SMU Science and Technology Law Review

Volume 26 | Number 2 | Article 8

2023

Cryptocurrency’s Clash with Bankruptcy: Insolvent Crypto Exchange Companies Create Difficulties for Courts & Customers

Mary Taylor Stanberry
Southern Methodist University, Dedman School of Law

CRYPTOCURRENCY'S CLASH WITH BANKRUPTCY: INSOLVENT CRYPTO EXCHANGE COMPANIES CREATE DIFFICULTIES FOR COURTS & CUSTOMERS

Mary Taylor Stanberry[*]

ABSTRACT

This comment explores the novelty of cryptocurrency, its legal ambiguity in the realms of securities, property, and tax law, and the difficulties arising from insolvent crypto-exchange company's estates within the context of the United States Bankruptcy Code. For the purposes of this comment, individuals who invested in crypto-exchange platforms will be referred to as "customers" rather than "investors" to avoid potential confusion in the context of 11 U.S.C. § 507 of the Bankruptcy Code. Customers who invested with insolvent crypto-exchange companies are concerned about being last in line for repayment of their investments based on traditional bankruptcy creditor priority. These concerns, combined with the alleged mismanagement and undercapitalization of many insolvent crypto-exchange companies, have introduced new issues of legal interpretation and the weighing of various policy concerns both within and outside of the bankruptcy process. By examining the bankruptcy process, the history of cryptocurrency, and analyzing several current cases of insolvent crypto-exchange companies, this comment explores the multi-faceted issues surrounding cryptocurrency as well as the need for guidance and clarity of cryptocurrency's classification for the purposes of bankruptcy law.

I. INTRODUCTION

The complicated nature of bankruptcy is magnified under the lens of the volatile, novel, and largely unregulated world of cryptocurrency. The looming threat of investment loss is not reserved for only wealthy, seasoned investors; rather, the increased accessibility to cryptocurrency and successful marketing by celebrities and financial gurus led costumers to unknowingly expose themselves to substantial financial loss.[1] Alleged acts of mismanagement and

---

https://doi.org/10.25172/smustlr.26.2.8

* Mary Taylor Stanberry is a 2024 candidate for Juris Doctor from SMU Dedman School of Law. She received a Bachelor of Arts in History with double minors in Religion and Political Science from Texas Christian University in 2020.

1. *See, e.g.*, Winston Cho, *Celebrities Shilling Crypto Face More Than Just Mockery*, HOLLYWOOD REP. (Dec. 16, 2022, 6:45 AM), https://www.hollywoodreporter.com/business/digital/ftx-crypto-regulators-feds-scrutiny-1235283202/ [https://perma.cc/FP7X-H7AL].

undercapitalization resulted in various cryptocurrency lending and exchange companies to begin filing for bankruptcy in as early as 2014, snowballing into what became known as "Crypto Winter" beginning in 2022.[2] Now, bankruptcy courts around the United States are left to untangle the remaining mess of digital assets in an attempt to successfully reorganize failed crypto exchange companies; however, customers who entrusted their currency, both tangible and crypto, with those insolvent companies are left uncertain whether their investments, once advertised as the "future of money," will be returned to them in whole, in part, or not at all.[3]

Various courts have wrestled with how to categorize cryptocurrency as an asset in bankruptcy, varying between a security, a commodity, or a currency.[4] Customers are left bewildered and blindsided that their investments, the victims of alleged mismanagement and misuse, will earn them little to no return despite the assurances of success by crypto lenders and celebrities.[5] To further complicate the matter, a plethora of different government regulatory agencies have claimed jurisdiction over cryptocurrency, each with different methodologies of regulation.[6] The Securities Exchange Commission (the "SEC") has begun charging crypto lenders and exchange companies with violations of federal securities laws, and multiple class action lawsuits have been brought against celebrities who endorsed crypto lenders in exchange for compensation in the form of cryptocurrency and other digital assets.[7] The aftermath of Crypto Winter has left courts and customers to pick up the pieces of failed crypto exchange companies.

2. Keith Miller, John D. Penn & Sara Chenetz, *Crypto-Related Bankruptcies Timeline*, Perkins Coie (Sept. 16, 2022), https://www.virtualcurrencyreport.com/2022/09/crypto-related-bankruptcies-timeline/[https://perma.cc/NUJ4-3BPB]; *see* Jordan S. Blask & Jared M. Tully, *Crypto Winter Series: What Are the Current Insolvency Concerns and What Do They Mean – Part 1*, Frost Brown Todd (July 11, 2022), https://frostbrowntodd.com/crypto-winter-what-are-the-current-insolvency-concerns-and-what-do-they-mean/ [https://perma.cc/DQ5C-D8VS].

3. Berkman Klein Center, *A Brief History and Overview of Cryptocurrency*, https://cyber.harvard.edu/cyberlaw_winter10/A_brief_history_and_overview_of_cryptocurrency [https://perma.cc/WK6Q-RK87] (last updated Feb. 24, 2022).

4. Jordan S. Blask, Shirley Palumbo & Jared M. Tully, *Digital Assets, Cryptocurrency, and NFTs in Bankruptcy: Administration, Classification, Valuation, and Recovery*, Strafford (Sept. 28, 2022), https://www.straffordpub.com/products/digital-assets-cryptocurrency-and-nfts-in-bankruptcy-administration-classification-valuation-and-recovery-2022-09-28 [https://perma.cc/T934-H6ZR].

5. *See, e.g.*, Cho, *supra* note 1.

6. Jonathan Miller & John Wagster, *DC Deep Dive: The Future of Cryptocurrency*, CivicPoint (Dec. 8. 2022), https://www.civic-point.com/post/dc-deep-dive-the-future-of-cryptocurrency [https://perma.cc/4YWL-P4EB].

7. *See, e.g.*, Cho, *supra* note 1.

II. DIGITAL ASSETS: DODGING REGULATION

Cryptocurrency, once thought of as the "future of money," is traced back to "eChash," an encrypted system of currency created by David Chaum in 1983.[8] In 1986, Wei Dai, a Chinese computer engineer, spawned the "idea of a decentralized cryptographic payment system."[9] Following the global economic turndown of 2008, customers began to explore the idea of a currency independent from heavy regulation by government agencies, such as the SEC, Internal Revenue Service (the "IRS"), Commodities Futures Trading Commission (the "CFTC"), the United States Treasury Department, and third party financial institutions, such as banks and finance companies.[10]

Cryptocurrency is verified through transactions on special networks known as *blockchains*, making them "counterfeit resistant."[11] Blockchains are networks of shared ledgers that record transactions and track the assets of a business.[12] Blockchain technology appeals to investors because the "immutable ledger" make it difficult, if not impossible, for participants to alter a transaction once it has been recorded.[13] Every transaction is "recorded as a 'block' of data," and includes information such as "who, what, when, where, how much, and even the condition" of the asset involved in the transaction.[14]

Cryptocurrency is exchanged for goods and services digitally, without the limitations, fees or regulation of third parties.[15] The success of popular cryptocurrencies, such as Bitcoin and Stablecoin, helped turn customers into novice investors.[16] Rumors circulated, endorsed by celebrity testimony, that

---

8. Berkman Klein Center, *supra* note 3.

9. *Id.*

10. *Id.*

11. Bethany Hickey, *How Do NFTs Work?*, Finder (Mar. 14, 2022) https://www.finder.com/how-do-nfts-work [https://perma.cc/6CD7-PHSP]; Amy Q. Nguyen, The Mysteries of NFT Taxation and the Problem of Crypto Asset Tax Evasion, 25 SMU Sci. & Tech. L. Rev. 323, 324 (2022) https://scholar.smu.edu/scitech/vol25/iss2/8 [https://perma.cc/75P7-HV2K].

12. *What is Blockchain Technology*, IBM, https://www.ibm.com/topics/blockchain [https://perma.cc/WTY9-F75Z]; Eric Rosenberg, *What Happens When a Crypto Exchange Goes Bankrupt?*, Investopedia (Feb. 28, 2023), https://www.investopedia.com/crypto-bankruptcy-affecting-investors-6274367 [https://perma.cc/4SQF-WJFC].

13. *What is Blockchain Technology*, *supra* note 12.

