WE GOT THE KINGDOM, WE GOT THE KEY: CORPORATE BANKRUPTCY AND CRYPTOCURRENCY

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INTRODUCTION

On November 7, 2022, Sam Bankman-Fried, the chief executive of the cryptocurrency exchange FTX, took to Twitter to reassure his customers: “FTX is fine.” On November 11, FTX and hundreds of affiliated companies filed chapter 11 petitions in Delaware.

One of the primary attractions of cryptocurrency seems to be the lack of government presence. Both libertarians and blackmailers relish the lack of governmental oversight and involvement that comes with bitcoin, ether, or stable coins, as compared with traditional currency.

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This anti-government tilt becomes problematic when chapter 11, or bankruptcy generally, comes around.\(^5\) Bankruptcy is all about government. The automatic stay, the bankruptcy “estate,” the power to impose a plan on dissenting creditors\(^6\)—key features of corporate bankruptcy—all flow from Congress’ powers under the Bankruptcy Clause.\(^7\) These tools are not easily replicated by contract, “smart” or conventional.\(^8\)

Nevertheless, the clash is underway. Two significant crypto-brokers have filed chapter 11 petitions in New York.\(^9\) FTX has filed in Delaware, as noted. Other similar firms have filed insolvency proceedings in jurisdictions across the globe.\(^10\) More bankruptcies will surely follow.\(^11\)

It is time to consider the changes that are needed to corporate bankruptcy law to address the uneasy fit between the worlds of crypto and bankruptcy. This article introduces that discussion.

In the modern context, traditional currency is essentially non-interest-bearing perpetual government debt. By law this debt is made “legal tender,” which allows its use in all sorts of routine transactions that do not directly involve the government. The government determines how much of this special debt exists,\(^12\) and when it is “called,” or retired.\(^13\) This special debt—government currency—can be used to pay taxes and judgments.

With cryptocurrency, however, an entirely different process is unfolded. In this article I develop a simple taxonomy, under which there are two broad types of cryptocurrency: speculative and pegged.\(^14\) The value of


\(^6\) 11 U.S.C. § 1129(b)


\(^12\) I am using “government” in the broad sense here to include all aspects of the government, including both treasury and central bank.

\(^13\) For example, the United Kingdom routinely announces that certain pound notes are going to be replaced with new notes of equivalent value, and the old notes will cease to be used in ordinary transactions after a certain date.

speculative crypto rises and falls with investor demand, just as the price of baseball cards or David Bowie twelve-inch records might. There is no inherent value to this speculative crypto, rather the value comes from demand and scarcity. Conversely, the value of pegged cryptocurrency is designed to track that of a traditional currency or a widely traded commodity, like gold. Pegged cryptocurrencies are not always successful in their tracking efforts, but that is their goal.

Neither form of cryptocurrency is backed or otherwise supported by a government. Instead, they are the creation of private parties, set loose on the world.

Most of the speculative cryptocurrencies will never “see” the inside of a bankruptcy court, because once their value hits zero they will simply be abandoned. These sorts of cryptocurrencies will become the 21st century equivalent of the old railroad stock certificates one might find in grandma’s attic. No bankruptcy procedure is required.

On the other hand, a pegged cryptocurrency might—in theory—file a chapter 11 petition if it experienced something like a “bank run.” The automatic stay—which acts as a statutory injunction against collection actions—could be useful in this context. But how would such a cryptocurrency file a bankruptcy petition, and how would it negotiate a reorganization plan? Would it negotiate such a plan? These and other related questions are one focus of this paper.

The other focus of this paper is on the more practical issue (because it is already in play in several chapter 11 cases) of how the Bankruptcy Code should adapt to the failure of crypto intermediaries. Most investors do not purchase cryptocurrency directly; they instead buy it through an account with an entity we might broadly call a “broker.” When the broker fails, as several have already, important questions of bankruptcy law arise.

For example, is the customer of such a broker a creditor of the bankruptcy estate, or do they have a right to their crypto back, similar to that of an investor as against their stockbroker? Cryptocurrency transactions are commenced by sharing keys (essentially a password) attributed to each individual crypto-asset—when a customer opens an account with a broker, it must give the broker the key. If the broker has the key, is it the owner of the

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16 At least until a central bank creates “central bank digital currency,” which has been proposed. Whether such a currency is really currency, or simply a better payment system is left for other articles.
crypto? And does the broker even belong in the world of chapter 11 analysis, or should it be in the special brokerage proceedings of chapter 7? These are other key issues form the second half of my analysis in this paper.

But I ultimately reject the notion that the Bankruptcy Code should be extensively amended to accommodate crypto. Instead, a simple amendment to the definition of “stockbroker,” and perhaps an additional power for bankruptcy trustees to file involuntary petitions, and use of existing tools should do the trick. Moreover, I argue that retail investors should be provided with more robust disclosures about the risks they face when interacting both with pegged cryptocurrencies and crypto brokers, but that is not a matter of amending the Code.

There is an extensive legal literature on crypto, but much of it focuses on the specific issues of securities, commodities, and banking regulation. Only a handful of papers touch on questions of crypto and insolvency, and the few that do have not addresses the question of a cryptocurrency itself in bankruptcy.

This Article builds on the small body of existing crypto and bankruptcy literature, but broadens the scope to consider both the implications of dealing with a wider range of debtors and whether chapter 11 is even appropriate in this context.

