ARTICLE IV

CRYPTO BANKRUPTCIES REVEAL FAULT LINES IN ASSET RECOVERY

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INTRODUCTION*

The crypto industry contains a wide variety of institutions and business models, including centralized and decentralized exchanges, hedge funds, brokers, decentralized autonomous organizations (DAOs), and bank-like entities.

Some are close analogues of traditional financial institutions, while others are altogether novel. As crypto prices plummeted in the first half of 2022, several centralized crypto institutions experienced financial distress, and their customers faced uncertainty about how asset recovery may occur in the event of bankruptcy.

This issue came into sharp relief as Celsius Network LLC, a company that offered customers interest-bearing crypto accounts, froze customer assets and filed for bankruptcy in July.

Celsius customers quickly discovered that their assets do not have the same level of protection expected of traditional financial institutions despite some similarities in products and services.

More recently, while the precipitating circumstances vary, the customers of crypto exchanges FTX and BlockFi find themselves in a similar predicament as the two entities froze customer assets and filed for bankruptcy in November.

In this article, we compare the protections customers are afforded in traditional U.S. financial institutions to those provided by similar institutions in the crypto space. We then discuss how asset recovery protections in the crypto ecosystem may evolve.

* The views expressed are the authors' and do not necessarily represent the views of their respective firms.

ASSET PROTECTION AT TRADITIONAL FINANCE INSTITUTIONS VERSUS CRYPTO BUSINESSES

Banks in the United States are generally considered safe and well-regulated places to keep savings. The U.S. has a dual banking system, with banks chartered either at the national level by the Office of the Comptroller of the Currency (OCC) or a state regulator. Bank holding companies and state-chartered Federal Reserve member banks are federally regulated by the Federal Reserve, and state-chartered banks that are not Federal Reserve members are federally regulated by the Federal Deposit Insurance Corporation (FDIC).

Banks are subject to comprehensive prudential supervision, including with respect to their capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (the so-called "CAMELS"), as well as how they meet the needs of borrowers in their communities (e.g., under the Community Reinvestment Act).

If a bank fails due to an inability to meet obligations to depositors, the FDIC – established by the Glass-Steagall Act in 1933– steps in to ensure depositors get prompt access to their insured deposits.

Prior to Glass-Steagall, bank failures and bank runs were quite common. These days, in the event of a bank failure (the most recent wave of which came in the wake of the 2008 financial crisis), the FDIC acts in two capacities: as an insurer and a receiver.

As the "insurer" of a bank's deposits, the FDIC will, as a matter of last resort, pay deposit insurance to the depositors up to the insurance limit (although in most bank failures the FDIC usually arranges for a healthier financial institution to assume all of the deposits of the failed bank and frequently its assets as well, albeit subject to FDIC loss-sharing).

FDIC deposit insurance covers the balance of each depositor's account, dollar-for-dollar, up to the insurance limit (the standard amount being $250,000 per depositor), including principal and any accrued interest through the date of the insured bank's closing.

As the "receiver" of the failed bank, the FDIC assumes the task of collecting and selling the failed bank's assets and settling its debts, including claims for deposits in excess of the insured limit.

Meanwhile, assets held by broker-dealers – such as E-Trade, Vanguard, and TD Ameritrade – are covered by the Securities Investor Protection Act (SIPA). Aimed at protecting cash, investor funds, and most types of securities in the event of the failure of their broker, SIPA in 1970 established the Securities Investor Protection Corporation (SIPC), a federally mandated, member-funded nonprofit whose purpose is to expedite the recovery and return of customer assets during the liquidation of a failed broker-dealer.

SIPC provides protection up to $500,000, which includes a $250,000 limit for cash. SIPC only protects the custody function of the broker-dealer, meaning that SIPC works to restore to customers their securities and cash in their accounts with the brokerage when the firm liquidation begins. SIPC does not protect against the decline in value of securities or losses due to a broker's investment advice or recommendations.

These protections afforded to bank deposits and customer accounts at broker-dealers do not currently extend to assets held or custodied with centralized crypto institutions such as Celsius, which as a general matter do not have bank charters and are not operating as broker-dealers. While some centralized cryptoasset exchanges and custodians are subject to prudential supervision under state law (such as New York's "BitLicense" regime), their regulation is often limited to money transmittal licensure with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).