14. *Id.*

15. Berkman Klein Center, *supra* note 3.

16. *Id.* ("Blockchain is a decentralized technology used across computers to manage and record transactions with an online ledger secured by bulletproof cryptography.").

cryptocurrency would continue to exponentially increase in value over a short period of time, making crypto the next big investment.[17] After the initial success of a variety of cryptocurrencies, the world saw an increase in Decentralized Finance platforms ("DeFis") and Centralized Finance platforms ("CeFis") which "conduct transactions through the creation and maintenance of a 'lending protocol' that exists on a blockchain."[18] These lending platforms found great success in marketing to everyday consumers and received billions of dollars in investment in exchange for lending cryptocurrency and facilitating exchanges on their platforms.[19]

Crypto lending allows borrowers to secure loans through the lending platforms by "using their crypto holdings as collateral."[20] Lenders can deposit their cryptocurrency with the exchange company for various rates of interest, and the lending platforms fund borrower loans using that cryptocurrency.[21] The lending platforms act as intermediaries between lenders and borrowers, setting the interest rates to control its net interest margins.[22] DeFis are decentralized platforms, meaning there is no single company or person in control of the trading or selling of assets, giving customers control of their cryptocurrency on the blockchain.[23] Generally, DeFis are more complicated, less user-friendly, and present a higher investment risk; however, there is less risk of security breaches and higher returns on investment.[24] CeFis, which are centralized platforms, allow registered users to create accounts and apply for loans under the supervision of a third party company, making it more user friendly and more popular amongst customers.[25] CeFis act as "brokers and custodians" of

17. Sofia Rocher, *Cryptocurrency & Celebrity Endorsements*, Fordham J. of Corp. & Fin. L.: Blog (Apr. 6, 2023), https://news.law.fordham.edu/jcfl/2023/04/06/cryptocurrency-and-celebrity-endorsements/ [https://perma.cc/FBB2-L8VN].

18. Noah Schottenstein, Rachel E. Albanese, Deborah R. Meshulam, & Mark F. Radcliff, *DeFi Participants Should Prepare to Confront the Unknown as Bankruptcies Loom*, Lexology (June 23, 2022), https://www.lexology.com/library/detail.aspx?g=69d2f87a-2d43-4e06-862d-48e3bb06bf48 [https://perma.cc/B8BT-JUU2].

19. *Id.*

20. Wayne Duggan, *Crypto Lending: Earn Money From Your Crypto Holdings*, Forbes Advisor (Jan. 30, 2023, 10:10 AM) https://www.forbes.com/advisor/investing/cryptocurrency/crypto-lending/ [https://perma.cc/Z8AE-PYHB].

21. *Id.*

22. Schottenstein et al., *supra* note 18.

23. Crypto Trends, *Difference Between Centralized and Decentralized Exchanges*, YouTube (Nov. 24, 2022), https://www.youtube.com/watch?v=fHYqAeXpgnQ [https://perma.cc/MAH7-XBYG].

24. *Id.*

25. *Id.*

an investor's crypto, safeguarding the digital assets exchanged on the site and commingling the funds of users on the platform to fund their crypto-lending.[26] Primarily, it has been CeFis filing for bankruptcy and facing scrutiny for the mismanagement of customer investment funds.[27]

The accessibility of cryptocurrency and the increase of activity online as a result of the COVID-19 pandemic created the perfect opportunity for customers to research, invest, and sell cryptocurrency.[28] Stories of "average Joe" customers and their newly earned riches from simple investments in crypto fanned the flames of the crypto-craze, but the risks associated with investment did not gain customer attention until it was too late.[29] Customers who invested in crypto lending and exchange platforms learned of these risks the hard way once the "Crypto Winter" began.[30] As the world has seen in the past year, successful blockchain companies have floundered, opting to file chapter 11 reorganizations under the United States Federal Bankruptcy Code (the "Code").[31] As a result of alleged mismanagement and undercapitalization of crypto lending and exchange platforms, customers are facing the consequences of their risky investments and realizing the potential dangers surrounding the crypto-craze.[32]

III. A NOTE ON NFTS

Along with the increased notoriety of cryptocurrency, customers also began purchasing Non-Fungible Tokens ("NFTs"), digital files that possess unique identifications verified through blockchain technology and put into circulation as "tokens."[33] The appeal of NFTs over traditional cryptocurrency is their "utility, rarity and demand," as each NFT is completely unique.[34] However, the tokens are indivisible and non-substitutable.[35] Unlike a typical

26. *Id.*

27. *See* Miller & Wagster, *supra* note 6.

28. Sirin Kale, *'I Put My Life Savings in Crypto': How a Generation of Amateurs Got Hooked on High-Risk Trading*, The Guardian (June 19, 2021, 2:00 PM), https://www.theguardian.com/lifeandstyle/2021/jun/19/life-savings-in-crypto-generation-of-amateurs-hooked-on-high-risk-trading [https://perma.cc/RYB3-FVJJ].

29. *Id.*

30. Blask et al., *supra* note 4.

31. *See* Miller & Wagster, *supra* note 6; *see also* Schottenstein et al., *supra* note 18.

32. Kale, *supra* note 28.

33. Hickey, *supra* note 11.

34. *Id.*

35. *Id.*

cryptocurrency coin, an NFT token is not automatically worth the same value it was purchased or traded for, thus possessing no inherent value.[36] NFTs are digital representations of assets, encompassing broad items such as art, gaming characters, "trading cards, sport memorabilia, music, domains, [and] virtual real estate."[37] Sharing the similar appeal of cryptocurrency to customers, NFTs promised the possibility of quick returns without interference of third party regulators.[38] But customers who took a deep dive into digital assets by investing into NFTs are now faced with the same troubles as those who invested in cryptocurrency.[39] The failure of crypto exchange platforms has forced bankruptcy courts and customers to navigate the novel and complicated seas of unregulated digital assets.

Individuals with exchange-held assets who invested with crypto exchange companies are left unsure of exactly how much money they will receive from their initial investments, if any, and whether their cryptocurrency will be considered currency or property of the estate for purposes of 11 U.S.C. § 550(a) of the Code, which addresses the liability of a transferee of an avoided transfer (to be explained in greater detail in Part IV).[40] Another aspect of the Code requiring judicial insight are avoidance powers by the debtor and trustee under 11 U.S.C. § 547 which allow the debtor to recover preferential transfers made to creditors within a certain time period prior to filing.[41] This generates the question of whether a debtor-crypto exchange company is entitled to recover digital assets traded or withdrawn from the platform by customers leading up to the bankruptcy, and whether the debtor's estate receives the cryptocurrency in like-kind exchange, the value at the time of initial deposit, the value at the time of the bankruptcy filing, or the value at the time of filing the preference action by the Trustee.[42]

On the other hand, customers whose digital assets remained on the platform at the time of filing care about the court's choice in timeline to determine how their claims will be prioritized amongst the other creditors. Their claims will be classified as (1) the customer-creditors will receive the amount they originally invested; (2) the amount the crypto was worth at the time of filing; or (3) the amount the crypto will be worth at the time of distribution by

---

36. *See* Alonso Rondon, *This is Why NFTs Will Continue to Disrupt Our World*, YouTube (Apr. 7, 2023), https://www.youtube.com/watch?v=WYTVEc5xcTU&t=155s [https://perma.cc/WUX4-XK8Z].

37. Nguyen, *supra* note 11, at 324.

38. *Id.*

39. *See generally id.* (explaining the relationship between the tax framework for cryptocurrencies and NFTs).

40. *See* 11 U.S.C. § 550(a).

41. *See* 11 U.S.C. § 547 (2002).

42. Blask et al., *supra* note 4.

the trustee.[43] Several class-action lawsuits have been filed in response to the cryptocurrency exchange and lenders' bankruptcy filings, as creditors allege to have been intentionally misled of the financial standing of the lenders and customers demand the courts classify their claims as priority and administrative claims rather than as unsecured claims, or last in line for distribution from the estate as shareholders.[44]

IV. A (VERY) BRIEF BACKGROUND ON BANKRUPTCY

Bankruptcy is a complicated and, often times, arduous process.[45] The major players in a bankruptcy proceeding are the Judge, the debtors, and the creditors, which at times form creditor committees to help expedite the bankruptcy in large chapter 11 cases consisting of dozens, if not hundreds, of creditors.[46] Creditors are either secured or unsecured, with secured creditors receiving payment or repossession of collateral before unsecured creditors see a single penny.[47] Bankruptcy courts carefully weigh both the interests of creditors and debtors to create a viable plan for repayment and debt relief, a federal court of equity unlike any other.[48] Bankruptcy allows an opportunity for "the honest, but unfortunate, debtor" to liquidate their assets and pay off outstanding debts to satisfy relentless creditors in a process known as a chapter 7 liquidation.[49] A chapter 11 reorganization provides for an alternative to liquidation by allowing a corporation or individual to retain their assets, benefit from the automatic stay, and create a plan with creditors and the court to satisfy their

43. *Id.*

44. Ana Paula Pereira, *Genesis Unsecured Creditors' Committee Appointed*, Cointelegraph (Feb. 4, 2023), https://cointelegraph.com/news/genesis-unsecured-creditors-committee-appointed [https://perma.cc/28YK-ZTMV].

45. This is a *very* brief and incomplete overview of the Chapter 11 corporate restructuring process. For more information regarding bankruptcy, please see https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics for a brief overview of Chapter 11.

46. *Chapter 11 – Bankruptcy Basics*, United States Courts https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics [https://perma.cc/4XMV-QLWR] (last visited Apr. 3, 2023).