This Article proceeds as follows. Part I provides a concise overview of cryptocurrency. It develops the distinction between speculative and pegged cryptocurrencies, which has important insolvency and regulatory implications. Part II turns to the problem of cryptocurrencies themselves in the bankruptcy context. It shows that the issue is more significant with regard to pegged cryptocurrencies, and identifies several holes in the present Bankruptcy Code’s ability to address such a bankruptcy filing. Part III turns to the question of crypto brokers in bankruptcy. The status of customer

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20 11 U.S.C. §101(53A) (“The term ‘stockbroker’ means person—(A) with respect to which there is a customer, as defined in section 741 of this title; and (B) that is engaged in the business of effecting transactions in securities—(i) for the account of others; or (ii) with members of the general public, from or for such person's own account.”).


claims in such bankruptcy cases and the suitability of chapter 11 for such debtors are the key issues here. Part IV concludes with a consideration of possible reforms, including clarifying amendments to the Bankruptcy Code and the creation of disclosure obligations to alert retail investors to the risks they face upon insolvency of either a pegged cryptocurrency or a crypto broker. But ultimately, as noted, I doubt the need for substantial changes to the Code, and instead advocate for slight changes along with continued skepticism about subsidizing purported innovation through changes to bankruptcy law.

I. AN OVERVIEW OF CRYPTOCURRENCY

A. Cryptocurrency in General

One of the key differences between digital currencies and traditional currencies is the decentralized structure that digital currencies are based on. Each type of cryptocurrency is based in a specific blockchain.\textsuperscript{23} Blockchain is a system for securely recording and storing information and transactions in a database that is duplicated and distributed across an array of computer systems, meaning that there is no single location of this database.\textsuperscript{24} Thus, while all physical dollars come from the Federal Reserve, headquartered in Washington, cryptocurrency comes from a digital ledger with no single location.\textsuperscript{25}

Every time a new set of transactions is added to this database, it is called a “block”—hence the name blockchain.\textsuperscript{26} Most blockchains are public, and you can only add data, not remove it. The duplicative and public nature of blockchain databases is designed to prevent fraud, while avoiding the need for a central party, like a depository or a clearinghouse, to regulate transactions.\textsuperscript{27} Avoiding a central party also avoids (in theory) the potential

\textsuperscript{24} The blockchain database is referred to as a “ledger” and for this reason, blockchain is also referred to as “distributed ledger technology.” Trevor I. Kiviat, Beyond Bitcoin: Issues in Regulating Blockchain Transactions, 65 DUKE L.J. 569, 578 (2015), https://scholarship.law.duke.edu/dlj/vol65/iss3/4.
for government control or surveillance of the “distributed ledger” or database.  

A pair of keys (passwords) is associated with each account created on any blockchain. First, each unit of value has its own public and private key. In other words, the keys are not associated with an owner but with a specific token. Second, the keys enable confirmation of ownership of the relevant unit. Imagine that there was a product of two very high prime numbers. It turns out that having the product is not enough to figure out what the two prime numbers are in a reasonable time. That product is the public key.

A private key is one of those prime numbers, which can be used together with the public key. In this way, each unit (or token) can have a public key and the owner of the unit can have a private key that—when used—can be verified as a match to the private key by other nodes across which the ledger is distributed. The holder of the private key is presumed to be the owner, and, just as the bearer bonds of the nineteenth century were subject to theft by safe crackers, private keys are subject to theft by hacking—or simple theft.

Cryptocurrency, then, is a generic term for any digital means of representing value by employing blockchain technology. For example, on the Ethereum blockchain there is a “native” cryptocurrency called ether (or ETH), which I discuss in more detail in the next section. Once a user creates an account on the Ethereum blockchain, they can deposit ETH into the account, and transfer ETH from their accounts to other users’ ether accounts.

B. Speculative Crypto

I find it helpful to sort cryptocurrency under a simple taxonomy that divides the world of “coins” into two broad categories: speculative and pegged. Speculative currencies have no redemption rights and derive their value from their own market prices. Pegged cryptocurrency, which I address in the next subpart and which are frequently (and somewhat misleadingly) called “stable” coins, are tied to “something else,” typically one or more traditional currencies. The success of this peg can vary, but they are

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designed to derive their value from the peg and if the coin is working as designed, trading values should approximate the value of the peg. Many such stablecoins come with redemption rights, where a holder (if they hold directly with issuer) can exchange their coin for the equivalent in pegged (traditional) currency.  

Bitcoin is the name of the best-known cryptocurrency, the one for which blockchain technology was first invented. It is also a prime example of a speculative cryptocurrency. It has no intrinsic value and is not backed by anything, and derives its value from demand. There are some elements of the Bitcoin structure that create a kind of artificial scarcity of the coin, but that alone does not explain its widely gyrating price. Lots of things are scarce without having much value: hydrogen filled dirigibles, for example.  

The key example of this artificial scarcity comes from the process bitcoin uses to generate new coins, referred to as bitcoin mining. Users volunteer their computers to solve complex equations to demonstrate their trustworthiness in validating transactions on the blockchain. The reward for their work is earning new bitcoin. Since its inception, the reward for mining bitcoin has progressively been reduced by half for every 210,000 blocks created, further ensuring scarcity.

Essentially this is the 21st century version of two knights charging at each other on horseback: lots of specialized equipment and energy devoted to a very stylized task. Indeed, special computers called “mining rigs” are manufactured for this purpose and tremendous amounts of electricity are devoted to the task: 0.4% to 0.9% of annual global electricity usage, as of summer 2022, which is comparable to the annual electricity usage of all data centers in the world. According to a recent White House report:

“...the United States is estimated to host about a third of global crypto-asset operations, which currently consume about 0.9% to 1.7% of total U.S. electricity usage. This

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32 As discussed in Part III, if the investor holds through a brokerage, the brokerage might be the party with the redemption right.