Traditionally, money transmitters – also known as money service businesses (MSBs) – are services that help individuals and businesses pay bills, make online purchases, and remit money to friends and family. Any business that issues money orders, traveler's checks, or other types of monetary value can be classified as an MSB; payment services like Square, Venmo, and PayPal are familiar examples.

Unlike banks and broker-dealers, money transmitters are largely regulated at the individual state level, and they operate without insurance protection like that of the FDIC or SIPC (although customer funds may have the benefit of FDIC insurance by virtue of arrangements established by a money transmitter with a bank). Many states require MSBs to post surety bonds – essentially a fixed guaranty amount by a third party – of varying amounts against defaults on an obligation in the event of insolvency, but even where in place, this protection may provide inadequate coverage to retail customers in the event of an insolvency.

FIGURE 1: ASSET PROTECTION WITH TRADITIONAL FINANCIAL INSTITUTIONS

	Banks	Broker-Dealers	Money Transmitters
Protection	Deposit insured by FDIC (federal government)	Brokerage account insured by SIPC	Surety bonds – varying amounts
Level of protection	$250,000	$500,000	Depends on state law
When funds become available after a failure	Usually no disruption	Usually 30 to 60 days	Varies widely by state

Sources: Pew Trusts, SIPC, Federal Reserve Board, SEC

WHAT HAPPENS WHEN A CRYPTO INSTITUTION GOES BANKRUPT?

Because crypto institutions are not protected by insurance like that of the FDIC or SIPC, recovery of customer assets in the event of bankruptcy will in most cases be administered – at least in part – in bankruptcy proceedings, with customers potentially having the status of unsecured creditors.

A look at the business models and recent bankruptcies of centralized cryptoasset lenders illustrates the fragile asset protections for customers of such institutions, and highlights the need for customers to proceed with care before determining to either lend to or use these centralized services to custody their cryptoassets.

Crypto Lenders

Among the many innovations accompanying the growth of "Decentralized Finance" (DeFi) in recent years is the emergence of centralized crypto lenders such as Celsius, which have offered remarkably high interest rates on deposits – in many cases, up to 20% annually.[1]

The business model for these lenders at a surface level resembles that of traditional banking. The provider accepts customers' deposited cryptoassets, offers a return, and rehypothecates the deposited cryptoassets, either lending them to borrowers at a higher rate or themselves participating in DeFi yield strategies.

1 Customer protections, associated with decentralized cryptoasset lending platforms are beyond the scope of this article.

Predictably, when the cryptoasset market crashed, this business model came under tremendous pressure, which was exacerbated by lacking prudential oversight.

As shown in Figure 2, the assets locked up in crypto lending protocols, such as Aave, Maker, and Compound, grew from essentially zero in 2020 to $50 billion by April 2022, at which point the market experienced a pronounced crash.