47. *Id.*

48. *Id.*

49. Donald L. Swanson, *The "Honest But Unfortunate Debtor": An Old and Still-Evolving Concept*, American Bar Institute, https://www.abi.org/feed-item/the-%E2%80%9Chonest-but-unfortunate-debtor%E2%80%9D-an-old-and-still-evolving-concept [https://perma.cc/L7KJ-7D6E] (last visited Apr. 8, 2023).

debts, remain in business, and emerge out of bankruptcy with a clean slate as a reorganized and solvent corporation.[50]

Chapter 11 bankruptcy starts with a voluntary petition, where the debtor chooses to place themselves in chapter 11 under 11 U.S.C. § 301, or through an involuntary petition, where creditors unite to force a debtor into bankruptcy under 11 U.S.C. § 303.[51] Once the debtor enters bankruptcy, 11 U.S.C. § 362 immediately enacts the automatic stay.[52] The automatic stay prevents creditors from attempting to collect any pre-petition debt white the debtor is in bankruptcy, halting collection efforts and providing relief for debtors.[53] The bankruptcy estate is born at the moment of filing the bankruptcy petition.[54] The bankruptcy estate is controlled by the debtor-in-possession (the "DIP"), and the debtor is allowed to remain in control of the corporation and operate in the normal course of business to give the business a better chance of survival post-bankruptcy, since industries are often specialized and require expertise that the courts and creditors do not possess.[55] As one of my favorite law school professors[56] says, a business is better off alive than dead.[57] Rather than losing a corporation to complete liquidation, corporations under a chapter 11 cooperate with the court, the U.S. trustee, and creditors to confirm a plan. This provides a solution to both the creditors and debtors by allowing the debtors to continue their business, keep employees on the company payroll—instead of on the dime of taxpayers—and stimulate the economy by providing entrepreneurs and investors a solution to potential insolvency as a result of risky business ventures.[58] If the corporation survived, it brought more money into the estate, and thus more money into the pockets of creditors.[59] The law favors those who extend credit to consumers to facilitate circulation of funds in the economy

50. *Chapter 11 – Bankruptcy Basics*, *supra* note 46.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. Hon. Judge Harlin D. Hale, a retired and respected Bankruptcy Judge, teaches Creditors' Rights at SMU Dedman School of Law. He served as a Federal Bankruptcy Judge in the United States Bankruptcy Courts of the Northern District of Texas for over twenty years: https://www.smu.edu/Law/Faculty/Profiles/Hale-H-DeWayne-Cooter [https://perma.cc/8HSD-ZCAL].

57. *Id.*

58. Bill Fay, *Chapter 7 vs. Chapter 11 Bankruptcy*, DEBT.ORG (Aug. 25, 2021), https://www.debt.org/bankruptcy/chapter-7-vs-chapter-11/ [https://perma.cc/TU6K-TNDC].

59. *Id.*

and bankruptcy courts spend ample time, energy, and resources in weighing the interests of debtors, creditors, and public policy.

It (quite literally) pays to be a secured creditor. Secured creditors may "obtain an order from the court granting relief from the automatic stay" to allow them the opportunity to repossess the secured asset to satisfy pre-petition liens.[60] Alternatively, the creditor may request the court to require the debtor to provide monthly payments called "adequate protection," or adequate assurance, to protect the creditor's collateral from continuously losing value while awaiting confirmation of a chapter 11 plan; For example, a piece of machinery that is necessary for the successful reorganization of a corporation that loses value through the debtor's continuous use, a creditor may request payments in lieu of repossession in the event the debtor fails to satisfy the bankruptcy plan.[61] If the debtor defaults after a period of time, the creditor is left with machinery that is worth significantly less than it was at the start of the bankruptcy process and the imposition of the automatic stay.[62] Adequate assurance pays the creditor for the debtor's use of the collateral until a plan is confirmed and the debtor begins making monthly payments towards the plan.[63]

The process of bankruptcy moves at a rapid pace to mitigate losses from the estate and pay back creditors.[64] Once a debtor enters into bankruptcy, the court requires the debtor to produce a disclosure statement consisting of the debtor's financial affairs, containing enough "adequate information" of the debtor's financial standing that the court reviews along with the creditors to design a plan of restructuring.[65] If a plan cannot be confirmed, either as a result of creditor objection or unviability of the proposed plan, the chapter 11 is converted into a liquidation proceeding where a trustee will be appointed by the court, who will then begin to sell off every asset not subject to exemption in an effort to satisfy creditors in order of payment priority set out in § 507 of the Code.[66] Repayment of creditors in both chapter 7 and chapter 11 rarely renders 100% on the dollar, but rather it is common for unsecured creditors to receive "pennies on the dollar–or even nothing at all."[67]

60. *Chapter 11 – Bankruptcy Basics*, *supra* note 45.

61. *Id.*

62. *Id.*; 11 U.S.C. § 361.

63. *Chapter 11 – Bankruptcy Basics*, *supra* note 45.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Not All Creditors Are Created Equal: Critical Vendors and Bankruptcy*, Foley & Lardner LLP (Sept. 5, 2019), https://www.foley.com/en/insights/publications/2019/09/not-all-creditors-are-created-equal [https://perma.cc/38LB-NKGF] [hereinafter *Not All Creditors*].

Repayment of creditors is governed by priority status under 11 U.S.C. § 507, where each creditor is placed into a class and paid back in a waterfall manner, and each class in order of priority is paid in full before payments are made to the next class of priority creditors, ending with pro-rata payments to the last group of creditors to receive payments from the estate.[68] Last in line for payment are the general unsecured creditors and equity security holders (i.e., stockholders).[69] Under chapter 11, a debtor is required to obtain creditor approval of the repayment plan to receive a full discharge of their debts and obligations under § 1141(d).[70] In the event of nonconsensual plan confirmation, the corporation must adhere to the absolute priority rule, requiring repayment of the entirety of the nonconsensual class of creditors' claims before the debtor is allowed to maintain equity and control over the corporation.[71]

Another important aspect of the Code is the policy against preferential or fraudulent transfers, also known as "avoidable transfers."[72] An avoidable transfer occurs when a debtor transfers assets out of the bankruptcy estate prior to filing for bankruptcy in anticipation of liquidation or repossession by the creditor to avoid funneling that particular asset into the bankruptcy estate.[73] The trustee is tasked with identifying these transfers and recovering the value of the transfer from the debtor, and the debtor risks possible denial of discharge.[74] When it comes to trustee avoidance powers, intent of the debtor is not relevant; the requirements for avoidance only require that the transfer occurred to a creditor within the presumption of insolvency of the debtor.[75]

At the end of the chapter 11 process, the DIP receives a discharge after all payments of the plan are completed and the debtor is released from bankruptcy as a successfully restructured company.[76] Plenty of large corporations have filed for chapter 11 such as Party City, Tuesday Morning, Bed, Bath & Beyond, and Southwest Airlines to name a few.[77] By filing under chapter 11, these companies maintained control over their respective corporations and

68. *Chapter 11 – Bankruptcy Basics*, supra note 45.

69. *Not All Creditors*, *supra* note 66.

70. *See* 11 U.S.C. § 1141(d).

71. *Absolute Priority Rule*, Wall Street Prep, https://www.wallstreetprep.com/knowledge/absolute-priority-rule-apr-priority-of-claims-waterfall/[https://perma.cc/AA4U-YYVG] (last visited Apr. 6, 2023).

72. *Chapter 11 – Bankruptcy Basics*, *supra* note 45.

73. *Id.*

74. *Id.*

75. U.S. Dep't of Just., Civil Resources Manual § 58-547 (2019).

76. *Chapter 11 – Bankruptcy Basics*, *supra* note 45.

77. *Id.*

continued operating while paying off their insurmountable debts.[78] Unlike individuals in a chapter 11, corporations receive a broad discharge, free from the limitations set forth on dischargeability under 11 U.S.C. § 523(a) and § 1141(d)(5).[79]

V. THE CONFUSION SURROUNDING CRYPTOCURRENCY

As mentioned in Part II, Cryptocurrency's clash with bankruptcy hinges on whether the bankruptcy courts decide to classify cryptocurrency as a commodity, currency, or considers it property of the estate.[80] Some argue that bankruptcy courts should consider digital assets in possession of the corporation at the time of filing as part of the bankruptcy estate to fund the reorganization.[81] If the cryptocurrency is liquidated and returned to the estate, then the estate receives more money to pay off creditors.[82] Many of the crypto exchange companies listed their customers as general unsecured creditors or as equity holders, forcing customers to the back of the line for repayment priority behind every other creditor.[83] Customers have argued that their deposits still belonged to the customer at the time of filing, while the crypto exchange companies and trustee argue that the crypto belongs to the estate.[84] While the Code is clearer on its treatment of cryptocurrency in a chapter 13 bankruptcy for *individuals*,[85] the Code remains unclear on how courts should treat cryptocurrency belonging to customers of crypto exchange companies who file for chapter 11 relief.[86]

Different regulatory agencies have varying ideas of how cryptocurrency should be classified, thus affecting its status in bankruptcy and the different agency's ability to regulate the exchange platforms.[87] Valuation, or "the

---

78. *Id.*

79. *Id.*

80. Blask et al., *supra* note 4.

81. Cadwalader, Wickersham & Taft LLP, *Quantifying Cryptocurrency Claims in Bankruptcy: Does the Dollar Still Reign Supreme?*, 7 Nat'l L. Rev. 341 (Dec. 7, 2022), https://www.natlawreview.com/article/quantifying-cryptocurrency-claims-bankruptcy-does-dollar-still-reign-supreme [https://perma.cc/3Q4Z-A8F7].

