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What A Crypto Exchange Bankruptcy Filing Could Look Like

By **Darren Azman and Gregg Steinman** (May 27, 2022, 3:40 PM EDT)

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To date, no cryptocurrency exchange in the U.S. has sought bankruptcy relief.[1]

As cryptocurrency prices fall to some of the lowest levels since 2020, however, there is growing concern regarding how customers of cryptocurrency exchanges will be treated if an exchange commences bankruptcy proceedings. Namely, whether customers' crypto-assets constitute property of the bankruptcy estate.

If the answer is yes, then customers will not be entitled to the return of their crypto-assets. Instead, all customers — and other unsecured creditors — will share pro rata in whatever assets remain at the exchange.

This article addresses these issues and provides a general discussion regarding how customers can take proactive measures to protect their assets.

Can a cryptocurrency exchange qualify as a debtor under the Bankruptcy Code?

There is an open question as to whether cryptocurrency exchanges qualify for bankruptcy under Title 11 of the U.S. Bankruptcy Code. Section 109 of the Bankruptcy Code governs who may be a debtor and contains specific exclusions, including commodities brokers and banking institutions, except uninsured state member banks or corporations organized under Section 25A of the Federal Reserve Act.[2]

Although cryptocurrency exchanges do not fall within the traditional regulatory frameworks for a bank, an argument can be made that cryptocurrency exchanges constitute banks because of their designation as a financial institution under the Bank Secrecy Act. Moreover, certain cryptocurrency exchanges with trust charters take the position that they are a bank under applicable state banking regulations.

Exchanges likely do not constitute commodities brokers, which are defined as an entity that is in the business of engaging in leverage transaction subject to regulation under Section 19 of the Commodity Exchange Act.[3] For these reasons, it cannot be said with certainty that a cryptocurrency exchange is eligible to be a debtor in bankruptcy. For purposes of this article, however, we will assume that exchanges can seek bankruptcy relief in the U.S.

Are customer crypto-assets property of the bankruptcy estate?

Section 541 of the Bankruptcy Code defines the scope of property of the bankruptcy estate as "all legal or equitable interests of the debtor in property as of the commencement of the case. ... wherever located and by whomever held."[4] Courts have emphasized

That Section 541(a) was intended to sweep broadly to include all kinds of property, including tangible or intangible property ... The term "property" has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.[5]

One of the key components of whether customer assets purchased through a cryptocurrency exchange constitutes property of the estate is whether the assets are custodially held.

At a high level, custodially held assets are assets held by a cryptocurrency exchange for the benefit of customers. Meaning that when a customer purchases cryptocurrency on the exchange, the cryptocurrency amount and value is reflected in the customer's wallet, but the asset itself is actually being held in a common pool of assets that may include the exchange's own assets and assets of other customers.

Provided that the terms of service, or user agreements, of cryptocurrency exchanges are readily available, such documents may provide guidance as to whether assets are custodially held. Generally, these terms will include language stating that the assets are being held for the customers' benefit, but that the assets are not segregated — and the exchange has no obligation to segregate — from other customer assets or the exchange's assets.

Additional terms that indicate custodially held assets may include that the exchange maintains control over the private keys associated with wallet addresses. And although the terms may state that legal title to the assets remains with the customer, if the assets are not segregated, then they likely constitute custodially held assets.

For example, cryptocurrency exchange FTX's terms of service state that title to digital assets in customer accounts remain with the customer, but the balances in those accounts are not segregated and instead are held in shared addresses or accounts.[6] Cryptocurrency exchange Gemini Trust Co. LLC's user agreement states that customers using depository accounts are pooled together in one or more of Gemini's digital asset wallets.[7]

Accordingly, although these exchanges acknowledge that customers have title and some form of control over assets in their accounts, the exchange itself has a possessory right to the assets and the right to move, pool and even use the assets pursuant to terms agreed to by customers.

Indeed, it is likely that the majority of exchanges in the ordinary course of business maintain customer assets in commingled wallets and rely on an internal accounting ledger to reconcile customer assets. For these reasons, a court may conclude that custodially held customer assets may fall within the broad scope of property of the bankruptcy estate.

What about assets in noncustodial wallets?