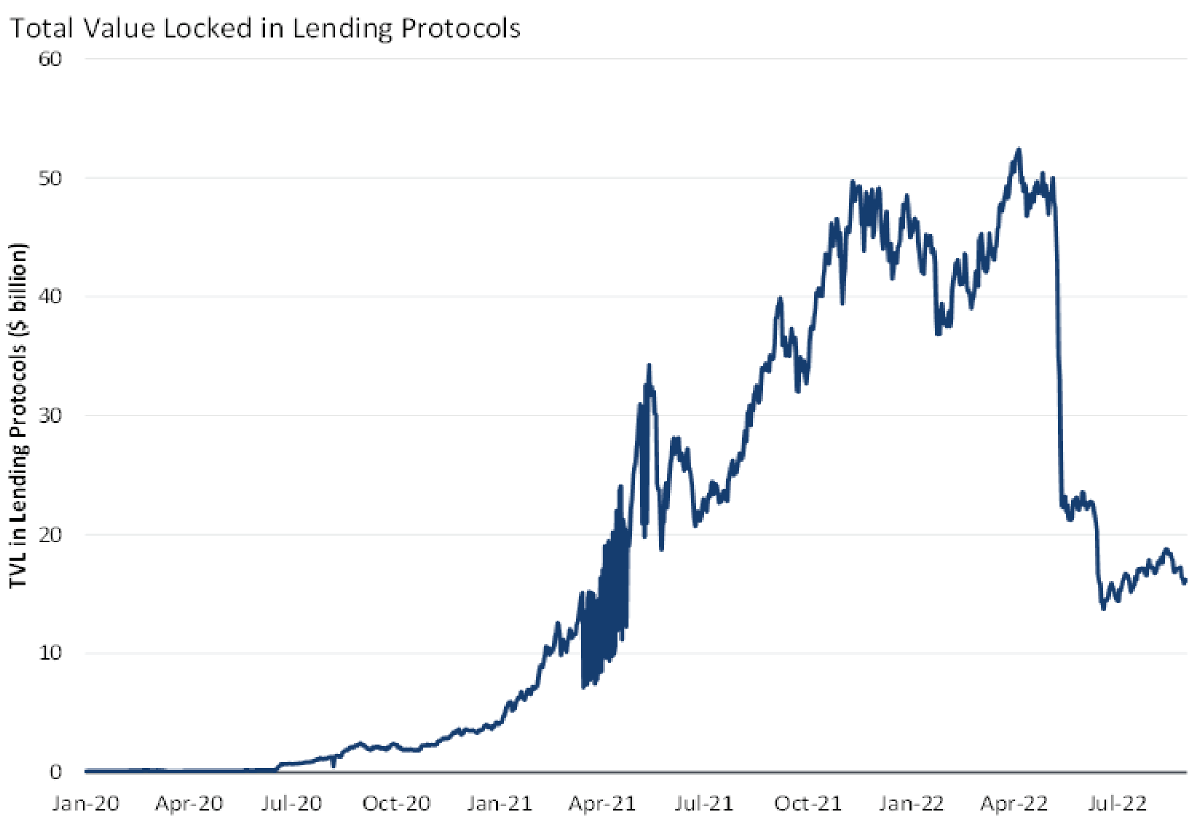
Despite having facial similarities to traditional banking, crypto lending platforms are not regulated like traditional banks and can engage in a variety of return-seeking strategies (such as highly concentrated lending to a small number of counterparties) that are unavailable to traditional brick and mortar banks, including by not having to abide by CAMELS requirements imposed by banking regulation.

Prominent among these is the lending platform Celsius that declared bankruptcy on July 14, 2022, shortly after freezing all customer assets and blocking withdrawals.

Celsius described itself as "a platform of curated services that have been abandoned by big banks – things like fair yield, zero fees, and lightning quick transactions."[2] Essentially, customers would deposit their crypto assets on the platform, and Celsius would deploy those assets to various return strategies, promising yields as high as 17%.

Unlike a bank deposit, however, Celsius described in its terms of service that customer deposits are controlled by Celsius and, in essence, a loan to Celsius.[3] Celsius aimed to generate those returns through institutional lending (to exchanges, hedge funds, and other counterparties), retail lending (allowing customers to borrow stablecoins, which are digital assets pegged to "stable" reference assets, like the U.S. dollar), "yield farming" through which crypto investors earn yield by lending and "staking" (i.e., locking up through a smart contract) crypto for interest and other rewards, deploying crypto in decentralized finance protocols, cryptoasset mining, and proprietary hedge fund-like trading strategies.

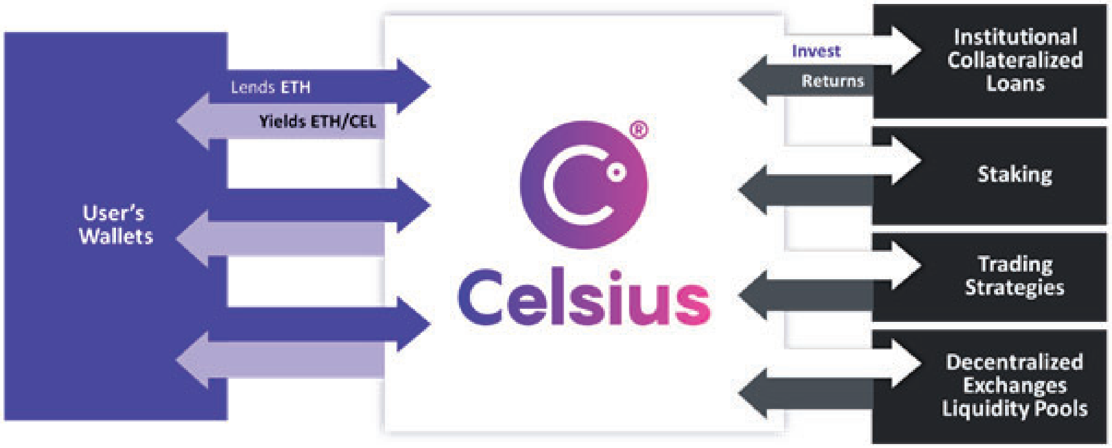
FIGURE 2: DEPOSITS AT CRYPTO LENDERS (2020 – 2022)