82. Fay, *supra* note 57.

83. Blask et al., *supra* note 4.

84. *Id.*

85. *Id.*

86. *Id.*

87. *See generally* Josephine Shawver, *Commodity or Currency: Cryptocurrency Valuation in Bankruptcy and the Trustee's Recovery Powers*, 62 B.C. L. Rev. 6 (2021).

process of determining the cash value of an asset in bankruptcy," is difficult to achieve when dealing with a fluid and volatile asset such as cryptocurrency.[88] The CFTC has classified cryptocurrency as commodities, and the SEC continues to attempt to regulate cryptocurrency as securities; however, bankruptcy courts have yet to come to a conclusion."[89]

To date, there are still no courts that have determined how to classify cryptocurrency in the currency vs. commodity battle.[90] The hesitancy of bankruptcy courts to classify cryptocurrency arises from one of the most appealing characteristics of cryptocurrency to investors—that crypto is not tied to "existing currency of any government" and has "no value in and of themselves," as their value is not tied to "gold," a "physical commodity," or "to a government's assurance of full faith and credit, such as is the case for the U.S. dollar."[91] Often, bankruptcy courts will rely on the IRS classifications to determine how the court will choose to classify something.[92] The IRS has classified cryptocurrency as property for the purposes of federal taxation, while the CFTC has classified cryptocurrency as a commodity.[93] The SEC maintains that the classification of each cryptocurrency "depends on the characteristics and use of that particular [digital] asset,"[94] relying on the *Howey* test of whether something is considered a security for the purposes of federal securities regulation.[95] The SEC and the U.S. Treasury have classified Bitcoin, a popular cryptocurrency, as *not* a security due to its operation "via decentralized platforms, rather than through a centralized system, the risk that investors assume is not the type of risk" that the SEC is concerned with.[96]

The importance of this classification is due to the recovery powers of the trustee for avoidable transfers.[97] If a bankruptcy court holds that cryptocurrency is a commodity, then the trustee could prevent fraudulent transfers by

---

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. Shawver, *supra* note 86.

94. Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. Securities & Exchange Comm'n (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [https://perma.cc/7KW6-AJD6].

95. Nathan Reiff, *Howey Test Definition: What It Means and Implications for Cryptocurrency*, Investopedia (July 31, 2023), https://www.investopedia.com/terms/h/howey-test.asp [https://perma.cc/3YWQ-NC44].

96. Shawver, *supra* note 86.

97. *Id.*

recovering the actual cryptocurrency coins themselves; thus, requiring customers who withdrew their cryptocurrency within ninety days of the exchange company's filing to return the cryptocurrency in like-kind.[98] If the bankruptcy court decides to classify crypto as currency, then the trustee will be dealt the almost impossible task of attributing a dollar value to the volatile and fluid cryptocurrency at a timeline of the court's choosing.[99]

Bankruptcy courts have three different time periods in which to consider the value of the cryptocurrency for purposes of the estate: the date of the original deposit by the customer with the exchange company, the date of the exchange company's filing for relief, or the date of distribution by the trustee.[100] For the debtor and the creditors, these dates mean varying valuations of their claims.[101] For the debtor and trustee, the trustee can use their avoidance powers to avoid the preferential transfers made according to § 547 and have those assets returned to the estate for distribution in the satisfaction of their debts.[102] For the creditors, this would impact the amount of their claim against the estate in the event their deposits are not returned.[103] Many exchange companies halted withdrawals from user accounts when they filed for relief, preventing customers from withdrawing their funds from the platforms before the estate and automatic stay took effect.[104] If a bankruptcy court chooses to classify loans from crypto-lenders as securities transactions, then contracts involving "stockbrokers, banks, investment companies, [and] clearing agencies" will be exempt from the protection of the automatic stay, one of the biggest protections afforded to debtors to shield them from creditors.[105] Because of this, crypto firms began including provisions in the customer agreements prior to the creation of an account on the platform to agree to be classified as a general unsecured creditor or an equity holder for the purposes of bankruptcy, thus implicating the automatic stay to customers despite the brokerage relationship.[106]

98. *Id.*

99. *Id.*

100. Blask et al., *supra* note 4.

101. *Id.*

102. *Id.*

103. *Id.*

104. Kathleen Marshall, *BlockFi Declares Bankruptcy as FTX Fallout Spreads*, Investopedia (Nov. 28, 2022), https://www.investopedia.com/blockfi-files-for-bankruptcy-6833163 [https://perma.cc/H9TS-9M9E].

105. Schottenstein et al., *supra* note 18.

106. Marshall, *supra* note 103.

Creditors who are unable to recover their digital assets will likely be required to file a proof of claim to recover from the estate.[107] Depending on the timeline the court relies on, the creditor's claim may be the value of the asset the date it was deposited, the value at the time of the exchange company's filing, or the date that the trustee begins making distributions of the estate to creditors.[108] Customers who invested with the exchange companies claim to have been unaware of the risks associated with the investments, and did not expect to be last in line behind other priority creditors to receive payments if they are lucky enough to receive anything at all.[109]

Much to the disappointment of customers, cryptocurrency is not insured by the Federal Deposit Insurance Corporation (FDIC).[110] When a bank or financial institution fails, the FDIC insures deposits made by consumers.[111] Because cryptocurrency is not insured by the government, when a cryptocurrency exchange company goes under, the funds invested by others are dissolved into the bankruptcy estate, and depending on the terms of use on a company-by-company basis, the classification of creditors may result in their receiving nothing at the end of the bankruptcy, depending on their classification in the priority statute.[112] While some cryptocurrency, such as Stablecoin, is backed by assets, most are not and do not have an equity cushion to protect against such events.[113]

VI. CRYPTO'S CONTROVERSY WITH FEDERAL SECURITIES LAW

Customers claim to have "deposited" or "stored fiat currency and cryptocurrencies on the debtors' platforms," and unbeknownst to users, the funds "allegedly were commingled or rehypothecated," resulting in insolvency and underfunding.[114] The SEC announced in May 2022 that it would increase the size of its Cyber Unit to ensure compliance by crypto firms with securities laws.[115] The Securities Act of 1933 and the Securities Exchange Act of 1934

107. *Recovering Digital Assets in Chapter 11 Bankruptcy*, Winston & Strawn LLP (July 29, 2022), https://www.winston.com/en/insights-news/recovering-digital-assets-in-chapter-11-bankruptcy [https://perma.cc/X7BC-LW9V].

108. Shawver, *supra* note 86.

109. Rosenberg, *supra* note 12.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. Cadwalader, Wickersham & Taft LLP, *supra* note 80.

115. Rakesh Sharma, *How SEC Regs Will Change Cryptocurrency Markets*, Investopedia (Apr. 3, 2023), https://www.investopedia.com/news/how-sec-regs-will-change-cryptocurrency-markets/[https://perma.cc/9KVQ-3APF].

led to the decision by the United States Supreme Court ruling in *W.J. Howey Co.*, developing the *Howey* test for determining what is a security and subject to regulation by the SEC.[116] This test has four criteria: (1) money is invested; (2) with the expectation of profit; (3) the investment is in a common enterprise; and 4) profits are generated by utilizing the efforts of others.[117] Common examples of securities are stocks and bonds.[118] A security is a fungible financial instrument that is used to raise capital.[119] The SEC Chair, Gary Gensler, stated in June 2022 that crypto exchange companies that refused to cooperate with securities laws were "operating outside of the law and may be at risk of enforcement action" from the government agency.[120] Gensler expressed concern that the cryptocurrency exchange businesses were targeting the investing public, who "anticipate[] profits based on the efforts of others."[121]

The CFTC is a government agency tasked to "protect the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial future options," and along with the Department of Justice, has increased regulation of cryptocurrency exchange platforms to better shield the public from potential securities crimes and scams.[122] Common crimes committed by these cryptocurrency exchange companies are allowing users to trade unregistered securities and comingling investment funds across multiple affiliates without the knowledge or consent of customers.[123] Among those facing the wrath of the SEC include Kim Kardashian, who settled for a $1.2 million fine for her failure to disclose the compensation received from her promotion of EthereumMax on social media in 2021.[124] While part of the appeal of cryptocurrency is its independence from traditional government regulations, the SEC has made it clear that cryptocurrency still must comply with securities

116. Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293 (1946); Wayne Duggan, *Crypto Regulation: Is Cryptocurrency a Security?*, Forbes Advisor (Oct. 7, 2022), https://www.forbes.com/advisor/investing/sec-crypto-regulation/ [https://perma.cc/SHH9-L74B].

117. Duggan, *supra* note 115.

118. Monica Renee, *What Are Securities?*, Investment Firms (Apr. 13, 2021), https://investmentfirms.com/what-are-securities/ [https://perma.cc/N42V-32E7].

