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# TECHNOLOGY MARATHON

**Post-FTX: Navigating the Regulatory Waters  
after Crypto Bankruptcies (Part 1)**

Edwin E. Smith and David K. Shim

**Wednesday, May 24, 2023 | 12:00–1:00 pm ET**

# Presenters



**Edwin Smith**



**David Shim**

**Morgan Lewis**



# Notable Crypto Bankruptcy Cases



## FTX / Alameda

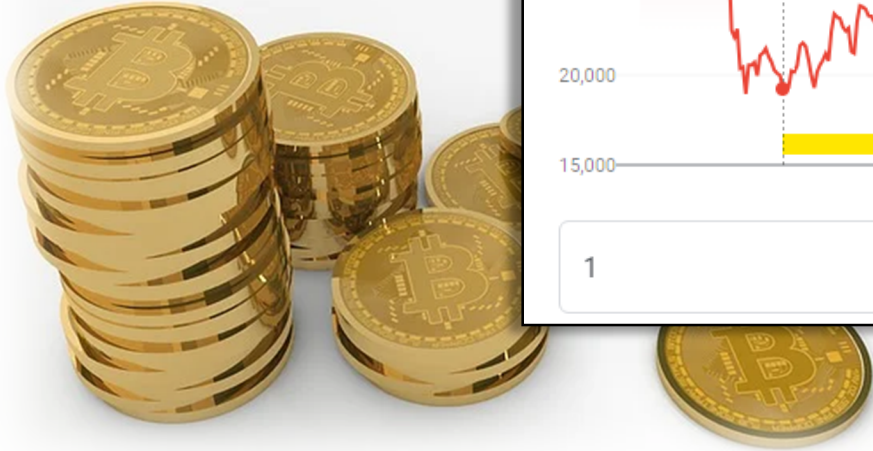
## BlockFi

## Celsius Network

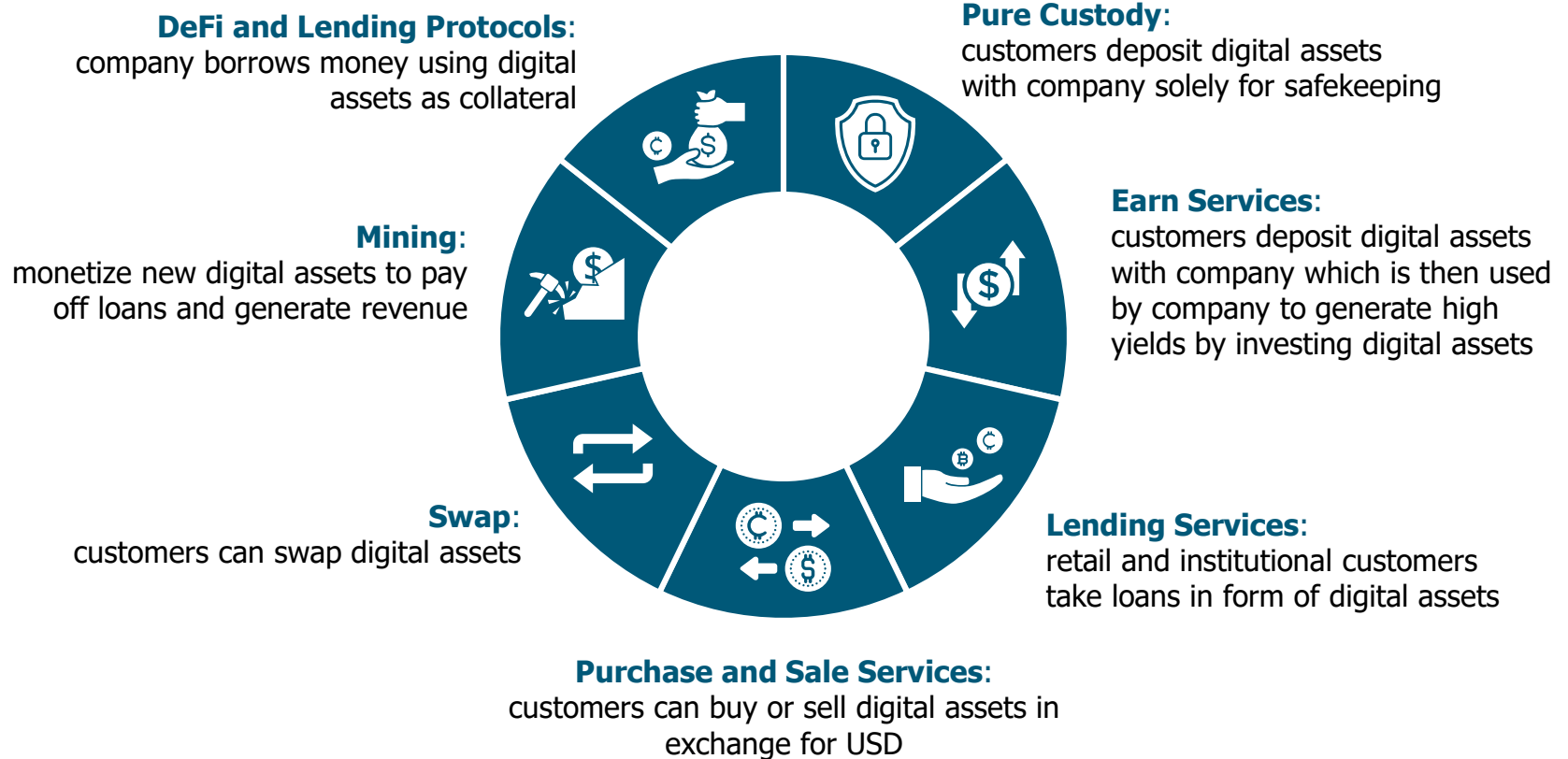
## Voyager Digital

Chapter 11 filed in Nov 2022 in DE	Chapter 11 filed in Nov 2022 in NJ	Chapter 11 filed in July 2022 in SDNY	Chapter 11 filed in July 2022 in SDNY
Crypto exchange and platform	Crypto exchange and platform	Lending platform	Brokerage platform
Unreliable prepetition financial reporting; ~\$8.9b liabilities ~\$900m in liquid assets Recently announced ~\$7.3b recovery of cash and digital assets	\$1b–\$10b liabilities \$1b–\$10b assets	~\$5.5b liabilities ~\$4.3b assets	~\$5.8b liabilities ~\$6.0b assets
Filed due to liquidity crisis and failure of corporate controls	Filed due to liquidity crisis and collapse of FTX / Alameda	Filed due to crypto run and Three Arrows default on loan	Filed due to crypto run and Three Arrows default on loan
Reorg plan anticipated in early 2024	Reorg plan proposed but liquidation anticipated; Auction date TBD	Reorg plan proposed; Auction continues	Reorg plan confirmed but Binance/FTX deal fell through; Voyager resorted to liquidation

# Bitcoin Price



# General Business Structure



# General Business Structure



## Pure Custody:

customers deposit digital assets with company solely for safekeeping