Anyone with lots of money to hand over to utility companies can become a miner.\footnote{Blocktree Properties, LLC v. Pub. Util. Dist. No. 2 of Grant Cnty. Washington, 380 F. Supp. 3d 1102, 1110 (E.D. Wash.), aff'd, 783 F. App'x 769 (9th Cir. 2019).}

The other major speculative cryptocurrency is the aforementioned ETH or ether, on the Ethereum blockchain. Recently ETH converted from a mining system, like bitcoin, to a “staking” system which is supposed to require far less energy usage.\footnote{Joshua Oliver, Ethereum 'Merge' Concludes in Key Moment for Crypto Market, FINANCIAL TIMES (Sept. 15, 2022), https://www.ft.com/content/4d3c85ee-c812-47b2-a973-acaf1c141a50.} Staking—which involves locking up coins as proof of your earnestness—gives large ether owners the right to add a block of transactions to the ledger; they are rewarded with new ether when they do so.\footnote{Ethan D. Trotz, Million Dollar Bash: A Nuanced Approach for Calculating Tax Liability for Participants in Decentralized Finance, 54 TEX. TECH L. REV. 575, 578 (2022), https://katten.com/Files/TTLR_Vol_54_Book_3_Trotz_Published.pdf.}

Mathematical problems are replaced by an algorithm that appoints validators at random from those in the staking pool; transactions must be verified by enough validators to be approved. All ether tokens will now pay interest when placed into staking pools. Conversely, anyone who uses the Ethereum network for transactions must pay a fee in ETH.\footnote{Gas and Fees, ETHEREUM.ORG, https://ethereum.org/en/developers/docs/gas/.}

This change to Ethereum has the potential to decrease the decentralized nature of this blockchain, and increase its susceptibility to regulation. The staking process relies on validation of transactions by larger holders, and those larger holders are more apt to be subject to regulation than the many, many defuse “miners” of the original bitcoin.\footnote{The minimum required stake is 32 ETH—equal to just under $48,000 at present.} On the other hand, mining is itself increasingly becoming centralized, and as there are economies of scale in mining operations, it may itself become subject to more regulation, given its environmental impact. Of course, environmental regulators have different concerns than financial regulators.

Unlike Bitcoin, whose function is limited to the role previously described, the Ethereum blockchain also hosts other programs (or applications) that run on its chain and provide for payments in ETH.\footnote{Chris Brummer & Yesha Yadav, Fintech and the Innovation Trilemma, 107 GEO. L.J. 235, 272 (2019), https://scholarship.law.vanderbilt.edu/faculty-publications/1084.} This
enables the creation of new digital assets (often called “tokens”) and the use of “smart contracts” that build off of the Ethereum platform.

Smart contracts are self-executing contracts expressed as a piece of code on the blockchain and are designed to carry out a set of instructions without human involvement. In many circumstances, smart contracts are immutable and cannot be changed or upgraded once launched, even if the result turns out to be less than smart.

For example, imagine a company borrows (traditional) cash secured by ETH. If the value of posted digital collateral securing the company’s borrowings falls below a certain threshold, a smart contract might automatically liquidate the collateral and set off its value against the loan balance.

### C. Pegged Crypto

What I call pegged crypto—more often termed stablecoins—attempts to address the dramatic fluctuations of speculative crypto by tying the value of the cryptocurrency to other more traditional assets—usually conventional currencies.\(^45\) For explain, Circle has issued USD Coin (or “USDC”) is one of the largest stablecoins by market capitalization, and is pegged 1:1 with the U.S. Dollar. Like many other pegged coins, USDC operates on the Ethereum blockchain and is redeemable for traditional dollars. As of mid-September 2022, Circle reported that there was about $50 billion of USDC outstanding, held by 1.5 million holders.

On its web page, Circle states that:

> “[E]very digital dollar of USDC on the internet is 100% backed by cash and short-dated U.S. treasuries, so that it’s always redeemable 1:1 for U.S. dollars. USDC reserves are held in the custody and management of leading U.S. financial institutions, including BlackRock and BNY Mellon. Each month, Grant Thornton LLP, one of America’s largest audit, tax and advisory firms, provides third-party assurance as to the size of the USDC reserve.”


\(^46\) Formally, Circle Internet Financial Limited, a private company limited by shares incorporated in Ireland, is a holding company for a complex chain of companies formed in jurisdictions around the world.

There is a fair amount of nuance there, particularly in the second paragraph, but the first paragraph indicates that USDC is backed solely by cash or short-term treasuries. Even that is not without risk, as it was recently disclosed that a sizable chunk of that cash was held in a single account at Silicon Valley Bank, whose failure then caused Circle to briefly drop below $1 when the FDIC took over the bank. Other pegged cryptocurrencies use money market funds (which might be included in the definition of “cash” used in USDC; the web page is unclear) and short-term corporate debt.

For example, Tether issues several pegged tokens tied to conventional currencies or gold that reside on the Ethereum and other blockchains. These are centralized instruments, controlled by Tether Limited Inc. and its affiliates, which issues and redeems coins to adjust the supply of coins to user demand.

The dominant tether token is the U.S. dollar tether token, commonly referred to as “USDt” or just “USDT,” with about $68 trillion outstanding. According to its web page (as of September 2022), this coin is backed by holdings comprised of:

- 79.62%—Cash & Cash Equivalents & Other Short-Term Deposits & Commercial Paper
- 5.25%—Corporate Bonds, Funds & Precious Metals
- 6.77%—Secured Loans
- 8.36%—Other Investments (Including Digital Tokens)

Tether then breaks down the first category as being comprised of US Treasury Bills (54.57%), commercial paper and certificates of deposit (15.89%), money market funds (12.88%), and cash and bank deposits (10.25%). The latter category is a bit confusing, because how Tether can hold cash without it being in a bank or money market fund is unclear, unless there are bags of currency distributed about the corporate headquarters.