119. *Id.*

120. Duggan, *supra* note 115.

121. *Id.*

122. *Id.*; *see U.S. Commodity Futures Trading Commission*, USA gov, https://www.usa.gov/federal-agencies/u-s-commodity-futures-trading-commission [https://perma.cc/95HH-88VX].

123. Duggan, *supra* note 115.

124. *Id.*

laws.[125] Each cryptocurrency exchange company and its attorneys will need to be wary of the "nature and use" of the platform by individual customers to avoid overlap with the SEC's test for securities.[126]

With the overlapping of cryptocurrency and securities laws, it is important to understand how the Code addresses securities. While some sophisticated stock traders look to chapter 11 as a unique and cheap opportunity to invest in a failing and desperate company, there exists great risks associated with common investing in companies planning to file for bankruptcy relief.[127] The absolute priority rule requires that a creditor pay back the entirety of a dissenting class of creditors to maintain equity, and therefore stock in the company.[128] Companies will relinquish control to creditors and bondholders as "the new owners of the shares," thus incorporating into the company's reorganization plan the cancellation of existing shares that belong to current stockholders.[129] Stockholders, i.e. customers of exchange sites, are moved to the bottom of the list of people to be paid back during the reorganization process and risk losing any ownership they may have had over their deposits if the estate is not large enough to pay back existing creditors.[130] Therefore, shareholders are forced behind repayment from the estate of secured *and* unsecured creditors, forcing customers to wait and hope for a return of their investments.[131]

VII. "CRYPTO WINTER"

The decline of cryptocurrency started with the failure of Luna Crypto.[132] To hedge against the unstable and volatile nature of cryptocurrency, Stablecoins

125. *Id.*

126. Temitope Olatunji, *Are Cryptocurrencies Securities? The Howey Test and Its Implications*, Make Use Of (Nov. 14, 2022), https://www.makeuseof.com/are-cryptocurrencies-securities [https://perma.cc/9MUH-3VFV] (last visited Apr. 3, 2023).

127. *Bankruptcy: What Happens When Public Companies Go Bankrupt*, U.S. Sec. Exch. Comm'n (Feb. 3, 2009), https://www.sec.gov/reportspubs/investor-publications/investorpubsbankrupt [https://perma.cc/74LH-QZNC] [hereinafter *Bankruptcy*].

128. *Absolute Priority Rule*, *supra* note 70.

129. *Bankruptcy*, *supra* note 126.

130. *Id.*

131. *Id.*

132. Daniel Van Boom, *Luna Crypto Crash: How UST Broke and What's Next for Terra*, CNET (May 25, 2022), https://www.cnet.com/personal-finance/crypto/luna-crypto-crash-how-ust-broke-and-whats-next-for-terra/ [https://perma.cc/KN6X-QG6V].

were designed to maintain a consistent value of one U.S. dollar, i.e., remain stable.[133] Stablecoins are traditionally "tightly pegged to a traditional fiat currency, such as the US dollar, or to a commodity like gold," allowing for investors to store money in the cryptocurrency infrastructure, away from regulators and easing the process of international transactions.[134]

A new type of Stablecoin, called "algorithmic stablecoin," produces crypto coins that, as some critics have phrased it, are "just a fancy way of saying, '[w] e are going to say that this is worth a dollar because it's backed by another asset that we also create out of thin air.'"[135] In the case of TerraUSD, the cryptocurrency exchange platform produced Luna Crypto, their "out of thin air" asset used to stabilize each Terra coin.[136] Luna Crypto was not a Stablecoin, but traders could "engage in a process called arbitrage . . . by exploiting fluctuations" in either Luna Crypto or TerraUSD, with traders exchanging Lunas for Terras to maintain Terras value of one dollar, despite the fluctuating market.[137] Part of TerraUSD's strategy to entice customers to trade Terra for Luna was implementing a 19.5% interest on investment in Luna.[138] TerraUSD retained its value by being exchangeable with the concurrent amount of Luna–for example, if TerraUSD dropped to ninety-nine cents, investors could exchange the Terra for one dollar worth of Luna, where they would see a profit of 1 cent per token.[139] However, over two billion dollars' worth of Terra remained unstaked without the backing of Luna and subsequently sold onto the market.[140]

Because of the flood of unstaked Terra, the price of Terra went down to ninety-one cents and traders attempted to trade their Terra for Luna; however, the platform only allowed $100 million of Terra to be traded for Luna per day.[141] Investors "flocked to sell their [Terra] once the Stablecoin couldn't retain its peg," resulting in one Luna, once worth $82.55, decreasing to being worth only $0.01 per Luna.[142] Over seventeen billion dollars in cryptocurrency was wiped

133. Allison Morrow, *Why This Obscure Corner of the Crypto World Has Investors in a Panic*, CNN Bus. (May 13, 2022, 4:36 AM), https://www.cnn.com/2022/05/12/investing/luna-terra-stablecoin-explained/index.html [https://perma.cc/9HW7-MCFX].

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. Van Boom, *supra* note 131.

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.*

out between Luna and Terra.[143] The illusion of protection purported by cryptocurrency exchange companies was shattered, customers began to see the risks associated with investment and withdrew their funds from the platforms in droves – creating a domino effect of bankruptcy filings from successful cryptocurrency exchange companies like FTX.[144] Shortly after the collapse of Luna, crypto lenders such as Three Arrows Capital (3AC), Voyager, FTX, Celsius Network, and Blockfi sought chapter 11 relief, leading to a frenzy of litigation by customers against the exchange and lending companies, their directors and officers, and celebrities who endorsed the exchanges to the public.[145]

A. Crypto Winter: Three Arrows Capital &Voyager Digital

After the crash of Luna and Terra in May of 2022, customers began to panic as they learned the risky nature of cryptocurrency investments from the consequences suffered by investors of Luna and Terra.[146] In June of 2022, the British Virgin Island Courts ordered 3AC to liquidate after a creditor, DRB Panama, Inc., filed an application to appoint a liquidator, an involuntary petition.[147] 3AC's heavy investments in Luna, and Luna's subsequent failure, caused 3AC to default on its obligations, including a $675 million loan from Voyager Digital Holdings ("Voyager").[148] Soon after, without the ability to recoup the loan from 3AC, Voyager filed for chapter 11 bankruptcy in July 2022.[149]

The $675 million loan from Voyager to 3AC was funded by customer deposits because of their "Bedrock" business model, which relied on a self-custody wallet system.[150] Voyager's customer agreement included a provision that allowed Voyager to acquire control over the customer's deposits once the deposits were verified through the Bedrock system.[151] Customers would make a deposit, it would be verified through Voyager's system, and then Voyager had free reign to commingle those deposits with other customers' deposits in a general Voyager account, preventing customers from having direct access and

143. *Id.*

144. Van Boom, *supra* note 131.

145. *Id.*; Blask & Tully, *supra* note 4; Eric Mack, *The Fall of FTX and Sam Bankman-Fried: A Timeline*, CNET (Feb. 24, 2023, 2:03 PM), https://www.cnet.com/personal-finance/crypto/the-fall-of-ftx-and-sam-bankman-fried-a-full-timeline-of-events/ [https://perma.cc/T5MY-B36T].

146. *See* Blask et al., *supra* note 4.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

control over their investments.[152] Voyager would then use those funds to make loans to third parties, such as 3AC.[153] Once 3AC filed for bankruptcy, Voyager had no choice but to follow suit.[154] In its pleadings, Voyager calls itself a "crypto brokerage," where normally customers in a brokerage bankruptcy are given priority status to receive their deposits back as the money didn't belong to the broker; however, the chapter 11 plan produced by Voyager classifies their customers as mere unsecured creditors, meaning they will receive a pro rata distribution of their deposits, and most likely receiving less than the full value of their original deposits to the platform.[155]

Once customers deposited their funds on the Voyager platform, and the funds were intermingled, ownership transferred to Voyager giving them the ability to use those funds to make loans and investments to others.[156] Because Voyager did not maintain a capital cushion to shield it from unexpected losses, the default of third parties on those loans led to Voyager being unable to repay all deposits back to customers, nor its debts as they became due – thus leading to Voyager's own insolvency and customers without their deposits.[157]

B. Crypto Winter: FTX

Futures Exchange ("FTX") is one of the largest cryptocurrency exchange platforms in the world.[158] Recovery for creditors rarely guarantees 100 cents on the dollar, and some experts are speculating that FTX creditors will be lucky to receive "more than 2 cents on the dollar."[159] During its reign of cryptocurrency, FTX allowed users to buy, sell, hold, and trade cryptocurrency using their blockchain technology.[160] Originally founded in 2019 by Sam

152. Blask et al., *supra* note 4.

153. *Id.*

154. 153. *See id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *FTX Scandal: What Is It and How Did It Unravel? Here's All You Need to Know*, The Econ. Times (Dec. 12, 2022, 11:27 PM), https://economictimes.indiatimes.com/news/international/us/ftx-scandal-what-is-it-and-how-did-it-unravel-heres-all-you-need-to-know/articleshow/95589010.cms [https://perma.cc/2LUC-S88S] [hereinafter *FTX Scandal*].