## Lending Services:

Retail and institutional customers take loans in form of digital assets



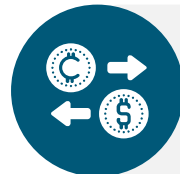
## Swap:

customers can swap digital assets



## Earn Services:

customers deposit digital assets with company which is then used by company to generate high yields by investing digital assets



## Purchase and Sale Services:

customers can buy or sell digital assets in exchange for USD



## Mining:

monetize new digital assets to pay off loans and generate revenue



## DeFi and Lending Protocols:

company borrows money using digital assets as collateral



# BANKRUPTCY CODE

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# Bankruptcy Code: Automatic Stay

- Automatic stay snaps into place upon filing but, in multinational cases, it is not uncommon for debtors to take a more proactive approach given the large number of foreign parties involved that may not be versed in the US Bankruptcy Code.

## Automatic Stay

- Section 362: “Worldwide” automatic stay that enjoins debt collection and/or enforcement actions against a debtor, **except** for actions by governmental units to enforce police and regulatory powers.
- Section 365(e): Once a debtor files for bankruptcy protection, its rights under an existing contract are considered property of estate. Any provision in a contract that provides for its termination or other modification based solely on the bankruptcy filing or the financial condition of such debtor at the time of filing, constitutes an unenforceable “ipso facto” clause in bankruptcy.
- Section 525: Provides that a governmental unit may not revoke a license, permit, charter, franchise, etc., solely because debtor filed for bankruptcy protection.





