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Legal Sidebar

Crypto Assets and Property of the Bankruptcy Estate: An Analysis

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As the effects of the recent sharp decline in cryptocurrency prices, or "crypto winter," spread to the dockets of bankruptcy courts, those courts face a novel legal question: Are crypto account holders' assets the property of the account holders themselves, or are they the property of a bankrupt crypto company? The answer to this question yields varying results based on case-specific facts and jurisdiction. For account holders, the determination can mean the difference between immediate access to funds or recovering pennies on the dollar, if anything at all.

This Legal Sidebar summarizes four sources of legal authority from which bankruptcy courts might draw when determining the ownership of crypto assets. First, it discusses the Bankruptcy Code's broad definition of property of the estate, along with the Code's exceptions. Second, the Sidebar examines Uniform Commercial Code Articles 8 and 9 and their effect on state property rights. Third, it considers how securities and commodities law offer a middle ground for the ownership question. Fourth, the Sidebar summarizes pending legislation on the issue.

The Bankruptcy Estate: Creation and Exceptions

A debtor's filing for bankruptcy brings into existence the bankruptcy estate under Section 541(a)(1) of the Bankruptcy Code. The bankruptcy estate is, with limited exceptions listed in subsections (b), (c), and (d) of Section 541, "comprised of the debtor's property as of the commencement of the case."

An asset's designation as part of the bankruptcy estate has several repercussions for the debtor and creditors. The debtor cannot use estate property as he or she sees fit. The automatic stay that takes effect upon a bankruptcy filing precludes creditors from trying to recover estate property to satisfy debts during the pendency of the bankruptcy. Those assets will be pooled with others to ensure the proper administration of the estate.

Given the largely unregulated nature of crypto assets, placement of crypto assets within the bankruptcy estate of a crypto company debtor would be troubling for crypto account holders. This difficulty would

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arise because crypto assets differ from traditional bank accounts or securities in that they are not backed or guaranteed by any governmental entities such as the Federal Deposit Insurance Corporation or the Securities Investor Protection Corporation (SIPC). Some practitioners have observed that without these protections, a court would likely determine that holders of crypto assets are unsecured creditors, a disadvantageous position that could leave them recovering "pennies on the dollar."

Despite this general rule, Section 541 contains numerous exceptions. Among the listed exceptions is Section 541(b)(1), which excludes from property of the estate any power that the debtor may exercise solely for the benefit of another. Similarly, Section 541(d) provides that the estate does not include "any power that the debtor may exercise solely for the benefit of an entity other than the debtor," including the power to distribute assets of a trust. The Supreme Court in *United States v. Whiting Pools, Inc.* commented in a footnote that "Congress plainly excluded [from Section 541(a)] property of others held by the debtor in trust at the time of the filing of the petition." The Seventh Circuit, in *In re Joliet-Will County Community Action Agency*, reached a similar conclusion that property held by the debtor as a custodian or other intermediary without beneficial ownership rights is not estate property. Whether these exceptions might encompass crypto assets held in an account with a crypto company debtor remains an open question.

Similarly, while Section 541(a)(1) broadly states that the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case," the Bankruptcy Code leaves unanswered the fundamental question of what qualifies as a property interest of the debtor. To answer that question, federal courts normally look to state law, although the Supreme Court has several times noted the possibility of a "federal interest" that would stand in the place of state law. Neither the Supreme Court nor any federal court of appeals has yet identified such an interest, however.

The Uniform Commercial Code: On the Precipice of Change

Another source of uncertainty comes from the Uniform Commercial Code (UCC), a collection of standardized laws that apply to most commercial transactions under state law. All 50 states have adopted Article 8 (Investment Securities) and Article 9 (Secured Transactions) of the UCC.

Article 8 contains guidance regarding securities intermediaries and the ownership interest of a customer whose assets are held by a securities intermediary such as an exchange. Section 8-503(a) provides that a customer with a financial asset on an exchange retains ownership of that asset (not the exchange) if (1) the exchange is a securities intermediary; (2) the securities intermediary has agreed with the customer to treat the asset as a financial asset; and (3) the securities intermediary has credited the financial asset in a securities account. This retention of ownership prevails even if the securities intermediary holds the financial assets in fungible, or commingled, form. Some practitioners have observed that while Article 8 dictates property rights for securities intermediaries, the UCC does not deem digital exchanges as falling under that definition, though the exchanges "resemble" one another.

Article 9 governs security interests in both tangible and intangible assets and provides a framework for perfecting a security interest. It divides property into several categories, though applying crypto assets to any of them may prove difficult. Cryptocurrency does not readily fit into the categories of "money," "general intangible," "deposit account," or "financial asset."

In July 2021, however, the sponsors of the UCC approved amendments geared toward cryptocurrencies. A proposed Article 12 addresses "controllable electronic records," or intangible digital assets that have the characteristics enabling them to be subject to control, and thus, perfected. This definition includes digital assets, and was crafted to encompass future digital assets. Under this article, a party might perfect a security interest in controllable electronic records—that is, ensure that no other party has rights to an asset—by obtaining "control" of such records. A revised Article 9 would allow a party to perfect a

security interest in certain controllable electronic records. In perfecting a security interest in crypto assets, creditors would find themselves at the front of the line of priority in a Chapter 11 bankruptcy.

The Unpredictability of State Law

A bankruptcy court faces a winding path on its way to deciding the property-of-the-estate question. First, the court must resolve a choice-of-law question on the debtor's property interests, i.e., whether state or federal law applies to determine what is property of the estate. As noted above, neither the Supreme Court nor the federal courts of appeals have yet articulated what would constitute an adequate "federal interest."

