013) (noting that "Section 741(7) . . . defines 'securities contract' with extraordinary breadth . . . [and] includes contracts for the purchase or sale of securities, as well as any agreements that are similar or related to contracts for the purchase or sale of securities."); *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011) ("Although our circuit has not yet addressed the scope of § 741(8)'s definition, other circuits have held it to be 'extremely broad'"). *See also In re Trib. Co. Fraudulent Conv. Litig.*, 946 F.3d 66, 92 (2d Cir. 2019) (noting the legislative purpose of Section 546(e) "reflected a larger purpose memorialized . . . in the broad statutory language defining the transactions covered.").

24 *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.,* 651 F.3d 329, 336 (2d Cir. 2011). *See also In re Bernard L. Madoff Investment Securities LLC,* 976 F.3d 184, 197 (2d Cir. 2020)("the statutory definition of a 'settlement payment' should be broadly construed to apply to 'the transfer of cash or securities made to complete a securities transaction.'"); *In re Boston Generating LLC*, 617 BR 442, 485 (Bankr. S.D.N.Y. 2020) ("Simply put, a transfer of cash to a financial institution made to repurchase and cancel securities—in other words, to complete a securities transaction—qualifies for the safe harbor as a settlement payment.").

25 11 U.S.C. § 546(g).

26 *See* 11 U.S.C. § 101(53B); Josephine Shawver, *Commodity or Currency: Cryptocurrency Valuation in Bankruptcy and the Trustee's Recovery Powers*, 62 B.C. L. Rev. 2013, 2039 (2021); Christopher Donnelly, *Commodity or Currency: Interpreting U.S. Bankruptcy Courts and Code Approach to Cryptocurrency Classification*, DCLJ (Apr. 1, 2022) https://djcl.org/commodity-or-currency-interpreting-u-s-bankruptcy-courts-and-code-approach-to-cryptocurrency-classification.

for future delivery are presently or in the future dealt in."[27] Certain non-bankruptcy courts have accepted arguments that cryptocurrency may be a commodity under the logic that a cryptocurrency is an "interest" in which futures are or can be "dealt in," but the law is still unsettled how to interpret the definition.[28] Likewise, the CFTC has publicly asserted that digital assets fall within the CEA's definition.[29]

In short, the critical question of whether to classify digital assets as securities, commodities, currencies, or something else, could have a material effect on the applicability of these safe harbor defenses to protect against potential avoidance actions by debtors.[30]

Transfer Dates and Smart Contracts

Another open issue for avoidable preferences is how transactions involving smart contracts might be treated differently for purposes of determining the applicable transfer date.[31] As discussed above, a trustee may avoid transfers made within certain specific time periods. Under the Bankruptcy Code, the date of a transfer is rarely in dispute because for ordinary contracts or negotiable instruments such as checks, courts generally hold that transfer does not occur until the property at issue is actually transferred, under the logic that a number of potentially superseding actions that could occur before transfer.[32] However, there is uncertainty whether a payment made pursuant to a smart contract prior to a bankruptcy filing is deemed made at the time that the smart contract was entered into or at the time at which property was received.

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27 7 USC § 1a(9).

28 *See, e.g., In Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 496 (D. Mass. 2018) (finding that because contracts for future delivery of virtual currency are "dealt in," then a virtual currency is a commodity); *Commodity Futures Trading Comm'n v. McDonnell*, 287 F. Supp. 3d 213, 228 (E.D.N.Y 2018) (finding that virtual currencies fall within the common definition of "commodity" by focusing on the phrase "all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in.").

29 *See Introduction to Virtual Currency*, CFTC, https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_aivc0218.pdf (asserting that "Virtual currencies have been determined to be commodities under the Commodity Exchange Act.").

30 It is worth noting that the *Lummis-Gillibrand Responsible Financial Innovation Act* proposes to incorporate digital assets into the Commodities Exchange Act and add digital assets to the definition of "commodity contract" in Section 761 of the Bankruptcy Code and certain other related defined terms.

31 While not the focus of this article, smart contracts also present several other novel bankruptcy issues, including whether smart contracts can be rejected by the debtor and whether self-executing nature of a smart contract could be a violation of the automatic stay.