# Bankruptcy Code: Postpetition Transfers of Property

- Once in bankruptcy, debtor-in-possession (i.e., the Debtors) must seek court approval of any use, sale, or lease of its assets outside the ordinary course of business.
- Generally, transactions are approved when they are supported by the Debtors' business judgment and in accordance with non-bankruptcy law applicable to the transfer of property. This may include requisite approval in foreign jurisdictions, such as with the transfer of regulatory licenses.
- Unauthorized transfers? Subject to avoidance and clawback.



# Bankruptcy Code: Prepetition Avoidance Actions

- Two primary types of prepetition avoidance actions:
  - 1. Preference Action
    - DIP or trustee may avoid transfer (made while debtor insolvent) of debtor's property to a creditor on account of antecedent debt (i.e., debt predating payment) that puts creditor in more favorable position than other creditors
    - Payment must be made within 90 days of bankruptcy filing or 1 year in case of insiders
    - Creditor must have received more by payment than it would have received in Bankruptcy Code chapter 7 liquidation if payment had not been made
    - Common defenses:
      - Payments made in ordinary course of business (i.e., payment made within normal billing cycle)
      - Payments which are substantially contemporaneous exchange
      - Payments for which new value is given



# Bankruptcy Code: Prepetition Avoidance Actions (cont'd)

- Two primary types of prepetition avoidance actions
  - 2. Fraudulent Transfers
    - Actual v. constructive fraudulent transfers
    - DIP or trustee may avoid transfer of interest of debtor in property made within 2 years of bankruptcy filing, if debtor (a) made transfer with actual intent to defraud creditors, or (b) received less than reasonably equivalent value in exchange for such transfer, and was insolvent at time of transfer or became insolvent because of transfer.
    - DIP or trustee may also avoid such transfer made within 4 or more years of bankruptcy filing under applicable non-bankruptcy law. 11 U.S.C. § 544. Applicable law in this context is construed as applicable *US* law.
    - Purpose is to ensure that no creditor receives unfair advantage and to prevent debtor from improperly sheltering assets.
  - Note: If a crypto asset is considered to be a “security,” a “safe harbor” defense might be available on a preference claim or, absent intent by the debtor to hinder, delay or defraud its creditors, a fraudulent transfer claim. This potential defense has not yet been tested in the courts.





# BANKRUPTCY COURT

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# FTX / Alameda in Delaware Bankruptcy Court

- 102 FTX and Alameda entities filed chapter 11 in Delaware in November 2022
- Ex-CEO Sam Bankman-Fried authorized chapter 11 filing before stepping down
- U.S. government criminally charged SBF and his FTX colleagues for fraud
- John J. Ray III (of Enron fame etc.), the newly appointed CEO, stresses “unprecedented” chaos present at FTX upon taking over
- Zero confidence in prepetition financial reporting/controls
  - Balances of customer crypto assets on deposit were not recorded as assets and not presented
  - Characterized by numerous, related party transactions. Includes: \$4.1b in outstanding loans by Alameda, which were reportedly made to related parties and entities that include \$1b to SBF
- Recently announced the recovery of ~\$7.3b of cash and digital assets



# FTX / Alameda in Delaware Bankruptcy Court

- Potential disputes among FTX debtor entities
  - FTX Digital Markets (FTX DM)
    - Venue dispute over FTX DM's chapter 15 filing in SDNY; FTX DM ultimately agreed to the venue transfer
    - "Cooperation" agreement; FTX and FTX DM agreed to cooperate and respect their respective bankruptcy proceedings; however, disputes are brewing over what it actually meant
  - Emergent Fidelity Technologies (Emergent)
    - FTX affiliate special-purpose entity 90% owned by SBF; Liquidators appointed in Antigua
    - SBF obtained a loan from Alameda to purchase assets in the name of Emergent which are subject to competing claims by FTX, BlockFi, SBF and other creditors
    - Assets are currently seized by U.S. government in connection with SBF forfeiture proceeding
    - Emergent filed chapter 11 in DE and jointly administered with FTX