159. Jacquelyn Melinek, *Lost Your Crypto Amid Chapter 11* Bankruptcy *Filings? You're Probably Not Getting it Back*, TechCrunch+ (Jan. 31, 2023, 11:00 AM), https://techcrunch.com/2023/01/31/lost-your-crypto-amid-chapter-11-bankruptcy-filings-youre-probably-not-getting-it-back/ [https://perma.cc/6MHM-D7JV].

160. *See FTX Scandal*, *supra* note 157.

Bankman-Fried ("SBF") in the Bahamas, FTX quickly rose to the top as one of the most successful and influential cryptocurrency exchange companies in the world.[161] Before its fall from grace, FTX was the second largest crypto-exchange company in the world, valued at nearly $30 billion, just behind its first investor, Binance.[162]

Despite an attempted bailout negotiation with Binance, FTX failed to maintain enough liquidity to remain solvent.[163] FTX, along with 130 of its affiliates, filed for chapter 11 bankruptcy on November 11, 2022.[164] Following the trend of other failed crypto-exchange platforms, FTX froze customer's accounts and halted all deposits, withdrawals, and trading.[165] Investigation into FTX's financial dealings revealed mismanagement of customer deposits, and calls for regulation have catapulted cryptocurrency into the world of regulation.[166]

A string of recently revealed documents filed as evidence in the FTX bankruptcy reveals that the alteration of financial documents and the misuse of corporate funds by employees and advisors led to the downfall of FTX.[167] John J. Ray, the new CEO of FTX after SBF stepped down and his attorney, who oversaw the infamous Enron bankruptcy, revealed to the court that he has "never seen a company in as bad a shape as FTX in [his] 40 years of dealing with bankruptcies," led by "inexperienced executives" who demonstrated "complete failure of corporate controls."[168] Along with the enlightening evidence as to how FTX's financial situation remained hidden from investors, information about FTX's failure to track cashflow and to log "numerous security failures" revealed more troubling news for investors who entrusted their digital assets

161. Mack, *supra* note 144; Pete Evans, *Crypto Trading Platform FTX Collapses into Bankruptcy, Dragging Bitcoin Price Down with It*, CBC (Nov. 11, 2022), https://www.cbc.ca/news/business/ftx-bankrupt-friday-1.6648872 [https://perma.cc/N3PB-SWUM].

162. Mack, *supra* note 144.

163. *FTX Scandal*, *supra* note 157.

164. Grace Key, *Read the Explosive Bankruptcy Filing where FTX's New CEO Called Out Sam Bankman-Fried*, INSIDER (Nov. 17, 2022, 8:40 AM), https://www.businessinsider.com/read-full-ftx-bankruptcy-filing-online-new-ceo-2022-11 [https://perma.cc/85CP-A3AE].

165. Evans, *supra* note 160.

166. Mack, *supra* note 144; Van Boom, *supra* note 131.

167. Sindhu Sundar & Samantha Delouya, *Lawyers Walked Us Through the FTX Bankruptcy Filing. It's Really, Really Bad*, INSIDER (Nov. 18, 2022, 5:40 AM), https://www.businessinsider.com/ftx-bankruptcy-sam-bankman-fried-legal-filing-fraud-sec-details-2022-11 [https://perma.cc/CD48-AYXN].

168. Key, *supra* note 163.

and private information on the popular crypto-exchange platform.[169] As noted earlier, one of cryptocurrency's major appeals to investors is the extra security provided due to the immutability and finality of cryptocurrency transactions – but FTX's insolvency, along with the subsequent Crypto Winter, has sent a warning to customers that their funds are not as secure as they may have been led to believe.[170] The former chief operating officer of the CFTC stated that the first major red flag of FTX's impending bankruptcy was the balance sheet "valuing itself based on something [FTX] invented," and that "no one really knew how much [FTX cryptocurrency] was valued at," resulting in FTX's publicly disclosed balance sheet concealing its troubling financial situation from investors and regulators.[171]

SBF is also "accused of fraud, conspiracy, and violating campaign finance laws" due to his involvement with the concealment of FTX's failing enterprise.[172] Various members of FTX's leadership are accused of borrowing over $546 million from Alameda Research to purchase 8% stock in Robinhood, a popular stock-trading platform.[173] The $546 million invested by Alameda has now been withheld by the SEC while it continues its investigation into FTX's allegedly corrupt and fraudulent dealings.[174] SBF is facing up to eight federal charges and is accused of swindling customers out of billions of dollars to fund the lavish lifestyles of the FTX executives and to cover the "losses at the sister cryptocurrency trading firm, Alameda Research."[175] SBF allegedly diverted funds, which were the product of "deposit[s] by millions of customers" on FTX and transferred those funds "without authorization to Alameda, a hedge fund," to compensate for substantial losses and to keep Alameda's financial troubles hidden.[176]

A hedge fund "is a limited partnership of private investors whose money is managed by professional fund managers" to try to "earn above-average

169. *Id.*

170. *See id.*

171. Evans, *supra* note 160.

172. Mack, *supra* note 144.

173. Thomas Barrabi, *FTX Customers File Class-Action Lawsuit to Recoup 'Diminished' Assets*, N.Y. Post (Dec. 28, 2022, 10:50 AM), https://nypost.com/2022/12/28/ftx-customers-file-class-action-lawsuit-to-recoup-diminished-assets/[https://perma.cc/ME89-GY4Q].

174. *Id.*

175. *Id.*

176. Shiona McCallum & Mike Farrell, *Crypto Lender Genesis Files for Bankruptcy*, BBC News (Jan. 20, 2023), https://www.bbc.com/news/technology-64343377 [https://perma.cc/Y9LM-EF8N].

investment returns."[177] Hedge funds are "often considered a risky alternative investment choice" and require "a high minimum investment or net worth," because the risk of losing often outweighs the benefits of gaining.[178] Customers who believed their funds were being placed in a cryptocurrency that shielded them from third-party involvement and regulations unknowingly had their assets and funds channeled out of the security of FTX and into the volatile world of hedge funds, resulting in substantial losses and undercapitalization of FTX.[179]

A large part of FTX's success with "average Joe" customers was its marketing scheme.[180] A multitude of high-caliber celebrities publicly endorsed SBF and FTX at popular events, such as Larry David in the 2021 Super Bowl Ad, who is now also facing his own lawsuit as a result of his involvement.[181] On November 15, 2022, indignant customers filed a class action lawsuit in Florida against FTX and the brand ambassadors, "including Larry David, Tom Brady, Gisele Bundchen, Kevin O'Leary, Naomi Osaka, Shaquille O'Neal, and Stephen Curry," with allegations of deception and misrepresentation to consumers.[182] Subsequently, FTX co-founder Gary Wang pled guilty to wire fraud, securities fraud, and commodities fraud on December 21, 2022.[183]

The class action was filed just days after the announcement of FTX's chapter 11 filing and technically post-petition; however, in a bankruptcy proceeding, the court looks to whether the damage occurred *pre-petition*.[184] Because the damage caused by FTX was a result of a its pre-petition conduct, the automatic stay applies and recovery for the class action claim is halted until the court orders a lift of the automatic stay under § 362 of the Code.[185] Plaintiff-customers' only choice for the time being is either moving the case to bankruptcy court, dismiss the case, or ask the court for relief from the automatic stay to pursue the lawsuit despite the pending bankruptcy.[186] The plaintiffs to the class action petitioned the court "to rule that remaining FTX assets

177. The Investopedia Team, *What Is a Hedge Fund?*, INVESTOPEDIA (Aug. 11, 2017), https://www.investopedia.com/terms/h/hedgefund.asp [https://perma.cc/2NF9-PVY9].

178. *Id.*

179. *See generally* Mack, *supra* note 144.

180. *See id.*

181. *See generally id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. 11 U.S.C. § 362 (Supp. III 2018).

186. *See* Barrabi, *supra* note 172.

belong to customers instead of the company" and that the plaintiffs "should be compensated for their losses before other creditors."[187] In other words, the plaintiffs sought to have higher priority than other creditors and demanded their deposits returned to them, as the deposits would have been in a brokerage bankruptcy or a financial institution insured by the FDIC.[188]

Order of priority in bankruptcy is governed by § 507(a) of the Code and requires repayment of priority creditors, such as administrative claims under 11 U.S. C. § 503(b), and secured creditors before general unsecured creditors receive payment, and only after their repayment are stockholders reimbursed on a pro-rata basis for their ownership of the corporation.[189] The absolute priority rule comes into play and requires "compliance to the strict hierarchy of claim payouts for 'fair and equitable' distribution of recovery proceeds" to all secured and unsecured creditors with a valid claim in the corporation's bankruptcy.[190] The absolute priority rule requires that higher-ranking claim holders receive full recovery before the lower-priority claim holders are entitled to recover *anything*.[191] While the debtors hope to retain the funds transferred to the platform from customers as general unsecured claims or as classified as stockholders, the customers claim in the class action that their transfers were merely deposits, and the "cash and other assets held by customers 'never belonged to FTX or Alameda' and should not be used to repay the platform's many creditors," especially given the fraudulent transfers by SBF.[192]

After the fall of FTX, more cryptocurrencies began to feel the pressures of the Crypto Winter, revealing how the unregulated nature of crypto lenders and exchange platforms allowed bad actors to take advantage of customer funds, create value out of thin air, and market to the public without disclosing the dangers and risks associated with investments.[193] Further, the incestual nature of cryptocurrency exchange companies continuously lending one non-staked coin for another to one another, backed by customer funds, has investors fearing an inevitable crash of cryptocurrency. This resulted in a rush to dump crypto investments at the first chance they received.[194] Multiple FTX-backed cryptocurrencies are reeling after the revelation of the FTX scandal, with some down nearly 94% in value post-FTX filing.[195]

---

187. *Id.*

188. *See id.*

189. *Absolute Priority Rule, supra* note 70.