There are other head scratchers here: does “Corporate Bonds, Funds & Precious Metals” mean corporate bond funds, or are these some other sort of funds? And why lump them together with precious metals, which are not very similar to corporate bonds, whatever the funds may be? What to make

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49 Tether’s gold cryptocurrency, in contrast, has a current market capitalization of about $411 million. Tether Gold, TETHER, https://gold.tether.to.
51 Id. They also report small amounts of money in non-US treasuries (presumably government debt) and repurchase agreements.
52 Or perhaps Tether has the world’s last remaining supply of traveler’s checks? More realistically, perhaps Tether is using third parties to access U.S. bank accounts, which creates its own sets of regulatory (and ownership) challenges.
of the secured loans? Are these some sort of bespoke repo transaction? A traditional repurchase transaction involves an overnight sale of a security in exchange for cash, with a corresponding obligation to buy back that security (for a higher price) the next day. The difference in sale prices represents interest on the transaction. 

In October 2021, the Commodity Futures Trading Commission issued a statement ordering Tether to pay a civil penalty of $41 million for making “untrue and misleading statements” and for the fact it “misrepresented to customers and the market that Tether maintained sufficient U.S. dollar reserves to back every USDT in circulation with the ‘equivalent amount of corresponding fiat currency.’” The New York Attorney General also brought similar claims against Tether at the same time. Transparency is not greatly improved since then.

There are examples of failed pegged cryptocurrencies, most famously TerraUSD. Terra was the blockchain that maintains the supply of two cryptocurrencies: LUNA and TerraUSD (also known as UST). TerraUSD was a pegged coin that promised it could be redeemed into $1 worth of LUNA, a speculative coin, and vice versa. Arbitrage was supposed to keep TerraUSD stable, and thus it had no reserves of traditional assets. UST’s collapse has been described as a classic Minsky Moment—a market collapse following a period of wild and sustained speculation—which happened when the market cap of LUNA fell below the market cap of UST. At that point trading out of TerraUSD would result in the creation of more LUNA, driving down its value further, and the process became unstoppable. The price of LUNA plummeted as more and more LUNA was created, and TerraUSD was now also in free fall. Moreover, bad actors

53. A traditional repurchase transaction involves an overnight sale of a security in exchange for cash, with a corresponding obligation to buy back that security (for a higher price) the next day. The difference in sale prices represents interest on the transaction.

54. Tether does state that USDT is also backed by $190 million of “Shareholder Capital Cushion.” Tether then explains that “Tether Holdings Limited and its shareholders allocate capital in reserves which are reviewed on a quarterly basis. This liquidity cushion is above and beyond the total market capitalization of Tether tokens.” This seems like a classic conflation of capital and reserves, and given that there is no “waterfall” set forth on the web page, one does not know what to make of this “cushion.”


57. Named for Hyman Minsky, an economics professor at Bard College’s Levy Economics Institute, who first described the phenomena.

could become the dominant validators on the blockchain by acquiring a large amount of LUNA for little cost, effectively destroying the system.  

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There are three primary uses of pegged crypto. First, these coins can be a kind of resting point for traders, in between buying and selling of tokens and other speculative cryptocurrencies. This “cash” feature of pegged crypto has recently meant that certain crypto brokers have become proprietary about what cash option its customers may use. For example, Binance, a large crypto broker, recently said it would automatically convert customers’ deposits of USDC into Binance’s own native pegged crypto, BUSD. Binance said it would do the same for deposits of two smaller pegged coins and also stop quoting certain crypto in terms of Tether (known as “trading pairs”).

Another use of pegged crypto is as a substitute for traditional currency for people in countries with unstable local currencies, or where such currency might not be easily taken out of the country. Of course, such this is just a more “modern” version of the old fashioned move of getting a bank account in another jurisdiction, like Switzerland.

Third, and most interestingly, pegged crypto is often lent out in a quest for yield, beyond that which can be obtained in a traditional bank account. Cryptocurrency lending platforms offer opportunities for investors to borrow against deposited crypto assets and the ability to lend out crypto to earn interest in the form of crypto rewards. The latter can take the form of either more of the pegged crypto lent (essentially payment-in-kind, or PIK, interest) or sometimes special platform-specific tokens.

As one investor web page proclaimed:

“If you're looking for a hassle-free loan, Celsius has it. Simply pick your loan amount, the desired interest rate, and payment plan—and that's it. No credit approval, closing fees, or background check. The loan is backed by your crypto assets on deposit. A great feature is that your coins stay in your wallet and continue earning, even while you're paying back the loan. You don't have to liquidate any asset,  

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59 Although ETH is a much larger system, their move to staking could also mean that large holders can dominate the system.
61 A cryptocurrency pair allows each asset in the pair to be valued without using traditional currency. One common pair is bitcoin to USDT.
and you still keep accruing—truly a rare win-win banking scenario.”

Crypto lenders make money by lending—also for a fee, typically between 5%-10%—digital tokens to investors or crypto companies, who might use the tokens for speculation, hedging or as collateral in other transactions. The lenders profit from the spread between the interest they pay on deposits and that charged on loans.

Through lending, the owner of the pegged asset can generate returns on an asset that, like traditional cash, otherwise does not provide much in the way of yield. As explained further elsewhere in this paper, however, doing so entails significant risk.

D. Taking Stock of Cryptocurrency

Cryptocurrency is said to be designed to replace conventional currency, but only a subcategory of it is fit for that purpose. As shown in the graph below, both bitcoin and ether are far more volatile than the S&P 500, hardly suggesting that they are safe stores of value (especially considering these are the largest and relatively most stable speculative tokens).