32 *Barnhill v. Johnson*, 503 U.S. 393, 399 (1992) (holding that transfer made by check is deemed to occur on date check is honored because "Myriad events can intervene between delivery and presentment of the check that would result in the check being dishonored.").

As a result, parties may seek to argue that the date of entry into the smart contact is determinative and that date occurred prior to the applicable clawback time period.

This potential argument rests upon the self-executing nature of smart contracts. Smart contracts are "self-executing contracts with the terms of the agreement between [a] buyer and seller being directly written into lines of code."[33] Once a smart contract has been created, "computer transaction protocols will execute the terms of a contract automatically based on a set of conditions," or a triggering event, agreed upon by the parties.[34] A smart contract therefore cannot be changed, and unlike ordinary contracts, any transfer of cryptocurrency can occur automatically in accordance with the smart contract's terms without the need for any additional action (unlike a check).[35] Accordingly, it is possible that the applicable transfer of assets under a smart contract out of the debtor's estate occurred at the time that the smart contract was entered into. An argument could be made that smart contracts should be viewed similarly to an escrow account. While it is fact specific based on the applicable escrow agreement, certain courts have held in the context of an escrow account, that money placed into an escrow account is not property of the debtor's estate.[36] Following that logic for smart contracts, the relevant date of transfer for avoidance actions would be the date that property was transferred from the debtor *into* the smart contract, rather than the date that property was released *from* the smart contract.

Conclusion

Much like many other intersections of bankruptcy law and crypto, there are many novel issues that courts will need to address. As a result, this area of the law is unsettled, and because the Bankruptcy Code does not provide bankruptcy-specific definitions for currency or commodity, affected parties cannot look solely to bankruptcy courts to

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[33] *Rensel v. Centra Tech Inc.*, 2018 WL 4410110, at *10 (S.D. Fla. June 14, 2018) (citing Tsui S. Ng, *Blockchain and Beyond: Smart Contracts*, Bus. L. Today, Sept. 2017.).

[34] *Id. See also* Alan Rosenberg, *Automatic Contracts and the Automatic Stay*, Am. Bankr. Inst. J., Jul. 2019. To do this, smart contracts use "oracles" that are mutually-agreed-upon real-time data providers used to confirm the occurrence of a triggering events. *Id.*

[35] Matthew N.O. Sadiku, Kelechi G. Eze, and Sarhan M. *Musa, Smart Contracts: A Primer*, 5 J. of Scien. & Eng. Res 538, 539 (2018).

[36] *See e.g.*, *Matter of TTS, Inc.*, 158 B.R. 583, 587 (D. Del. 1993) (holding that money in an escrow account was not property of the debtor's estate); *Matter of O.P.M. Leasing Servs., Inc.*, 46 B.R. 661, 668 (Bankr. S.D.N.Y. 1985) (holding that the transfer by an escrow agent to creditor within the 90–day preference period did not constitute a preferential transfer because the property was not within the control of the debtor once the property was deposited).

resolve the issue.[37] Further complicating matters is the lack of consistency amongst regulators on how to classify cryptocurrency and other digital assets.[38] As it stands now, those involved in these pending crypto bankruptcies have the ability to raise additional novel defenses in response to an avoidance action, in addition to the traditional defenses.

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[37] Josephine Shawver, *Commodity or Currency: Cryptocurrency Valuation in Bankruptcy and the Trustee's Recovery Powers*, 62 B.C. L. Rev. 2013, 2016-2017 (2021) ("The Code does not provide bankruptcy-specific definitions for currency or commodity, so bankruptcy courts must look elsewhere for an answer.'").

[38] *See e.g.*, *Introduction to Virtual Currency*, CFTC, available at https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_aivc0218.pdf (asserting that "Virtual currencies have been determined to be commodities under the Commodity Exchange Act."); *Framework for "Investment Contract" Analysis of Digital Assets*, SEC, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets; Statement of SEC Chair Gary Gensler, *Kennedy and Crypto* (Sept. 8, 2022), https://www.sec.gov/news/speech/gensler-sec-speaks-090822. On the other hand, the IRS treats cryptocurrency as property for tax purposes. *See* I.R.S. Notice 2014–21, IRS Virtual Currency Guidance, available at: https://www.irs.gov/irb/2014-16_IRB#NOT-2014-21.