2 FT. (2022, June 13). Celsius/cryptos: heat is on. Retrieved from Financial Times: https://www.ft.com/content/98a250fa-bebb-4269-97fe-605be597b2e7

3 Celsius. (2022, April 14). Terms of Use. Retrieved from Celsius: https://celsius.network/terms-of-use

FIGURE 3: CELSIUS BUSINESS MODEL



Celsius also sold a native token, CEL, and promised a higher yield to customers if they accepted the yield in CEL. Celsius also offered a plain vanilla wallet function whereby customers could simply store their digital assets, not receive yield. Unfortunately for these customers, Celsius evidently commingled custodial assets with assets that were lent to them, and apparently did not establish legal arrangements to insulate custodial assets from being reachable by Celsius's general creditors.

This year's sharp decline in the price of crypto assets frankly blew up Celsius's model. As cryptocurrency prices plummeted, Celsius suffered from trading losses, liquidations, major counterparty failures, and losses on under-collateralized loans, among other issues.[4] When it reached the point where it was unable to meet obligations, on June 13 Celsius froze withdrawals. According to its bankruptcy filing, Celsius owes its customers more than $4.7 billion.[5]

As noted, Celsius is neither a bank nor broker-dealer despite having a business model sharing some attributes of both, which means its customers do not have the benefit of FDIC or SIPC insurance or the receiver/trustee role the FDIC and SIPC can play in a liquidation. The treatment of depositors in the Celsius bankruptcy case ultimately depends on the outcome of pending litigation.

If Celsius depositors are treated as unsecured creditors or investors, they will not receive preference treatment in the liquidation, which would prioritize their claims over other Celsius creditors. Among many issues likely to be considered by the court is the extent to which depositors' funds were commingled with those of Celsius and the interpretation of the terms of service agreed to by customers.

Crypto exchanges

Centralized cryptocurrency exchanges – probably the most widely familiar type of crypto institution – are platforms for custodying and trading cryptocurrency that operate 24 hours a day, seven days a week. There are hundreds of exchanges globally, with some of the more well-known in the U.S. including Coinbase, Kraken, and Gemini. These exchanges offer a simple custodial wallet function allowing customers to trade one cryptocurrency for another – e.g., Bitcoin for Ether – or to buy crypto using U.S. dollars.

Customers can also maintain dollar-denominated or stablecoin-denominated balances. Customers deposit their fiat and crypto assets directly with crypto exchanges, which take custodial control of the assets.

Crypto exchanges operating in the U.S. are commonly registered as money transmitters. This means that, in order to operate, they have registered individually with each of the states in which they have customers. Crypto exchanges are not registered as broker-dealers at present, despite some similarities in function, and they are not registered as banks.

4 Arkham, "Report on the Celsius Network" (July 7, 2022), https://www.arkhamintelligence.com/reports/celsius-report

5 Atkins, J. (2022, July 19). Celsius owes $4.7B to customers as the first bankruptcy hearing takes place. Retrieved from Coingeek: https://coingeek.com/celsius-owes-4-7b-to-customers-as-first-bankruptcy-hearing-takes-place/

Thus, customer assets are not protected by SIPC or FDIC insurance (although, as noted earlier, some cryptoasset exchanges are subject to state-level prudential supervision; for instance, Coinbase and Gemini each have a New York "BitLicense").