![Bitcoin; Ether; and SP500 One Year Change in Value (Google Finance)](image)

62 Tor Constantino, Celsius Review: Excellent DeFi Lending, Loaning, and Staking Services with Limited Crypto Trading, THE ASCENT (Feb. 20, 2023), https://www.fool.com/the-ascent/cryptocurrency/celsius-review. The page later added at the top an “editorial update:” “Due to the platform's bankruptcy filing, we do not recommend Celsius as a reliable cryptocurrency exchange. For better options to consider, check our list of the best cryptocurrency exchanges.”
Pegged crypto gets closer to the mark, although it still is quite variable compared to traditional currencies. In many respects it is more like currency in the United States before the Civil War\textsuperscript{63}—when state banks issues notes of fluctuating values—or even during the Civil War and extending to 1879, when the federal government issued legal tender “greenbacks” that traded at a discount to gold dollars.\textsuperscript{64} In this sense pegged crypto is like these historic examples of currency, but unlike modern notions of what a currency truly entails. Moreover, I have already alluded to the potential fragility of many pegged crypto structures.

The next two parts of this paper pick up the potential insolvency issues that arise from cryptocurrency. The next part looks at pegged crypto, while Part III will look at broader issues related to insolvency and the way most investors purchase cryptocurrencies.

II. THE BANKRUPTCY OF A STABLECOIN

Pegged cryptocurrency—or stablecoins—offers something close to traditional currency, without involving the government or actually being legal tender. The promise of maintaining a peg means that when the veracity of that promise begins to look doubtful, a run on the pegged currency is quite possible.\textsuperscript{65} We have already seen examples of this, such as the crash of TerraUSD, and its sister token Luna.

In this part of the paper, I consider the possibility of a bankruptcy filing by a pegged currency in response to a run on the coin. I do not consider such a run to be likely with regard to speculative crypto, because the value of such coins is free floating. That is, while it is entirely possible that the value of such a coin might go to zero, the “issuer” of these coins has no corresponding obligation to the holders. In this respect, speculative cryptocurrency is more like equity, while pegged cryptocurrency is more like debt. In the first there is no fixed obligation, while in the second there most certainly is.

\textit{A. Could a Pegged Crypto File for Bankruptcy?}


\textsuperscript{64} Starting in 1879 the greenbacks became convertible into gold dollars, which eliminated the discount.

\textsuperscript{65} Michael S. Barr, Vice Chair for Supervision, Supporting Innovation with Guardrails: The Federal Reserve’s Approach to Supervision and Regulation of Banks’ Crypto-Related Activities, Address at the Petersen Institute for International Economics (Mar. 9, 2023), https://www.federalreserve.gov/newsevents/speech/barr20230309a.htm.
A bankruptcy filing in the United States triggers an automatic stay, which immediately stops creditor collection activities.\textsuperscript{66} Such a stay avoids a “run on the debtor,” where individual creditors attempt to grab the firm’s assets to satisfy their claims. Instead, collection activity is funneled into the collective legal process we call “bankruptcy.”\textsuperscript{67}

If an issuer of a pegged cryptocurrency were facing a flood of redemption demands, more than it could possibly meet, such an automatic stay might provide useful \textit{breathing room} to conduct a more orderly redemption process. For example, we noted above that Tether provides redemption rights on its pegged tokens, but does not hold reserves in cash sufficient to redeem all of the outstanding tokens simultaneously.

In this respect, Tether is very much like a bank.\textsuperscript{68} It has issued debt that is “puttable” on short notice but has assets that have varying degrees of liquidity. For example, imagine that Tether’s “Other Investments,” which represent over 8% of total reserves, are someday feared to be of dubious value. Tether holders then calculate that the outstanding coins are only backed by reserves equal to 92% of the token’s face value. That is, not everyone will be able to redeem their tokens.

Tether would undoubtedly first endeavor to address the issue by resort to its “terms of service.” Buried deep in one paragraph is this nugget:

“Tether reserves the right to delay the redemption or withdrawal of Tether Tokens if such delay is necessitated by the illiquidity or unavailability or loss of any Reserves held by Tether to back the Tether Tokens, and Tether reserves the right to redeem Tether Tokens by in-kind redemptions of securities and other assets held in the Reserves.”\textsuperscript{69}

There is no apparent limit to how long the delay on redemption might be, although presumably litigation might ensue if the delay went on for more than a few days. Indeed, an extended hold could conceivably become the basis for an involuntary bankruptcy petition, although that petition might be

\textsuperscript{67} Stephen J. Lubben, \textit{The Law of Failure} 162 (2018) (“The reorganization or liquidation of a business is not a lawsuit in the ordinary sense of a procedure designed to settle issues between individual litigants, but a complex, collective proceeding that involves both mediation and corporate finance.”).
\textsuperscript{68} Arthur E. Wilmarth Jr., \textit{Gillibrand-Lummis Crypto Bill ignores the Lessons of History}, American Banker (June 17, 2022), https://www.americanbanker.com/opinion/gillibrand-lummis-crypto-bill-ignores-the-lessons-of-history (“Stablecoins are digital assets that are redeemable on demand and promise to maintain parity with the U.S. dollar or another designated fiat currency. Stablecoins are digital deposits. . . .”).
\textsuperscript{69} Legal, Tether, https://tether.to/en/legal/ (see paragraph 3 of the September 2022 version).
the subject of legal dispute.\textsuperscript{70} And distributions in kind solve liquidity problems but do nothing to solve a shortfall in reserves.

In such a situation, chapter 11 might be an attractive solution. The pegged cryptocurrency will have likely lost its ability to continue to operate, but like Lehman before it, chapter 11 would offer a controlled environment in which to wind down.\textsuperscript{71} Moreover, the Bankruptcy Code’s global reach—at least with regard to financial institutions—might offer added benefits.\textsuperscript{72}

\textbf{B. Difficulty of Applying the Bankruptcy Code to Pegged Crypto}

But as Lehman discovered a decade ago, chapter 11 is not designed to address a financial institution as a debtor.\textsuperscript{73} Indeed, over the past several decades financial institutions—mostly on the assumption that they would always be the creditor in chapter 11 proceedings—successfully obtained legislative “exceptions” to most of the normal rules of bankruptcy.\textsuperscript{74}

Moreover, chapter 11 is designed around the premise that it is better to keep a business operating—better, in the sense that an operating business is typically worth more than a shuttered business.\textsuperscript{75} But when the debtor’s business is intended to hold customer funds and return them upon demand, normal operations would undermine the very point of bankruptcy. Customers would resume their rush to the exits as soon as possible, and the breathing room bankruptcy provides would quickly disappear.