Exchanges have made the ability to purchase cryptocurrency simple and efficient, which has resulted in many retail customers entering the space. It is important for these customers understand the terms of service they are agreeing to, as well as the various programs that exchanges offer.

Specifically, many exchanges offer noncustodial wallet options. Assets in noncustodial wallets are segregated, and only the customer has access to the wallet and control over the assets. Moreover, customers are free to move assets from custodial wallets to noncustodial wallets outside of the exchange, including: (1) hot wallets, i.e., wallets connected to the internet) with providers such as MetaMask and MyEtherWallet Inc., (2) cold wallets, i.e., offline storage, and (3) warm wallets, i.e., wallets available through downloadable software that provide additional layers of security.

As a threshold matter, if the customer is truly the only person with the ability to access a noncustodial wallet within an exchange's ecosystem — not the exchange — then the analysis should stop there. If for any reason, however, the exchange could assert control over the assets, then the customer will likely have a colorable claim that those assets are not property of the estate because the exchange is holding the assets in trust.

Generally, assets that a debtor is holding in trust for a third party do not constitute property of the estate. That does not mean that these customers are free and clear. It is the customer's burden to establish that a trust relationship exists and the legal source — either statutory or common law — supporting the trust relationship.

The customer is also burdened with tracing the assets, which seems straightforward unless the assets have been commingled. Commingling is a serious obstacle to overcome.

If an exchange has access to a customer's assets and at any point commingles those assets with other assets — whether properly or improperly — the customer asserting a trust relationship must trace the assets in order to recover them. Because most cryptocurrency is fungible and does not contain unique characteristics, once cryptocurrency is commingled with other cryptocurrency it becomes very difficult — but not impossible — to trace.[8] This situation is not unique to cryptocurrency.

Take, for example, money held in a bank account that the debtor is holding in trust for a creditor. If the debtor wired additional funds into that account, it would not be possible to identify which specific dollar in the account was trust res or additional wired funds. To account for these situations, courts apply the lowest intermediate balance test.

Under the lowest intermediate balance test, if commingled collateral in an account has been reduced below the level of the initial transfer, but not depleted, then the claimant is entitled to the lowest intermediate balance in the account. Thus, even if a customer establishes a trust relationship and traces its assets to a specific account, the customer's ability to recover the assets in full will depend on the application of the lowest intermediate balance test.[9]

Conclusion

Because no cryptocurrency exchange has sought bankruptcy relief in the U.S., it is unclear how a bankruptcy court would characterize customer assets.

However, applying long-standing bankruptcy principles to the terms of service disclosed by exchanges demonstrates that there is a possibility that upon a bankruptcy filing, a cryptocurrency exchange's estate may encompass these assets. Notwithstanding that possibility, customers can take proactive measures to mitigate risk by ensuring that their assets are held in noncustodial wallets.

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[1] In 2014, the world's largest Bitcoin exchange, Mt. Gox, commenced bankruptcy proceedings in Japan.

[2] 11 U.S.C. § 109(d).

[3] There may be circumstances in which an exchange that offers certain services (e.g., leverage trading) may qualify as a commodities broker.

[4] 11 U.S.C. § 541(a).

[5] In re Majestic Star Casino, LLC, 716 F.3d 736, 750 (3d Cir. 2013) (citations omitted); see also In re Lee, 179 B.R. 149, 156 (9th Cir. B.A.P. 1995) (a debtor's interest in property includes "possession, custody, and control."); In re Street, 214 B.R. 779, 780 (Bankr. W.D. Penn. 1997) (stating that section 541 "defines property of the estate broadly enough to apply to a mere possessory interest in personal property").

[6] FTX Terms of Service, ¶ 6.

[7] Gemini User Agreement (Your Digital Assets).

[8] Certain exchanges, as well as other providers, have started to introduce nonfungible token (NFT) platforms. Tracing concerns would not impact NFTs because NFTs are easily identifiable in the event they are commingled with other assets in a wallet.

[9] This analysis is not intended to be exhaustive. A bankruptcy court may not find that a trust relationship exists in a cryptocurrency exchange case because by doing so would allow all customers to make the same argument. This would create an inequitable result wherein the customers are depleting a substantial amount of estate property.