What Happens When Crypto Meets Insolvency

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Since the introduction of bitcoin in 2009, the prevalence of cryptocurrency in the global financial markets has skyrocketed. Indeed, today there are more than 2,500 different forms of cryptocurrencies with a total market capitalization of over $120 billion.[1]

Despite the rapid growth of cryptocurrency, little is known about the issues that cryptocurrency poses in the restructuring and insolvency context. These issues should be of great significance for any participant in the cryptocurrency universe, including investors and users of cryptocurrencies, banks and other financial institutions, as well as federal, state, foreign, and international governmental and regulatory agencies.

This article examines four issues that are, or likely will be, at the forefront of the intersection of cryptocurrency and insolvency: (1) how courts will adjudicate ownership issues, particularly in instances in which a cryptocurrency is tied to a physical asset; (2) whether cryptocurrency will be classified under the Bankruptcy Code as a commodity, a currency or something else; (3) how cryptocurrency’s volatility can have a significant impact on various aspects of an insolvency proceeding; and (4) how cryptocurrency may be treated under the Uniform Commercial Code. There are many other issues of great importance, including jurisdictional considerations, but they are outside the scope of this article.

It must be emphasized that very few authorities have addressed cryptocurrency in the insolvency context.[2] As a result, we cannot predict with any degree of certainty how bankruptcy courts will adjudicate the issues described herein. That being said, educated guesses can and should be made. As the use of cryptocurrency becomes more and more widespread in our financial markets, restructuring professionals must be equipped to
address the many insolvency-related issues that will inevitably arise.

What Is Cryptocurrency?

Before examining these issues, let us first briefly summarize cryptocurrency. As a general matter, cryptocurrency is a digital representation of value. Unlike traditional currencies, cryptocurrencies are not issued by a central bank or government, nor are they necessarily attached to legal currency. Virtual currencies can enable purchases, sales and other financial transactions and can be transferred, stored and traded. Similar to the way that a bank tracks transactions involving traditional currency on a ledger, cryptocurrency transactions are tracked on a blockchain, which is an electronic record of all the transactions involving the cryptocurrency.

The most popular and well-known cryptocurrency is bitcoin, but there are thousands of other forms of cryptocurrencies. Bitcoin is based on blockchain technology, and the blockchain ledger is a publicly accessible ledger of all transactions involving bitcoin. The blockchain ledger allows parties to independently verify transactions, eliminating the need for a trusted intermediary like a bank, which is otherwise needed for transactions involving traditional currency.

Cryptocurrencies come in two primary forms: (i) virtual currencies tied to an asset such as fiat currency, "stablecoins"; and (ii) virtual currencies that are not tied to any asset and instead have value only because people are willing to trade goods and services for them, "untethered cryptocurrencies." Stablecoins are, of course, less volatile than untethered cryptocurrencies because they are tied to a fixed, knowable asset. For example, one stablecoin, Tether, is 100 percent backed by fiat currency in a reserve account with each "tether" coin having a value of $1. Bitcoin, by contrast, is a form of untethered cryptocurrency. Bitcoin has value only because the market believes it has value. Although bitcoin is not tied to an asset or fiat currency, it has an equivalent value in fiat currency and can act as a substitute for fiat currency.

Ownership Issues

Because stablecoins are tied to a particular asset, a fundamental issue in the insolvency context is which party possesses beneficial ownership of the underlying asset: the holder of the stablecoin to which the asset is tied, or the bank or other institution that holds the
underlying asset, i.e., the “custodian.” The answer to this question likely turns on how the stablecoin is structured.

For example, if the stablecoin is structured in a manner that entitles the holder only to a right to payment (contractual or otherwise) from the underlying asset, then in an insolvency proceeding, the court may very well determine that the assets underlying the stablecoins constitutes property of the custodian’s bankruptcy estate and that all of the custodian’s creditors are entitled to their share pro rata in such assets. In other words, in this scenario, the stablecoin holder will be treated simply as a creditor of the custodian (akin to the claim that a depositor has against a bank when it holds a bank account). Accordingly, if the custodian has insufficient funds or assets to satisfy the claims of its creditors, then the holder of a stablecoin, like the custodian’s other creditors, will receive only a partial recovery, notwithstanding the holder’s presumption that its stablecoin’s value was inextricably linked to the underlying asset.