Indeed, it is notable that most debtors that operate like a pegged currency does are excluded from chapter 11. Banks are typically resolved in FDIC receiverships, brokers in SIPA receiverships, and other similar entities.

\textsuperscript{70} 11 U.S.C. § 303h(1). Under Section 303 of the Bankruptcy Code, an involuntary petition must show that “the debtor is generally not paying such debtor’s debts as such debts become due.” If the terms of use allow for the debtor to extend the maturity date indefinitely, arguably the debt is not yet “due.” On the other hand, a court might imply a reasonable limit to the delay, after which time an involuntary petition might become viable.


\textsuperscript{73} Lubben & Woo, supra note 71, at 303.


find themselves directed to chapter 7, where a trustee can take charge of the debtor’s assets.\(^7^6\)

A chapter 11 case involving a pegged cryptocurrency would simply result in a pause in operations until management filed a chapter 11 plan to wind down the business. It is not clear why management should be vested with such power. In traditional chapter 11 cases, the assumption is that keeping management in place, at least initially, will be less disruptive to the business, but if the business is not going to operate again in any event, as seems likely in the case of a pegged cryptocurrency, this justification becomes less compelling. Certainly, old management’s participation might be useful in addressing the debtor’s affairs, but there is no obvious reason why they should control the debtor’s fate through control of the plan process.

As with the potential failure of other pieces of financial infrastructure, chapter 11’s main appeal might be that it is better than the alternative—namely, uncoordinated creditor or customer action. Chapter 11 is frequently deployed to supply the deficiencies of other areas of law, but that hardly makes it commendable.\(^7^7\)

A pegged cryptocurrency or stablecoin is at heart an inverted version of currency under the gold standard. Under that old approach to money, a commodity (gold) backed up sovereign notes.\(^7^8\) Under the contemporary approach, pegged crypto is ultimately backed up by sovereign notes. But essentially it is a question of convertibility, just like traditional currency under the gold standard, and a reorganization system offers little help. Regulatory intervention before the point at which convertibility becomes suspect is far more valuable.

In short, the bankruptcy of a pegged cryptocurrency is very conceivable, but pre-default regulation and resiliency is apt to provide more useful results. But if a pegged currency does fail, the ability to wind down the reserves in an orderly fashion could make bankruptcy attractive—although as suggested, chapter 7 might be more apt than chapter 11. At the very least, a chapter 11 trustee might be in order, since there seems to be no good reason to leave existing management in place.

III. CRYPTO BROKER-EXCHANGES IN CHAPTER 11

\textit{A. Buying and Holding Crypto}


\(^{77}\) See \textit{In re LTL Mgmt., LLC}, 58 F.4th 738, 763 (3d Cir. 2023).

As noted earlier, buying crypto involves two codes or keys, one which publicly identifies the crypto in question and another that represents ownership. This latter key—known as the “private key”—gives the holder control over the crypto. Formally crypto is never held by any individual buyer, since it always remains intangible, but individual buyers can control the crypto through their possession of the private keys.

The buyer then faces some choices about what to do with that private key, the variety of which depend upon the forum used to purchase the crypto. At a basic level, this choice turns on whether the customer leaves the crypto with the place they bought it, or instead withdraws the crypto (by taking the key) to a private “wallet.” The choice is further complicated by the fact that crypto exchanges—which I call broker-exchanges, because they are more like brokers than exchanges in many cases—offer their own wallets to customers, who might not fully appreciate the legal significance of moving the crypto out of a trading account and into a wallet at the same provider.

Individuals can buy crypto in a variety of ways. For example, bitcoin, ether and other crypto can be purchased directly through PayPal. A disadvantage of purchasing cryptocurrencies through PayPal is that an investor cannot transfer the crypto outside the PayPal platform to an external wallet. Somewhat similarly, Robinhood, the online stockbroker, had enabled trading on its platform for seven cryptocurrencies, albeit in accounts that are not traditional brokerage accounts, a subtlety that users might miss.

Some peer-to-peer (“P2P”) services provide a more direct connection between users. Cryptocurrencies are exchanged directly by sharing wallet information and the corresponding conventional currencies are exchanged via bank transfer.

But most individuals purchase crypto currency through broker-exchanges like Coinbase, Binance.US, or (until recently) FTX. Binance is the largest of these firms that offer dozens of cryptocurrencies to trade in. Lending platforms, many of which like Celsius, are now defunct, typically

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80 For example, unlike traditional exchanges, cryptocurrency trading venues also typically take custody of client funds. Perhaps they are both exchanges and brokers-dealers, but in this part I focus on the client-facing aspect of these firms.
82 *Robinhood*, https://robinhood.com/us/en/about/crypto/. A small footnote on the page notes: “Cryptocurrency trading is offered through an account with Robinhood Crypto. Robinhood Crypto is not a member of SIPC or FINRA. Cryptocurrencies are not stocks and your cryptocurrency investments are not protected by either FDIC or SIPC.”
offer fewer trading options. Rather, these firms instead offer ways to earn interest on deposited coins, either through staking or simple rehypothecation. At a high level of generality, both types of companies are similar in that they encourage investors to transfer their crypto to the companies, under a relationship that bears at least a superficial resemblance to traditional stock or commodity brokerage accounts.

