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Classifying Creditors in Digital Asset Bankruptcy Cases

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As digital asset markets continue to struggle, and multiple digital asset platforms seek refuge in Chapter 11 proceedings, courts will be confronted with several novel issues.

A previous article addressed how traditional bankruptcy recovery mechanisms might operate when the recoverable assets are digital assets recorded on a blockchain. This article discusses another critical issue: how digital asset customers will be classified under the Bankruptcy Code. The resolution of this thorny issue will significantly impact the extent to which customers can recover assets from digital asset firms in bankruptcy.

Priority of Claims in Chapter 11 Proceedings

The classification of creditors in a Chapter 11 case determines the likelihood of recovery in a bankruptcy case. The Bankruptcy Code contemplates at least four tiers of recovery for creditors. Each tier may have subgroups or classes:

• ***Secured Creditors***. The first group to recover from a Chapter 11 estate are secured creditors, whose claims are secured by a lien on the debtor's property (i.e., collateral). If a secured creditor's claim is greater than the value of the collateral, the claim may be divided into a secured claim—up to the value of the collateral—and an unsecured claim for the balance.

• ***Creditors With Administrative Claims***. Second in line for recovery are creditors with administrative claims. Pursuant to Section 503 of the Bankruptcy Code, claims for the actual, necessary costs and expenses of conducting the bankruptcy are administrative claims. Such costs include professional fees and wages, salaries, and commissions for post-petition services rendered to the debtor.

• ***Unsecured Property Claims.*** Third in line for recovery are unsecured priority claims. Section 507 of the Bankruptcy Code provides that priority claims include: certain wages of the debtor's employees, up to $15,150 for each individual; certain contributions to an employee benefit plan; and certain unsecured tax claims.

• ***Unsecured Creditors.*** Last in line are unsecured creditors, who will generally recover their pro rata share of any funds remaining after all creditors above them in priority have been made whole. When senior creditors in a bankruptcy case recover pennies on the dollar for the value of their claims, junior creditors often recover nothing. If all the prior four classes are satisfied in full, equity interests may receive a recovery.

Insolvency of Traditional Banks and Brokers

Banks cannot file for bankruptcy, but their holding companies can. In the event of a bank failure, the Federal Deposit Insurance Corporation (FDIC) generally facilitates the purchase and assumption of the insured deposits of the failed bank by a healthy bank. Up to $250,000 is insured for each customer of a FDIC-insured bank. A customer would retain an unsecured claim in the insolvency case for any amount in excess of $250,000 that had been deposited with the insolvent bank.

Pursuant to Rule 15c3-3 under the Securities Exchange Act of 1934, also known as the "customer protection rule," broker-dealers in the US must segregate customer cash and securities aside from the broker-dealer's own assets. Likewise, under Exchange Act Rule 15c3-1, broker-dealers must maintain minimum capital amounts in order to satisfy the claims of customers in the event they must liquidate.

The policy behind these rules is to ensure that, if a broker-dealer becomes insolvent, the broker-dealer will hold sufficient property to satisfy customer claims and, generally, to allow the government to move all customer accounts to a financially solvent broker-dealer. If the customer accounts cannot be transferred, and the insolvent broker-dealer does not have sufficient cash or securities available to make customers' whole, customers can file claims in the insolvency of their clearing broker-dealer. The Securities Investor Protection Corporation (SIPC) will then calculate each customer claimant's "net equity," or the amount of that customer's claim to the cash and securities in the segregated customer accounts, net of any amounts that customer owed to the broker-dealer.

The SIPC will then distribute the assets from the segregated customer accounts on a pro-rata basis among customers, up to the amount of their respective net equity. Finally, the SIPC will make up for any shortfall, up to $500,000 in cash and securities for each individual trader that invested in the broker-dealer.

Bankruptcy of Digital Asset Companies

Given the novelty and lack of regulation of digital asset companies and exchanges, there are currently no corresponding safety nets in place to protect digital asset investors as there are in traditional cases of bank or broker-dealer insolvencies. Indeed, in recent months, the FDIC has issued pronouncements stressing that digital asset firms must remain transparent with their customers about the nonapplicability of FDIC insurance.