In contrast, if the stablecoin is structured in a manner that entitles the holder to absolute beneficial ownership in the asset underlying the holder’s stablecoin, then it would be very difficult for creditors of the custodian to argue that they have any right to such assets. In this scenario, the custodian is like a custodian or escrow agent holding the underlying funds on behalf of the stablecoin holder. The custodian holds legal title to the underlying funds but has no beneficial interest in such funds.

Classification Issues

Another threshold issue is whether cryptocurrency is a commodity or a currency (or something else)? This question has far-reaching implications in bankruptcy because, as a general matter, the Bankruptcy Code affords greater protections to currencies[14] than commodities.[15]

The Bankruptcy Code does not define commodity or currency, so bankruptcy courts will need to rely on other sources of authority for guidance. Several authorities have held that cryptocurrency is a commodity because, unlike traditional currency, cryptocurrency is not issued by a government and vendors are not required to accept cryptocurrency as payment.[16] Other authorities, however, have held that cryptocurrency is currency because cryptocurrency is circulated through the international economy and can be exchanged for dollars and other currencies, and can be used to pay for goods and services.[17] These
non-bankruptcy rulings are highly fact-specific and the regulatory agencies’ positions seem to have been influenced by the agencies’ particular perspectives and outside concerns.[18]

There appears to be only one bankruptcy case that has addressed whether cryptocurrency is a commodity or currency.[19] In In re Hashfest Technologies LLC, the bankruptcy court was asked to adjudicate whether bitcoin should be classified as a commodity or a currency for purposes of adjudicating an alleged fraudulent transfer.[20] The court reasoned that, if bitcoin is a currency, then the party seeking to avoid the transfer at issue would be entitled only to the dollar value of the bitcoins at the time of their transfer; whereas if bitcoin is a commodity, the party seeking to avoid the transfer would be entitled to claw back the bitcoins themselves and therefore capture their appreciation in value, which was substantial in that case.[21] Ultimately, the bankruptcy court declined to adjudicate the issue and the parties eventually settled.[22]

If cryptocurrency is treated as a currency, then a contract involving the exchange of such cryptocurrency for dollars or other currencies will likely be treated as a “swap agreement” under the bankruptcy code.[23] Swap agreements are afforded special protections in bankruptcy, including: (i) a transfer made pursuant to a swap agreement cannot be avoided unless such transfer constitutes an actual fraudulent conveyance; (ii) a non-debtor party to a swap agreement is not subject to the limitations imposed by the bankruptcy code’s automatic stay; and (iii) a swap agreement may be modified or terminated and any right or obligation under such agreement may be modified or terminated based on a provision in the agreement that is conditioned on the bankruptcy or financial condition of the debtor.[24]

By contrast, if a cryptocurrency is classified as a commodity, transactions involving such cryptocurrency receive these protections only if the transaction constitutes a forward contract.[25]

Valuation Issues

Just as stablecoins present unique risks in the bankruptcy context, untethered cryptocurrencies do as well. Specifically, the value of untethered cryptocurrencies have been extremely volatile, which creates unique challenges in bankruptcy.

One potential challenge is that a debtor’s estate could go from being solvent to insolvent in a very short period of time due to fluctuations in the untethered cryptocurrency’s
value.[26] For the same reason, untethered cryptocurrency is an unreliable asset for distribution to creditors.[27] The fluctuation in the value of untethered cryptocurrency makes it difficult for a debtor to formulate a plan of reorganization and gain creditor approval of the plan because creditor recoveries cannot be determined until the untethered cryptocurrency is exchanged for other value (i.e., cash, equity in another entity, etc.).[28] Further, the creditors may attempt to delay or speed up the reorganization or liquidation process in order to maximize the value of the untethered cryptocurrency.[29]

The volatility of untethered cryptocurrency also raises issues regarding adequate protection.[30] If untethered cryptocurrency is pledged as collateral and the borrower subsequently files for bankruptcy, the bankruptcy court may find that the lender’s interest in the untethered cryptocurrency is inadequately protected because of the risk that the value of its collateral (i.e., the untethered cryptocurrency) may plummet after the petition date.[31] In order to adequately protect the lender, the bankruptcy court may require the debtor to provide additional forms of protection, including periodic cash payments, replacement liens and/or additional collateral. If the debtor is unable to provide such adequate protection, the bankruptcy court could grant the lender relief from the automatic stay to foreclose on its collateral, including the untethered cryptocurrency.