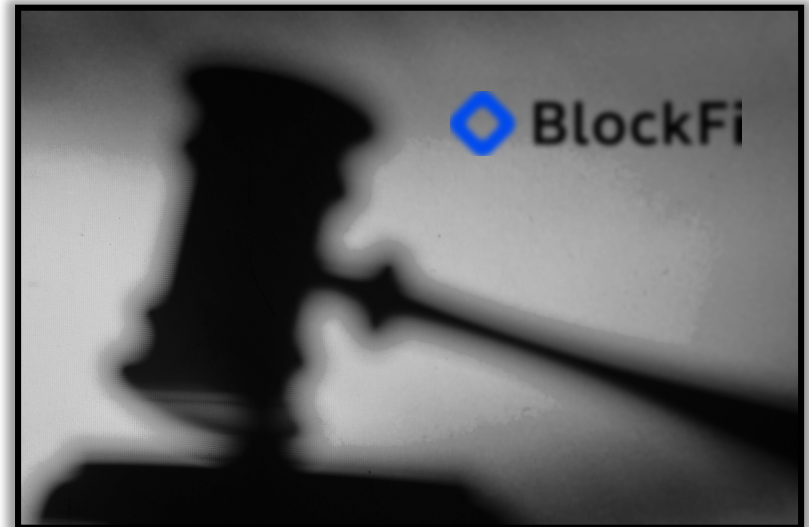
# FTX / Alameda in Delaware Bankruptcy Court

- FTX customers seek determination that, pursuant to the terms of use and service, customer property held in FTX accounts as well as misappropriated assets that are traceable to customer deposits belong to the customers and cannot be used to provide liquidity for FTX Chapter 11
- **Avoidance Actions**
  - FTX seeks to lift the automatic stay in Genesis Global to commence avoidance actions to avoid and recover repayment of ~\$1.8b loans to Genesis by Alameda in crypto
  - FTX commenced avoidance actions against Voyager to avoid and recover repayment of ~\$450m repayment of loans to Voyager by Alameda in crypto
  - These are just the tip of the iceberg. FTX believes it has compelling avoidance claims to recover several billion dollars from other parties.
- Bar dates proposed
- “Toggle” plan anticipated
- Asset recovery efforts ongoing
- Potentially contentious confirmation process



# BlockFi in New Jersey Bankruptcy Court

- 9 BlockFi entities filed chapter 11 in November 2022 in New Jersey
- “Toggle plan” proposed; auction of customer platform assets proposed early but continues to get delayed
- ~\$400m of digital assets frozen on FTX’s platform; Alameda defaulted on ~\$680m of allegedly collateralized loan obligations to BlockFi
- **Non-interest Bearing Wallet Accounts**
  - BlockFi conceded that, based on service contracts, title to crypto held in custodial, non-interest bearing BlockFi wallets belong to customers, but argued the attempted transfers to wallets after the Nov. 10th platform pause should be canceled
  - Unsecured creditors’ committee argued potential preference claims must be addressed first before BlockFi honors customer withdrawals
  - Court sided with BlockFi and cleared path to honor customer withdrawals and cancel transfers into wallet accounts after the platform pause