Unlike those familiar custodial accounts, however, crypto broker-exchanges operate under a general corporate law framework, perhaps supplemented by state laws like the Uniform Commercial Code, if domestically based. Keeping funds within the broker-exchange is typically encouraged through the creation of “in house” tokens. For example, Celsius had its own “CEL” token. Users that converted deposits to CEL and pledged not to use their tokens got discounts on lending rates, high returns on pledged CEL, and a 2% loyalty reward when combining CEL tokens with CelPay, the company’s in-house payment system.

Of course, the utility of owning CEL tokens was heavily dependent on the continued existence of Celsius, and when the firm crashed into chapter 11 the precise legal status of CEL token holders was far from obvious. Do subway tokens have value in the absence of a subway?

And there is the question of whether these internal tokens are not just an attempt, Enron-style, to create assets where there are none. For example, in the days before its collapse, FTX circulated a balance sheet to would-be investors: of the $9.6 billion of assets reflected on that balance sheet, at least $3.3 billion was in crypto tokens that were created by FTX itself, held mostly by FTX entities, and which were tied to the future value of FTX’s businesses.

More broadly, as Adam Levitin has noted, the legal status of investor accounts at crypto broker-exchanges is uncertain, and probably subject to variation among the broker-exchanges, based on the specific terms of the contracts with customers. This stands in contrast to other consumer facing investment firms, like mutual funds and stockbrokers, where assets are segregated and held by third parties.

Also note that the increasing use of intermediates to hold crypto in large part undermines the very basis of crypto itself. No longer does crypto

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84 Celsius, once one of the crypto industry’s most prominent lenders, suspended customer withdrawals in June 2022 and filed for bankruptcy protection the following month.
86 Antoine Gara, Kadhim Shubber & Joshua Oliver, Revealed: FTX’s Emergency Fundraising Term Sheet, FINANCIAL TIMES (Nov. 15, 2022), https://www.ft.com/content/54d946a7-f25f-4ef2-b1e7-292f851e12b3.
87 Levitin, supra note 22.
enable avoidance of the financial system, but rather it simply allows for interaction with a new and unregulated part of the financial system.

**B. Corporate Confusion**

One consequence of the lack of segregation of customer funds in crypto broker-exchanges is that those funds can flow through the entire corporate structure in a way that would be plainly illegal in a traditional broker. This issue is also present in pegged cryptocurrencies, where Tether has admitted that its reserves at times went to support the operations of related entities. In some instances, such movements might break contractual arrangements with the customers, but breach of contract simply adds an unsecured claim to the customers’ lists of losses if the broker-exchange fails.

The issue is illustrated by the FTX insolvency. Based in the Bahamas, FTX served U.S. customers through its U.S. subsidiary, FTX.US, except that New York residents were not allowed to create accounts with the U.S. entity, presumably because FTX wanted to avoid New York state regulation.

The bulk of the FTX entities, foreign and domestic, filed chapter 11 petitions in Delaware. A single FTX entity was placed into a liquidation proceeding in the Bahamas, and local regulators there seized hundreds of millions of FTX assets. It is not clear if those assets belong to the entity in the Bahamian proceeding. On the other hand, the Bahamian liquidators have in turn argued that preferential transfers were made into the U.S. entities on the eve of the collapse.

FTX’s complex structure illustrates the special challenges that can arise with regard to broker-exchanges. FTX was reportedly created to generate funding for Alameda Research, essentially an investment fund that made

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89 New York requires “virtual currency” businesses operating in the state to be licensed by the New York Department of Financial Services, which includes vetting of applicant leadership, affiliate relationships and risk controls. Applicants are also subject to capitalization and reserve requirements, and regular examinations once licensed, and they must get agency approval for subsequent “material changes” in their businesses.
leveraged arbitrage trades in cryptocurrency. While in the traditional space the large broker-dealers have been pushed out of proprietary trading, Alameda/FTX was actively creating a consumer base to support just such trading. Given the symbiotic (if not parasitic) relationship between the two parts of Alameda/FTX, it is hardly surprising that funds would flow with little regard for formalities. Indeed, Reuters reported that insiders created a “backdoor” in FTX’s accounting system that allowed vast transfers to cover losses at Alameda, while showing other employees and the outside world a healthy balance sheet.

C. Bankruptcy Implications

Unlike with regards to pegged crypto, we do not have to speculate how a broker-exchange would fair in bankruptcy, because we have several American cases, plus several foreign cases to draw from, including FTX and Celsius. In all of these cases, a key issue has been whether customers have trust-like claims, or instead those of creditors. That is, do we treat customers of these entities more like somebody who has parked their car at (or lent money to) a parking garage?

In the leading case on the topic, the New Zealand High Court (trial court) held that customer claims in the liquidation of a broker-exchange were trust claims, but this holding largely turned on the express provision for a trust in the terms of service, and the debtor’s actions in conformity with that provision. That is, if the contract had different terms, or the debtor had acted otherwise, an opposite result may have obtained. Many of the pending chapter 11 cases offer the possibility of such a result, and more generally the prospect of extensive litigation on this issue. While this litigation plays out, customers who thought they had relatively liquid investments will find themselves locked into their accounts.

Even more recently, Judge Glenn of the Bankruptcy Court for the Southern District of New York ruled that customer deposits in Celsius’s “Earn Program” constituted property of the bankruptcy estate and not customer property. This ruling, however, largely turned on the specific terms of Celsius’s terms of use, suggesting a case-by-case approach to the question.

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95 In re Celsius Network LLC, No. 22-10964 (MG), 2023 WL 34106 (Bankr. S.D.N.Y. Jan. 4, 2023)
Current SEC Chairman Gary Gensler has consistently said that most cryptocurrencies are securities, and most cryptocurrency broker-exchanges are thus unregistered securities exchanges.96 As such, it seems that most of the broker-exchanges currently in chapter 11 should instead be in chapter 7, as stockbrokers are not allowed in chapter 11.97

The point has not been raised in any of the cases to date, and in any event would only address the specific entities that are brokers. That may result in artificial distinctions among entities within the corporate group, especially given the frequent lack of formalities among the group-members noted earlier. As discussed in the next part of the paper, targeted amendments to the Bankruptcy Code might address this issue.