UCC Issues

Just as it is unclear how cryptocurrency will be treated under the bankruptcy code, it is also unclear how cryptocurrency will be treated under the UCC.

An argument could be made that, absent a designation to the contrary, cryptocurrency falls within the definition of a general intangible.[32] The UCC definition of “general intangible” includes, with a few exceptions, “any personal property” of a debtor that does not fall within a specifically enumerated class of collateral.[33] Proponents of classifying cryptocurrency as a general intangible argue that cryptocurrency does not fall within any of the other specifically enumerated classes of collateral, leaving the “catch-all” category of general intangible most applicable.[34]

On the other hand, an argument could be made that cryptocurrencies constitute “money” under the UCC. The UCC defines “money” as “a medium of exchange currently authorized or adopted by a domestic or foreign government. The term includes a monetary unit of account established by an intergovernmental organization or by agreement between two or
more countries."[35] If stablecoins tied to fiat currency are viewed simply as a beneficial ownership of the underlying fiat currency, an argument could be made that owning the cryptocurrency is equivalent to owning the fiat currency and therefore the cryptocurrency constitutes "money."[36]

If cryptocurrency is treated as a general intangible, a secured creditor's security interest in cryptocurrency would continue even following the debtor's disposition of the collateral, unless the secured creditor consents to the disposition.[37] If cryptocurrency is considered money under the UCC, transferees would take the cryptocurrency free of a security interest, unless the transferee acts in collusion with the debtor in violating the rights of the secured party.[38]

If cryptocurrency is considered money under the UCC, it would also be more difficult to perfect a security interest in the cryptocurrency. Unlike general intangibles which are perfected through a financing statement,[39] a security interest in money can only be perfected by possession.[40] If stablecoins backed by fiat currency are considered money under the UCC, the only entity which could obtain a perfected security interest in the cryptocurrency would be the custodian, which is in possession of the fiat currency.

Conclusion

While cryptocurrency has existed for less than a decade, it is here to stay and likely will be the source of significant debate and litigation in the future. Bankruptcy professionals need to be aware of, and be prepared to address, the insolvency-related issues that will inevitably arise as participants in the cryptocurrency universe and their counterparties enter into insolvency proceedings.

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[4] Id.

[5] Id.


[12] Each type of untethered cryptocurrency has its own unique characteristics. The basic characteristics of bitcoin are used for explanatory purposes.


[15] With that said, if cryptocurrencies are classified as a commodity, an argument could be made that agreements involving cryptocurrencies constitute “other commodity agreement[s],” which receive favorable swap treatment under the Bankruptcy Code. See 11 U.S.C. § 101(53B)(A)(i)(II). However, there is virtually no case law on what constitutes an “other commodity agreement,” so the law remains unclear.


[17] SEC v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex. Aug. 6, 2013) (holding that bitcoin is a currency because it “can be used as money…to purchase goods and services.”).

[18] See generally, Deppert, supra note 14, at 135. Further, the differences in the various types of cryptocurrencies, including the differences between Stablecoins and Untethered Cryptocurrencies, make it difficult to apply one uniform rule. Stablecoins backed by fiat currency bear a significant resemblance to currencies, while Untethered Cryptocurrency or even Stablecoins backed by non-fiat currency assets have fewer common traits.


[22] Id.

[23] Deppert, supra note 14 at 146.


[25] Id. at 131. Deppert, supra note 14. Under the Bankruptcy Code, a forward contract is a contract under which the parties agree to deliver the commodity at issue at least two days in advance of the contract’s maturity date. See 11 U.S.C. § 101(25).


[27] See generally, id.

[28] See generally, id. (discussing the Mt. Gox insolvency proceeding in Japan, where the value of the bitcoin in the trustee’s possession increased significantly).

[29] See generally, id.

[30] Id.

[31] See id.


[33] UCC § 9-102(42).
[34] See Helman, supra note 32; Schroeder, supra note 32.

[35] UCC § 1-201(b)(24). See also Schroeder, supra note 32 at 19.


[37] UCC § 9-315(a)(1); Schroeder, supra note 32 at 35.

[38] UCC § 9-332(a); Schroeder, supra note 32 at 15.

[39] UCC § 9-310(a); Schroeder, supra note 32 at 35.

[40] UCC § 9-312(b)(3); Schroeder, supra note 32 at 22-23.

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