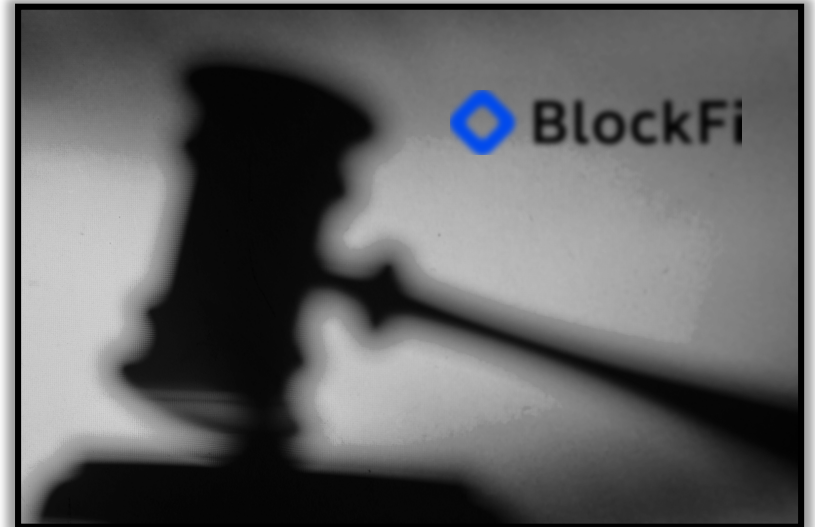




# BlockFi in New Jersey Bankruptcy Court

- **Retail Loan Accounts**

- Under the loan and security agreements, BlockFi lent retail loan account holders US dollars. In exchange, the holders agreed to repay principal and interest to BlockFi and pledged as collateral various crypto tokens and granted BlockFi a security interest
- The holders argue the collateral as well as its processes are not property of BlockFi's estate and the collateral may only be liquidated upon the holders' default
- BlockFi argues posted collateral is property of the estate and it is free to take any action, including rehypothecation, with respect to the collateral at any time until the repayment in full of the holders' obligations and termination of the agreements
- BlockFi argues the obligation to return property under the agreements is a monetary debt that entitles the holders to an unsecured claim against the estate
- Briefing continues



# Celsius in SDNY Bankruptcy Court

- With crypto winter at its peak, 11 Celsius entities filed chapter 11 in July 2022 in SDNY
- “Toggle plan” proposed; auction continues to date
- Customer platform froze in June 2022
- **Earn Accounts**
  - Court examined whether under the terms of use, title and ownership of account holders’ crypto deposited in the Earn accounts transferred to Celsius
  - Court held the terms of use, a “clickwrap contract,” formed a valid enforceable contract and “unambiguously” transferred title and ownership of crypto assets, including stablecoins, to Celsius, and thus Celsius is authorized to sell such assets to provide liquidity for its chapter 11 cases
- **Avoidance Action**
  - Creditors’ committee of Celsius commenced an avoidance action against Celsius debtor entity (Celsius Network Limited) for constructive fraudulent transfer resulting from “sham” transactions in which CNL transferred ~\$10.3b of liabilities to another Celsius debtor entity (Celsius Network LLC) and pilfered billions of dollars of assets from LLC, all for the benefit of CNL’s stakeholders and to the detriment of LLC.



# Voyager in SDNY Bankruptcy Court

- 3 Voyager entities filed chapter 11 in July 2022 in SDNY
- “Toggle plan” confirmed
- Binance and FTX deals fell through
- Voyager is now in liquidation mode
- Confirmed plan largely avoided legal disputes regarding ownership of crypto
- Potential avoidance actions against approximately 32,000 former customers and against 92 existing customers with greater than \$100k in preference exposure
- As noted above, FTX commenced avoidance actions against Voyager to avoid and recover repayment of ~\$450m repayment of loans to Voyager by Alameda in crypto





# LOOKING AHEAD

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# Looking Ahead: Crypto Customer Deposits

- Cryptocurrency deposits are not protected under any FDIC or other government insured program.
- It does not appear that crypto debtors complied with any custody related procedures (e.g., UCC Article 8 opt-in) that could have protected its customers. See April 2023 issue of *Business Law Today*.
- To the extent crypto debtors held cash on behalf of a customer, it is likely that the customer will be a general unsecured creditor of the applicable debtor entity.
- The customer may have FDIC insurance if the cash was held in an FDIC insured bank and the customer had “FDIC pass-thru” protection. But that protection requires that meaningful records be maintained by the applicable debtor entity.
- To the extent that a customer purchased crypto to be held by crypto debtors in a non-custodial wallet, it appears that crypto debtors may have used the crypto for their own purposes and claiming a direct right to recover the cryptocurrency will be difficult if not impossible.
- Legal theories related to recovering cash or cryptocurrency through the assertion of a constructive or resulting trust will be difficult to prove.
  - The arguments are not usually successful when the customer has a contract in place with the debtor
- It also does not appear that certain crypto debtors kept meaningful records linking the assets it held on behalf of customers to those customers.