The recent Chapter 11 filings of Voyager Digital Holdings Inc. and Celsius Network LLC, along with their respective debtor affiliates, present two case studies on treatment of customer claims in the digital asset space.

Voyager

Voyager has historically operated three main lines of business. First, Voyager operates a trading platform that caters to retail investors. Second, Voyager offers custodial services through which digital currencies are deposited and stored on the Voyager platform, as opposed to inside individual wallets or trust accounts, in exchange for interest payments. Finally, Voyager operates a lending business.

In a typical trade, the Voyager app allows a customer to purchase digital assets by transferring funds from a customer's personal bank account to one of two large "for the benefit of" customers bank accounts controlled by Voyager. At that point, Voyager would execute the customer's desired purchase and hold the digital assets. Voyager does not provide an individual digital wallet for each customer. Rather, all digital assets are commingled and swept from the Company's commingled wallet to a third-party custodial account.

At Voyager's first day hearing, Judge Wiles questioned the debtor's counsel about whether the company was a bailee of customer assets or if the relationship between Voyager and its customers was analogous to a trust arrangement. This line of questioning is significant for digital asset customers because it demonstrates that bankruptcy judges question whether digital assets are even property of the estate in the first instance.

Counsel to Voyager responded that the $350 million in the “for the benefit of” customers bank accounts were the customers’ property over which Voyager had no claim of ownership. Accordingly, these assets would not be property of the estate. Counsel for Voyager further stated that the remaining $100 million in commingled cash and digital assets on the platform were property of the estate presumably available for distribution to all creditors in their order of priority.

Voyager’s currently proposed plan provides that customers will receive their cash currently in the “for the benefit of” customer accounts. After that, customers will be entitled to an unsecured claim for their pro-rata share in the platform’s digital assets. In practice, this means that customers’ claims to digital assets will rank in priority after administrative claims and unsecured property claims. Fortunately for customers, Voyager has claimed in court filings to have no known secured creditors.

Celsius

In addition to offering an institutional lending program and a no yield-custodial service, the basic business model of Celsius permits customers to transfer digital assets to Celsius either as collateral for loans of fiat currency or to earn rewards by permitting Celsius to pool their digital assets with those of other customers and, using this economy of scale, “stake” the assets.

“Staking” refers to a mechanism that is generally not available to most retail investors, through which digital assets are effectively locked for a period of time on the blockchain to verify other transactions taking place on the blockchain in exchange for a reward. Notably, the Securities and Exchange Commission has suggested that some forms of staking can constitute securities offerings.

While Celsius operated similarly to a traditional bank by holding or reinvesting customer deposits, Celsius continually made clear in its Terms of Use as well as in its “First Day” Declaration that Celsius accounts are not bank accounts, deposit accounts, savings accounts, checking accounts, or any other type of asset accounts. Although customers retained title to digital assets held by Celsius through its custodial service, all such user assets are comingled, meaning under the Celsius Terms of Use, custody users are not entitled to the return of their specific digital assets, but rather the return of the same type of digital asset.

On the other hand, customers who transferred digital assets to Celsius either as collateral or in order to earn rewards also transferred “all right and title” to those assets “including ownership rights” and the right to “pledge, re-pledge, hypothecate, rehypothecate, sell, lend, or otherwise transfer or use any amount of” such digital assets.

In the Celsius bankruptcy case, the debtors have implied that their customers should be treated as unsecured creditors. Celsius has claimed in court filings to have $5.5 billion in liabilities, $4.3 billion in assets, and $23 million in secured debt. This means that most of the 1.7 million retail Celsius customers will fall in line behind secured creditors, administrative claimants, and priority unsecured claims.

Conclusion

Case law continues to evolve in the digital asset space. It remains to be seen how or if the bankruptcy courts will reach a consensus on this issue. To the extent that different approaches are taken by different courts, it will be critical to closely monitor this space as customer classification could impact the demand for digital investments throughout the industry.

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