

Recovering Digital Assets in Chapter 11 Bankruptcy

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On July 5, 2022, digital asset lender Voyager Digital Holdings, Inc. made headlines by filing a voluntary petition for Chapter 11 relief. Soon after, competitor Celsius Network filed for its own bankruptcy protection in the Southern District of New York. It is entirely possible that these news stories represent just the beginning of a wave of bankruptcies in the digital asset space.

While a surge in digital asset bankruptcies is going to give rise to a number of novel issues within the field of bankruptcy and restructuring, this article will address the novel issue of how traditional recovery mechanisms might operate when the recoverable assets are digital assets recorded on a blockchain.

recovery overview

In a typical bankruptcy case, a trustee can trace a debtor's assets by reviewing the debtor's bank accounts, tax returns, and financial statements, as well as relevant public records such as uniform commercial code filings. In conducting a review of the debtor's transactions, a trustee will identify certain types of transfers that are vulnerable to attack.

A trustee then has a set of tools to recover and claw back assets of the estate for the benefit of the general creditor body. If a trustee successfully proves to the bankruptcy court that a particular transfer was either a "preference" or a "fraudulent transfer," then the bankruptcy court will order the return of the assets to the bankruptcy estate.

But what if the debtor's books do not identify the recipient of an indisputably preferential or fraudulent transfer? This is precisely the situation presented to a trustee who seeks to recover digital assets.

preferences

The first tool a trustee can use to recover assets into the bankruptcy estate is the power to avoid certain “preferential” transfers made shortly before filing for bankruptcy. Generally speaking, although certain defenses can be asserted by a creditor that has received an alleged preference, Bankruptcy Code section 547(b) provides that a transfer is considered a preference if it was made within 90 days of the bankruptcy petition date and was made to or for the benefit of a less-than-fully-secured creditor on account of an insolvent debtor’s antecedent debt. The prototypical preference is a transfer made to a favored creditor on the eve of filing bankruptcy. The policy behind allowing the recovery of preferences is to promote the Bankruptcy Code’s guiding principle of facilitating equal distribution among similarly-situated creditors.

Once a bankruptcy trustee has identified a preferential transfer, the trustee typically sends a demand letter to the preference recipient. While most preferences are settled out of court, a trustee can also commence an adversary proceeding within a debtor’s bankruptcy case. The latter method allows for formal discovery and even trial to allow a trustee to recover a contested preference.

fraudulent transfers

The second tool at a trustee’s disposal is the ability to unwind fraudulent transfers. Under Bankruptcy Code section 548, a trustee has two lines of attack to avoid a fraudulent transfer that occurred within two years of the petition date.

First, a trustee can unwind an actual fraudulent transfer. A transfer is actually fraudulent if a debtor made a transfer or incurred an obligation with the actual intent to hinder, delay, or defraud its creditor(s).

Second, a trustee can unwind a constructive fraudulent transfer. Generally speaking, a transfer is constructively fraudulent if a debtor received less than reasonably equivalent value in exchange for a transfer and the debtor was insolvent at the time of the transfer or was rendered insolvent by the transfer; retained unreasonably small capital to engage in business or transactions; intended or believed that the debtor would incur debts beyond its ability to pay; or made such transfer or incurred such obligation to or for the benefit of an insider, under an employment contract, and outside of the ordinary course of business.

A bankruptcy trustee can also use non-bankruptcy law to avoid a fraudulent transfer. Section 544(b) of the Bankruptcy Code allows a trustee to avoid any transfer of an interest of the debtor in property or obligation incurred by the debtor that is voidable under applicable law, such as state fraudulent transfer law, by a creditor holding an unsecured claim. Notably, state law often extends the statute of limitations to bring fraudulent transfer actions to up to six years.

Under Bankruptcy Rule 7001, a trustee must bring an adversary proceeding within a bankruptcy case in order to unwind a fraudulent transfer. Unlike in preference actions, where a debtor’s insolvency is presumed, a trustee bringing a fraudulent conveyance action bears the burden of proving insolvency by a preponderance of the evidence. In cases of intentional fraudulent transfer, the trustee must prove intent to defraud by clear and convincing evidence.