# Looking Ahead: Avoidance Actions

- Section 550 of the Bankruptcy Code provides trustee may recover property fraudulently transferred or value of that property
- Delivery of crypto would be possible only if crypto were treated as commodity, in which case valuation fight could then be avoided
- If crypto is considered to be currency and thus delivery is not possible, then bankruptcy court may have to decide how to value transferred asset under 550
- Bankruptcy Code does not prescribe specific valuation date, and crypto is topsy-turvy investment
- Bankruptcy court may use (i) valuation as of transfer date (supported by Section 8(c) of the Uniform Voidable Transactions Act), (ii) valuation as of date of recovery, or (iii) valuation as of date of bankruptcy filing.





# LONG-TERM ISSUES

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# Long Term Issues in the Current Bankruptcy Cases



Sale of solvent subsidiaries



Possibility of substantive consolidation



Absent substantive consolidation, the likelihood of inter-estate claims and separate sets of professionals



Date for valuation of crypto-related claims



Federal forfeiture



The impact of foreign insolvency proceedings



Treatment of crypto debtor as a stockbroker or commodity broker under the Bankruptcy Code



# Long-Term Issues: Focus on Reform

- **State law**
  - Wider use of the UCC Article 8 opt-in
  - Impact of 2022 UCC amendments
- **Federal law:** bankruptcy reform
  - Property of the estate
    - Pure custody
      - UCC Article 8 model
      - Bankruptcy Code chapter 7, subchapter III model
      - SIPA model
    - Other services
      - SEC Rule 15c3-3 model





## Long-Term Issues: Focus on Reform

- **Federal law:** bankruptcy reform (cont'd)
  - Distributions in kind in lieu of cash distributions
  - Avoidance actions
    - Date of valuation of transferred assets
    - Clarification of whether the financial contract “safe harbors” apply to digital assets that can be characterized as securities or commodities

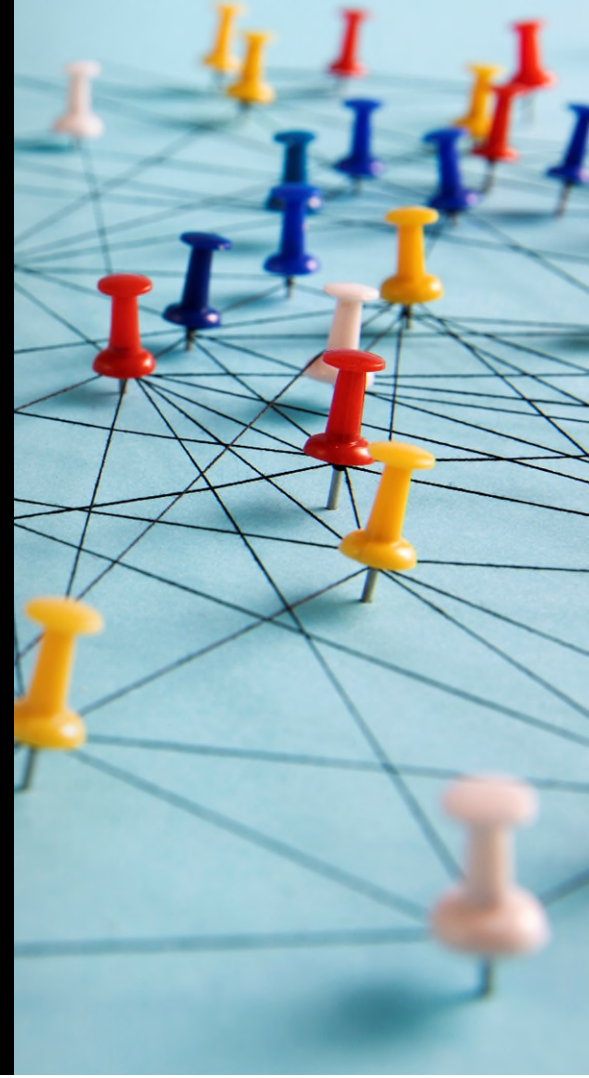
# Ukraine Conflict Resources

Our lawyers have long been trusted advisers to clients navigating the complex and quickly changing global framework of international sanctions. Because companies must closely monitor evolving government guidance to understand what changes need to be made to their global operations to maintain business continuity, we offer a centralized portal to share our insights and analyses.