190. *Id.*

191. *Id.*

192. Barrabi, *supra* note 172.

193. *See id.*

194. Mack, *supra* note 144; Van Boom, *supra* note 131.

195. Barrabi, *supra* note 172.

C. Crypto Winter: Genesis

On January 20, 2023, crypto firm Genesis filed for chapter 11 bankruptcy, with nearly $3.4 billion owed to its creditors.[196] Genesis's losses totaled $3 billion in active loans at the time of filing, a sharp decline from the $130.6 billion in crypto loans Genesis extended in 2022.[197] Genesis' two largest borrowers were 3AC and Alameda Research, the sister affiliate of FTX who received payments through SBF's shady dealings.[198] When 3AC, FTX, and Alameda filed for bankruptcy, Genesis was left with little choice but to follow suit.[199] Unlike traditional banks, crypto lenders are not required to hold capital cushions of cash or highly liquid assets to act as a reserve to hedge against external shocks, such as in the event that a borrower defaults on the loan or files for bankruptcy.[200] If Genesis had a liquidity cushion, the losses sustained by Genesis caused by the insolvency of FTX, 3AC, and Alameda would have been mitigated.[201] 3AC owed Genesis nearly $1.1 billion at the time of their filing, loans which had been taken out in an effort to save TerraUSD and Luna Crypto from collapse.[202]

After Genesis filed for relief, the SEC began an investigation for potential securities law violations.[203] The SEC has since charged Genesis with illegally selling securities, as the cryptocurrency transactions carried out on the Genesis platform were considered by the SEC to satisfy the *Howey* test.[204] Genesis's legal trouble did not start with the insolvency of other crypto lenders and exchange platforms.[205] At the time of this publication, Genesis is in an adversary proceeding with a third party claiming to be misled by the crypto firm.[206]

---

196. *Crypto Lending Unit of Genesis for U.S. Bankruptcy*, Reuters (Jan. 20, 2023, 12:48 PM), https://www.reuters.com/technology/crypto-lending-unit-genesis-files-us-bankruptcy-2023-01-20/ [https://perma.cc/4T7C-NY5T].

197. *Id.*

198. *Id.*

199. *Id.*

200. *See generally* Stephen Slivinski, *Federal Reserve: Capital Cushions*, Region Focus 6–7; see also Crypto Lending Unit of Genesis *for U.S. Bankruptcy*, supra note 195.

201. *See generally* Slivinski, supra note 199; *see also Crypto Lending Unit of Genesis for U.S. Bankruptcy*, supra note 195.

202. *Crypto Lending Unit of Genesis for U.S. Bankruptcy*, *supra* note 195.

203. Duggan, *supra* note 115.

204. *Id.*

205. *Crypto Lending Unit of Genesis for U.S. Bankruptcy*, *supra* note 190.

206. *Id.*

Gemini, another crypto firm, is in dispute over $900 million of assets deposited with Gemini by customers of Genesis.[207] Gemini Earn, the product created and backed by Genesis and Gemini, was promised to return 7.4% interest rate to investors.[208] Over 340,000 Gemini Earn users had access to their accounts, and withdrawals halted once Gemini filed for bankruptcy, peaking regulator interest and beginning the SEC's investigation into the alleged securities violations by Genesis.[209] The SEC has accused "both Genesis *and* Gemini of illegally selling crypto assets to investors," and Gemini blames Genesis, with Gemini co-owner Cameron Winklevoss publicly demanding an explanation from Genesis about the securities violations and making promises to Gemini Earn users to return their assets lost with Genesis.[210]

A common theme and major weak spot in crypto firms, as evidenced through FTX, 3AC, and Voyager, is the cross-reliance of crypto lenders on other crypto firms in the market by utilizing other crypto coins to attempt to stabilize the crypto firm's own digital assets.[211] Genesis's parent company, Digital Currency Group (DCG), had invested in other crypto exchanges such as "Coinbase," "Kraken," "Circle," "Stablecoin USDC" and other blockchain analytics companies such as "Chain Analysis, Dune Analytics, Elliptic, and Etherscan."[212] On February 4, 2023, a committee representing the unsecured creditors was appointed by William Harrington, a United States Trustee, to give unsecured creditors the opportunity to participate in Genesis' reorganization plan to ensure the fair and equitable treatment of the unsecured creditors.[213] The seven-member committee has "the right to be consulted before major decisions and to participate in the reorganization plan," with the specific members having been selected from a list comprising of the twenty largest unsecured creditors with claims against the Genesis Estate.[214]

Another class action lawsuit was filed against Gemini on January 24, 2023, by creditors claiming securities fraud and securities law violations.[215] The creditors claim that Genesis "committed securities fraud through a scheme

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *Crypto Lending Unit of Genesis for U.S. Bankruptcy*, *supra* note 195.

212. Rahul Nambiampurath, *Crypto Lender Genesis Files for Bankruptcy as FTX Contagion Spreads*, Investopedia: Cryptocurrency News (Jan. 20, 2023), https://www.investopedia.com/genesis-files-for-bankruptcy-7097358 [https://perma.cc/6KAU-ZGFA].

213. Pereira, *supra* note 43.

214. *Id.*

215. *Id.*

to defraud potential and existing digital asset lenders by making false and misleading statements," a violation under the United States Securities Exchange Act § 10(b).[216] The complaint alleges that DCG and CEO, Barry Silbert, failed to qualify for exemptions from the registration requirements under federal securities laws and executed lending agreements, which involved securities.[217] The scheme to defraud creditors involved the inducement of prospective lenders to loan digital assets to Genesis and then "[prevent] existing lenders from redeeming their digital assets."[218] This is yet another adversary proceeding that will remain on hold while the courts attempt to confirm a reorganization plan.[219] Because the customers will likely be classified as general unsecured creditors or stockholders under the plan, customers are seeking alternative measures, such as the adversary proceedings, in an attempt to recoup their losses and shine a light on the fraudulent behavior of giant crypto lenders and exchange companies.[220]

D. Crypto Winter: Celsius Network

Celsius Network ("Celsius") was one of "the largest and most sophisticated cryptocurrency-based finance platforms and lenders" with over "1.7 million users worldwide."[221] Prior to its own bankruptcy filing, FTX began acquiring other failing crypto exchange platforms, but they were overextended and unable to untangle Alameda's assets from the FTX exchange, subsequently leading to the FTX insolvency bringing down other crypto exchange platforms.[222] Celsius filed for bankruptcy on July 13, 2022.[223] In the same response as other insolvent crypto exchange platforms, the news of Celsius' filing was quickly followed with a "[pause of] all withdrawals, swaps, and transfers among customer accounts," and the Celsius balance sheet revealed a $1.2 billion deficit owed to their creditors, including their customers.[224]

216. *Id.*

217. Leo Jakobson, *Genesis Slapped with Securities Fraud Class Action Lawsuit*, Coin Market Cap (Feb. 2023), https://coinmarketcap.com/alexandria/article/genesis-slapped-with-securities-fraud-class-action-lawsuit [https://perma.cc/5P7R-HC4G].