Coinbase created a stir when, pursuant to a Staff Accounting Bulletin promulgated by the Securities and Exchange Commission (SEC),[6] it noted in its Q1 2022 Form 10-Q that customers with assets on the exchange would be given similar treatment as general unsecured creditors in the event of a bankruptcy:

Moreover, because custodially held crypto assets may be considered to be the property of a bankruptcy estate, in the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors.[7]

If the past is any indication, customers of bankrupt crypto exchanges are likely to face a frustrating and lengthy process for customers seeking asset recovery. Mt. Gox, once the largest crypto exchange in the world, filed for bankruptcy after a hack in 2014 resulted in the theft of 850,000 Bitcoins – now worth billions of dollars. Eight years later, Mt. Gox's creditors have yet to receive any recovery of the lost funds. The bankruptcy process is still ongoing, and there are signs that creditors may receive some form of recovery, but the timing remains unclear, as does the amount or form of any recovery (i.e., U.S. dollars or Bitcoin).[8]

6 https://www.sec.gov/oca/staff-accounting-bulletin-121

7 Coinbase Global, Inc., SEC Form 10-Q, March 31, 2022, p. 83

8 Kharif, O. (2022, July 7). Mt. Gox Creditors Inch Closer to Repayment as Bitcoin Dump Looms. Retrieved from Bloomberg: https://www.bloomberg.com/news/articles/2022-07-07/mt-gox-creditors-inch-closer-to-repayment-as-bitcoin-dump-looms

HOW ASSET RECOVERY IN THE CRYPTO ECOSYSTEM MAY EVOLVE

In its Staff Accounting Bulletin No. 121, released on April 11, 2022, the SEC noted that the lack of legal precedent and regulatory protections means that the treatment of arrangements between customers and crypto platforms will be decided in court proceedings. SEC Chief Gary Gensler echoed this at the 2022 Annual FINRA Conference in May, saying of crypto lending platforms, "The investing public is not that well protected. If the platform goes down, guess what? You just have a counterparty relationship with the platform. Get in line in bankruptcy court."[9]

After years of inaction from regulators, legislators, and litigators alike, the crypto landscape appears to be at an inflection point, with numerous items of proposed Federal legislation and intensified focus at the most senior levels of the U.S. government in the wake of President Biden's Executive Order of March 9, 2022 on "Ensuring Responsible Development of Digital Assets."

Based on the bitter experience of Celsius and its ilk, it seems clear that customers would greatly benefit from companies that hold cryptoassets for customers clearly stating the capacity in which it holds the assets — whether as principal (meaning the customer is an unsecured creditor); as regulated custodian (whereby the assets are held by a regulated financial institution responsible for safekeeping); or in an unregulated intermediary capacity, as governed by contract law.

In the first scenario, the customer is fully exposed to default risk—which poses consumer protection concerns, and depending on the facts, could require a cryptoasset lender to register its offerings as securities with the SEC—but at least the customers understand the risk at the outset.

9 Stein, Philip R. (2022, May 27). Crypto Companies, Investors Await Looming Regulations and Litigation Resolutions. Retrieved from JD Supra: https://www.jdsupra.com/legalnews/crypto-companies-investors-await-1522030/

In the second scenario, the custodied assets belong to the customer under existing regulations, and the custodian must comply with rigorous requirements for regulated custodians, such as the Investment Advisers Act of 1940 or applicable banking laws and regulations.

The third scenario presents a current gap in the law. One means of closing it would be the adoption of proposed amendments to the Uniform Commercial Code (UCC) related to digital assets to separate retail investor assets from bankruptcy estate assets, thereby preventing the commingling of assets deposited for purely custodial purposes with assets deposited through a yield-bearing product. The proposed amendments clarify that a customer retains ownership of cryptoassets held by a securities intermediary, such as an unregulated custodian (subject to satisfaction of certain requirements), even in the event of the intermediary's insolvency.

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The mantra "not your keys, not your coins" is often heard in cryptoasset space, meaning that irrespective of beneficial ownership, whoever holds the cryptographic keys that control the digital assets actually have control of the assets. However, self-custody remains a challenging task for many rank and file users. As a matter of public benefit, as well as preserving the integrity of markets and avoiding contagion in a downturn scenario, customers should be able to custody their cryptoassets with third party professionals with a clear understanding of their legal rights in a scenario of counterparty distress. Industry and customers alike must internalize the lessons of recent experience if crypto markets are to thrive going forward.

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