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# Biography



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Edwin Smith concentrates his practice in commercial law, debt financings, structured financings, workouts, bankruptcies, and international transactions. He is particularly knowledgeable on commercial law and insolvency matters, both domestic and cross-border. His representations have included those in major bankruptcies including Refco, Lehman, the City of Detroit, and PG&E. He often advises financial institutions on documentation and risk management issues.

# Biography



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David Shim focuses his practice on financial insolvency matters in the United States, as well as international financial restructurings. He represents a wide range of stakeholders, including corporate debtors, creditors, acquirers, equity holders, and investors in all aspects of corporate restructurings, bankruptcy proceedings, and related litigation.

Prior to joining Morgan Lewis, David worked as a financial restructuring associate at a major international law firm. He also served as a law clerk to Judge Julie A. Manning of the US Bankruptcy Court for the District of Connecticut and Judge Robert E. Grossman of the US Bankruptcy Court for the Eastern District of New York.

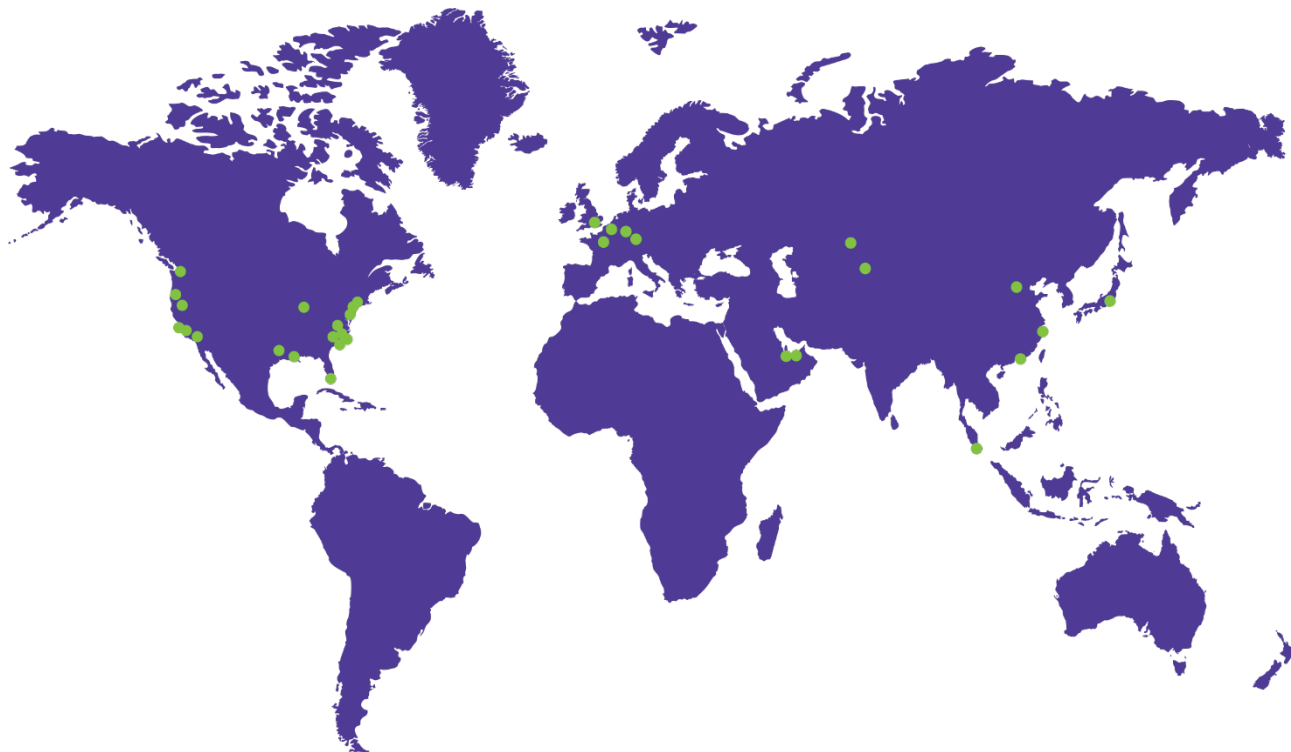


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