218. *Id.*

219. *Id.*

220. *Id.*

221. Cadwalader, Wickersham & Taft LLP, *supra* note 80.

222. *Id.*

223. Rosenberg, *supra* note 12.

224. *Id.*

On January 4, 2023, New York U.S. Bankruptcy Judge Martin Glenn ruled that "most" of customer's cryptocurrency deposits on the Celsius platform at the time of filing belonged to Celsius, affecting nearly 600,000 customer accounts.[225] These accounts amounted to nearly $4.2 billion of customer deposits, and the proposed restructuring plan will not pay back creditors 100 cents on the dollar, and because of Judge Glenn's classification of the deposits as belonging to Celsius, "Celsius customers will be last in line for repayment in the crypto lender's bankruptcy."[226] Judge Glenn's analysis of the classification took into account that "the Celsius' terms of service made clear that the crypto lender took ownership of customer deposits into its interest-bearing Earn accounts," and that allowing customers with interest-bearing accounts to recover their deposits would result in "similarly-situated customers" recovering varying percentages of their deposits back, with some receiving 100% and others receiving a small percentage of their deposits, despite being similarly situated creditors in the same class of priority repayment.[227] This ruling came after twelve U.S. states had previously rejected Celsius' claim of ownership over the digital assets, but Celsius customers will still "be able to bring fraud or breach of contract claims against the crypto lenders," and regulators will be able to investigate for possible securities fraud with the and deem the customer's account contracts as unenforceable due to violations of the securities law.[228]

E. Crypto Winter: BlockFi

BlockFi, a New Jersey-based crypto lending company, filed for Chapter 11 bankruptcy on November 28, 2022, having paused withdrawals by investors immediately following the collapse of FTX.[229] Subsequently, the SEC initiated an investigation and charged BlockFi for failing to register its interest rates account as a security.[230] FTX bailed out BlockFi in 2022 with a revolving credit of $400 million, while also providing the option to buy it back for

225. Dietrich Knauth, *U.S. Judge Says Celsius Network Owns Most Customer Crypto Deposits*, Reuters (Jan. 5, 2023, 11:50 AM), https://www.reuters.com/business/finance/us-judge-says-celsius-network-owns-most-customer-crypto-deposits-2023-01-05/ [https://perma.cc/3K7W-2MVP].

226. *Id.*

227. *Id.*

228. *Id.*

229. Marshall, *supra* note 103.

230. Rickie Houston, *What's Going on with BlockFi and How Does it Affect Crypto Users?*, Insider: Pers. Fin. (Dec. 1, 2022), https://www.businessinsider.com/personal-finance/blockfi-bankruptcy-tax-implications-2022-12 [https://perma.cc/3VDR-JMBX].

$240 million.[231] At a hearing in late November, BlockFi claimed that FTX and Alameda owe the company over $1 billion, while BlockFi owes FTX $275 million in USD Stablecoins.[232] An Official Committee of Unsecured Creditors was appointed to assist with unsecured creditor representation in the reorganization planning due to the high number of unsecured creditors who deposited funds on the platform.[233] David Kemmerer, co-founder and chief executive officer of CoinLedger, claims that "users who stored their digital assets on BlockFi may never be refunded" as a result of the bankruptcy filing.[234] The issue of priority has once again stifled customer attempts to recoup their deposits, with "assets held with a bankrupt crypto lender" being "sold to compensate [priority] creditors."[235] The main issue, according to general counsel Georgia Quinn, is the "lack of critical consumer and bankruptcy protections around crypto exchange custody," because "when crypto is held in custody on an exchange, client assets could be commingled with the exchange's assets, blurring the lines of whose assets are whose and what assets are subject to creditor claims."[236]

Many of the insolvent crypto lenders required customers to sign terms and conditions when creating their accounts.[237] These conditions almost universally declare customer funds as owned by the platform once the customer makes a deposit.[238] Bankruptcy courts are skilled at the weighing and balancing of creditor, debtor, and public interest, but with the increased use of digital assets and the novel and complicated nature of cryptocurrency exchange platforms, the process of balancing interests becomes almost impossible as the courts will have to determine whether to protect the debt and creditor body at large by requiring returns of preferential transfers and placing customers at the end of the line of priority for repayment, or choose to sacrifice the assets of the estate to pay back unsuspecting and unwary customers who believed their funds were deposited with the crypto exchange companies and remained in their possession and control.[239] The flood of adversary proceedings and the charges by the SEC further complicate the matter, requiring more resources

231. Marshall, *supra* note 103.

232. Houston, *supra* note 229.

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.*

237. *See generally* Blask et al., *supra* note 4.

238. *Id.*

239. *See id.*

to be diverted from the estate and the pockets of all creditors, secured and unsecured.[240]

VIII. THE NFT BUBBLE – HAS IT BURST?

NFTs have suffered as a consequence of the weary and suspicious investors who have been burned by the world of digital assets.[241] Customers have slowed down their investments in unregulated currency exchange platforms for fear of losing their assets in an insolvency proceeding.[242] NFT price tags plummeted in tandem with the falling cryptocurrency market.[243] For example, Sina Estavi recently put an NFT she purchased for $2.9 million on sale and received a measly $14,000.[244] The fall in NFT values has investors on edge regarding the instability of digital assets. Insolvency proceedings have illuminated the dangers of relying on a "currency" whose value is wholly reliant on the value given to it exclusively online without the protections of insurance or government relief.[245] The complicated nature of NFTs makes the U.S. trustee's job of valuation even more difficult, as NFTs "are blockchain assets representing unique asset classes" such as "digital artwork, music, pictures, real estate, videos, in-game items, domain names, event tickets, and non-digital collectibles."[246] NFTs are irrevocable digital certificates of ownership and are authenticated through the same process as cryptocurrencies, through blockchain technology.[247] NFTs connection with cryptocurrency arose when customers began to lock their NFT token in a blockchain contract in order to earn interest, a process called "staking."[248] Because of the cryptocurrency nose dive, NFT investors fear the worst with their nonfungible assets being tied up in potentially unrecoverable contracts.[249]

---

240. *See id.*

241. Max Antony Rapkin, *The NFT Bubble Explained*, NFT NEWS TODAY (June 5, 2022), https://nftnewstoday.com/2022/06/05/the-nft-bubble-explained/ [https://perma.cc/VJD2-48PU].

242. *Id.*

243. *See id.*

244. *Id.*

245. *Id.*

246. Josiah Makori, *What is the NFT Bubble and Has it Burst?*, COINGECKO (Feb. 16, 2023), https://www.coingecko.com/learn/what-is-the-nft-bubble-and-has-it-burst [https://perma.cc/Z38P-3K2E].

247. *Id.*

248. Rondon, *supra* note 35.

249. Makori, *supra* note 245.

A bubble refers to "an economic event" resulting from "the rapid growth of a market value of an asset," and the high demand driven by speculation results in the market value of that item exceeding its value or usefulness.[250] When an asset has a value so inflated, it creates a bubble around the asset's market.[251] This bubble "pops" when the inflation reaches a level that is "no longer justifiable or exceeds its utility."[252] The sharp decline in NFT prices, the low trading volume, and the decrease in media coverage are evidence of the NFT bubble popping.[253]

When FTX filed for bankruptcy, many consumers rushed to purchase NFTs from Bahamian holders on the NFTs exchange marketplace for a fee because of the restriction on access placed by FTX while the SEC and DOJ conducted its investigation.[254] Some users utilized this loophole to sneak their NFTs out of the exchange to "circumvent the restrictions that FTX" had put in place.[255] Yahoo Finance explained the loophole:

To take advantage of the loophole, a Bahamian user could buy an NFT for $1 and then list it for the amount of their locked funds, plus a fee, for example $10 million. If an FTX customer buys the NFT for $10 million, the money would transfer to the Bahamian Seller's account like a normal sale and could be recovered from the exchange.[256]

The loophole resulted in $50 million in trading volume but was subsequently stopped by FTX.[257] FTX takes a 2% fee from NFT transactions, likely resulting in a large recovery for FTX as a result of the NFT loophole.[258]

IX. CONCLUSION: THE FUTURE OF CRYPTOCURRENCY

Bankruptcy provides the honest but unfortunate debtor to receive relief from suffocating debts and obligations. In the world of cryptocurrency exchange bankruptcies, the debtors have proven to be, more often than not,

---

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*

254. Marco Quiroz-Gutierrez, *Desperate FTX Customers May Have Exploited NFT Loophole to Recover Funds Before Bankruptcy Filing*, YAHOO! FIN. (Nov. 11, 2022), https://finance.yahoo.com/news/desperate-ftx-customers-may-exploited-213605732.html [https://perma.cc/Z9V2-RFHR].

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

less than honest.[259] Further, the creditors who are hurt by the insolvencies are everyday people who entrusted their funds to a system they might not have fully understood, in part due to the increased popularity online and celebrity endorsements.[260] When weighing the interests of the creditors and debtors, the bankruptcy courts will be tasked with the heavy-duty of determining how to weigh the interests of innocent creditors against the depleted estate of debtors who used provisions in their customer agreements and complete control over the crypto accounts to shield themselves from liability and allow themselves to misuse the funds without agency oversight.[261] Bankruptcy courts will have to deal with increased litigation as Trustees file avoidance claims for the creditors who managed to retrieve their funds from their accounts prior to the bankruptcy filing.[262] Customers are still left in the dark about how much their claims will be and the order of priority they fall in.[263] Courts will have to decide further whether or not customers should be paid back for their deposits, such as with a brokerage bankruptcy, or if courts should consider the customer agreements that limit recovery by the customers.[264] Until there is an answer, customers will continue to file class action lawsuits for fraud, and the SEC and other government regulatory agencies will most likely be keeping a closer eye on crypto firms.[265]

259. *See* Swanson, *supra* note 48.

260. *See* Rocher, *supra* note 17.

261. *See* Shawver, *supra* note 86.

262. *See* Pereira, *supra* note 43.

263. *See id.*

264. *See id.*

265. *See id.*