Having resolved the choice-of-law question, and assuming that state law will govern, a bankruptcy court may next need to address a conflict-of-law question to determine which state's law will apply. States have varying laws on crypto assets. Determining which of them governs may prove particularly burdensome in the crypto sphere. Crypto assets are, by their nature, decentralized, although they are increasingly transacted through exchanges. In many instances, however, crypto customers and a crypto company will have a choice of law provision in their contract. This would streamline a court's legal analysis.

Courts' reliance on state law to determine property rights means that any bankruptcy court's determination whether a crypto company's assets are property of the estate will not necessarily predict how a different court would rule. For these reasons, a crypto asset's status vis-a-vis the bankruptcy estate will be a case-by-case determination. For instance, the crypto lender Celsius Network LLC has contended that assets in its "Earn and Borrow" program are estate property as part of a motion seeking authorization to withhold accounts in its bankruptcy case in the U.S. Bankruptcy Court for the Southern District of New York. The court is scheduled to hold a hearing on that motion in early October.

Customer Property: A Commodities- and Securities-Based Alternative

Section 541 of the Bankruptcy Code broadly defines property of the estate. State law, and even the terms of contracts for crypto exchanges, could carve crypto assets out of that broad definition. A middle ground exists through securities and commodities law.

The Securities Investor Protection Act (SIPA) empowers the Securities Investor Protection Corporation, upon identifying a failing or failed securities broker, to seek a protective order from a court. The court appoints a liquidating trustee and refers the SIPA liquidation case to bankruptcy court. During a SIPA liquidation, the trustee is "vested with the same powers and title with respect to the debtor and the property of the debtor . . . as a trustee in a case under title 11 [of the Bankruptcy Code]."

The trustee administers two separate estates during a SIPA liquidation. The first is a general estate consisting of property of the estate as defined in Section 541(a). The second estate consists of "customer property" that takes priority over the general estate. If the debtor's assets are insufficient to compensate customers for their losses, SIPA provides for the SIPC to draw money from a special fund capitalized by the general brokerage community (SIPA Advance).

As to commodities, Chapter 7, Subchapter IV of the Bankruptcy Code (codified at 11 U.S.C. §§ 1161-1167) as well as Part 190 regulations issued by the Commodity Futures Trading Commission (CFTC) apply to the bankruptcies of commodity brokers. These laws provide for a trustee to distribute customer property ratably to customers in priority over nearly all other claims. Unlike with SIPA, neither Subchapter IV nor the CFTC regulations provide for an additional advancing of funds.

Whether crypto assets are properly designated as securities or commodities has become a topic of considerable public debate. The SEC Chair and the CFTC Commissioner have issued competing statements about which regime governs, as have a number of other commentators.

Pending Legislation: An Emphasis on Commodities

In the current Congress, there are several pending bills concerning cryptocurrencies. Section 407 of S. 4536, the Lummis-Gillibrand Responsible Financial Innovation Act, covers the "Bankruptcy Treatment of Digital Assets." This provision proposes to incorporate crypto assets—here, "digital assets"—into the Commodities Exchange Act and to add a "registered digital asset exchange" to the definition of "Commodity Broker" in Section 101(6) of the Bankruptcy Code. The bill also would amend Chapter 7, Subchapter IV, of the Bankruptcy Code by adding digital assets to 11 U.S.C. § 761, which provides definitions for the Subchapter, and to Section 766, which governs the handling of customer property.

Another piece of pending legislation is H.R. 7614, the Digital Commodity Exchange Act of 2022. This bill also falls on the side of defining crypto assets as commodities. The bill expressly designates registered crypto exchanges as futures commissions merchants under Chapter 7, Subtitle IV.

Key Takeaways

The treatment to be given crypto assets in bankruptcies remains in flux as Congress, regulators, and state legislatures weigh in on that question and the broader issue of whether and how to regulate the crypto industry. The terms of the contracts between crypto companies and account holders also may dictate the account holders' rights in bankruptcy. The scope of those contract rights may flow from a combination of choice-of-law provisions and the governing state law selected by the parties, as well as express terms regarding the ownership of assets. For instance, if the terms of an agreement expressly establish a trust, then crypto account holders likely would have an argument under the Supreme Court's decision in *Whiting Pools, Inc.* that their property is not part of the debtor's estate. As noted above, this determination will vary from contract to contract and make bankruptcy court rulings difficult to predict.

Proposed UCC Article 12 and amended Article 9, if adopted by all 50 states, would bestow account holders with an additional means of safeguarding their assets. These amendments would not, however, automatically give them secured status as creditors; account holders would first need to obtain "control" over an underlying digital asset. Thus, these new amendments also might lead to more litigation over what constitutes "control" of a crypto asset.

Legislation by Congress putting crypto assets into either the security or commodity category would provide account holders as well as bankruptcy courts with greater clarity. A designation as a security might generate more protection for account holders through the SIPA Advance. Even a designation as a commodity would likely give account holders priority status when divvying up the estate.

The bills pending in Congress that would label crypto assets as commodities are the only ones to address bankruptcy ramifications. While those bills would not give crypto account holders immediate access to their funds, they would put account holders on strong footing relative to fellow creditors. These bills also would give account holders a baseline of certainty as to their status if a crypto company filed for bankruptcy. Further, they would allow bankruptcy courts to operate from a common position on what constitutes estate property and to generate a body of case law on crypto assets in bankruptcy.

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