Like preference laws, fraudulent transfer laws prevent an inequitable windfall for one creditor by allowing a trustee to recover for the benefit of the general creditor body assets that were improperly transferred by a debtor. Today’s fraudulent transfer laws can be traced back to the Statute of Elizabeth, enacted in 1571. Now, 450 years after the first fraudulent transfer statute, fraudulent transfer actions have proven to be a nimble tool to recover a broad array of assets, including digital assets.

unmasking asset holders

Digital assets, such as bitcoin and ethereum, are decentralized digital currencies that are capable of being transferred electronically without relying upon an institutional intermediary. In lieu of employing a trusted central

intermediary to record and facilitate transfers of digital assets, transfers of digital assets are recorded on the blockchain, a digital public ledger that is hosted across an array of computers on a peer-to-peer network.

While each transaction is recorded on the public ledger of the blockchain for all to see, the respective identities of the transferor and transferee are represented only with an “address,” similar to a bank account number, that consists of a series of 26-35 alphanumeric characters instead of each individual’s name. These characters are called a “public key,” which is publicly available and acts as the mailing address to which digital assets can be sent. In order to verify digital asset transactions, prove ownership of digital assets on the blockchain, and transact with those digital assets, a “private key” is also required. The private key is essentially a password.

Public and private keys are stored in a “wallet.” Thus, ownership of digital assets is not truly anonymous. Rather, it is pseudonymous, in that individual transactions between concealed individuals take place in the public forum of the blockchain.

The decentralized and pseudonymous nature of many digital assets means that any bankruptcy trustee who knows the identity of a debtor’s blockchain address can review the public blockchain to uncover every transaction that the debtor has ever engaged in, including the transfer of preferential or fraudulent conveyances on the eve of bankruptcy. The unique issue presented by digital assets in bankruptcy is the difficulty of tracing exactly which person or entity received the digital assets from the debtor via their own personal address.

However, solutions to this issue are emerging. Blockchain forensics companies now specialize in not only tracing the movement of these digital assets across the blockchain, but even de-anonymizing the identities of the individuals involved. This was done successfully in the recent bankruptcy case of cryptocurrency lender Cred Inc. In that case, a former executive had absconded with millions of dollars in bitcoin and refused to return the assets to Cred. Counsel to Cred’s Official Committee of Unsecured Creditors worked with a digital asset tracing consultant to identify and ultimately recover nearly \$6 million in stolen digital currency from the former executive.

In addition, trustees can resort to more traditional methods of asset recovery. For example, like traditional banks, public digital asset exchanges typically operate out of omnibus accounts in which customer assets are commingled. A trustee can subpoena the exchange to recover from their omnibus accounts. Additionally, if digital assets are sent from a personal wallet to an exchange wallet, an exchange can provide the identity of the exchange wallet holder.

Many issues in this rapidly evolving space are difficult to solve. For example, sophisticated parties can create their own digital wallets that are not hosted by an institutional exchange. In such cases, a trustee cannot simply subpoena the exchange to recover the digital assets. Additionally, individuals wishing to avoid public visibility can engage in transactions using “privacy coins,” which are designed to preserve the privacy of their users by obfuscating the transactions on their blockchain through advanced cryptography.

However, tracing may still be possible, as the requisite privacy options are not always used or “turned on” by users of privacy coins. Additionally, tools can be used to detect the identity of individuals using privacy coins, such as matching private transaction timestamps to simultaneous real-world activities such as online purchases or sales of digital assets for fiat currency.

conclusion

For centuries, debtors in possession and bankruptcy trustees have been able to recover certain improper transfers of debtor assets that took place shortly before the filing of a bankruptcy petition. To do so, a trustee or debtor in possession can bring an action for a preference or a fraudulent transfer to claw back estate assets and to distribute such assets more equitably among the creditor body.

Today, a potentially pending wave of bankruptcy filings in the digital asset industry may shed some light on whether these historically dependable methods of asset recovery may prove to be more difficult to apply in the modern sphere of digital assets recorded on a blockchain.

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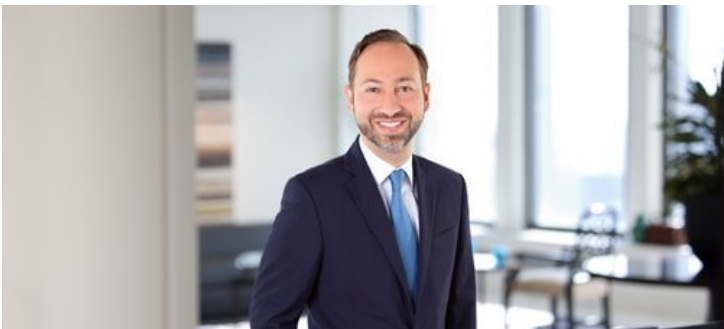
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