IV. FIXING CRYPTO BANKRUPTCY

A crypto broker-exchange presents as a kind of financial institution, and lures investors on that basis, but in actuality is a normal corporation, in that it has none of the regulatory arrangements associated with a financial institution. It has become common to analogize these entities to uninsured banks of an earlier era, but that may do a disservice to nineteenth-century banks. In most cases those banks attempted to run a sensible operation, while the same often cannot be said for the broker-exchanges, whose founders disdained conventional thinking like accounting and governance.

How can the Bankruptcy Code adapt to such an exceptional firm? We might begin by considering whether traditional the chapter 11 framework applies to a broker-exchange conglomerate. Chapter 11 operates on a premise that business entities created under state law are to be respected absent unusual circumstances, and that that existing management should initially control debtor-firms’ fate. Both are subject to question in the crypto context.


97 11 U.S.C. § 109(d) (“Only … a person that may be a debtor under chapter 7 of this title (except a stockbroker or a commodity broker) … may be a debtor under chapter 11 of this title.”).
In the insolvency of a traditional broker-dealer, chapter 11 applies to the holding company and the unregulated subsidiaries, while the regulated subsidiary is resolved in a SIPA proceeding, under the control of a trustee appointed by SIPC and the bankruptcy court. The trustee’s focus is on protecting customer property and transferring customer accounts to a new broker whenever possible.

In the crypto broker-exchange insolvency, there is no regulatory structure that ensures that customer property will only be in the regulated entity. And if a regulated entity exists, it is likely not a SIPC member. Thus proceedings need a wider and flexible scope in this context.

At the same time, the need for a trustee that replaces pre-insolvency management is greater than ever in the broker-exchange context, where the anti-regulatory mindset that undergirds the crypto industry presents real challenges in a context of legally mandated transparency. Stated alternatively, life in the chapter 11 “fishbowl” is antithetical to an industry premised on secrecy.

Thus, there is a need for a trustee, as in traditional broker-dealer cases, but the scope of the trustee’s authority must be broader, extending to include entities that would otherwise be subject to “normal” chapter 11 procedures. Indeed, one fundamental question that must be addressed is whether chapter 11 is the right tool for this type of insolvency—non-SIPC stockbrokers and commodity brokers are themselves subject to special chapter 7 provisions.

What is needed then is clarity that a crypto broker-exchange is a broker for purposes of the Bankruptcy Code, and that the “broker” might entail more than one legal entity. The first point could be addressed by a simple amendment to the definition of “stockbroker,” in Section 101 of the Code. As present it reads:

(53A) The term “stockbroker” means person—
(A) with respect to which there is a customer, as defined in section 741 of this title; and
(B) that is engaged in the business of effecting transactions in securities—
(i) for the account of others; or
(ii) with members of the general public, from or for such person’s own account.

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98 15 U.S.C. § 78eee(a)(3)(A) provides that SIPC may file an application for a protective decree with district court if it determines that any SIPC member has failed (or is in danger of failing) to meet obligations to customers and meets the conditions specified in 15 U.S.C. § 78eee(b)(1). Upon the appointment of a trustee, the district court will order the transfer of the proceeding to the bankruptcy court in the same district, 15 U.S.C. § 78eee(b)(4), but a SIPA proceeding is not a bankruptcy proceeding, because it does not arise under the Bankruptcy Code.


100 11 U.S.C. § 741 et seq.
As noted earlier, arguably this covers crypto broker-exchanges, inasmuch as “security” is further defined under the Code to include an “investment contract … required to be the subject of a registration statement filed with the Securities and Exchange Commission under the provisions of the Securities Act of 1933, or is exempt under Section 3(b) of such Act from the requirement to file such a statement.”\(^{101}\) That would seem to trigger the well-known *Howey* test, which defines investment contract quite expansively,\(^{102}\) and has been used to define crypto as a security.\(^{103}\) Crypto broker-exchanges thus help customers “effect transactions” in securities, are therefore stockbrokers for purposes of the Code.

With the addition of the phrase “(and any affiliate of such person in possession of customer assets on the petition date)” after “person” in the existing definition of stockbroker, it would be clear that crypto broker-exchanges, and their affiliated entities, belong in chapter 7, rather than chapter 11. Moreover, that chapter 7 proceeding would extend to cover not only the broker itself, but related entities that are potentially part of the functional broker relationship.

In addition, we might consider granting the trustee the power to file involuntary bankruptcy petitions against other affiliates of crypto broker-exchanges.\(^{104}\) That is, even if such entities are not obviously holding customer property, the trustee should have an ability to quickly draw the affiliate of a crypto broker into bankruptcy if there is a risk of assets disappearing, and especially in circumstances when grounds for substantive consolidation of the corporate group might be present.\(^{105}\) For example, just as under Section 303(b)(3) of the Bankruptcy Code one partner may put a partnership into bankruptcy without the consent of other partners, the trustee of a stockbroker should have an ability to sweep other members of the corporate group into bankruptcy when time is of the essence.\(^{106}\)

More generally, more robust disclosure up front, mandated by regulators, would address most of the concerns here. Customers should be told where their assets are being held and how they are being used, and that

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\(^{104}\) 11 U.S.C. § 303(b).

\(^{105}\) Substantive consolidation is an equitable doctrine that permits a bankruptcy court, under certain circumstances, to disregard distinctions between parent companies, subsidiaries and affiliates that operate together as a corporate group. In re Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005). Note that the author represented the debtor in this case while in practice, long ago.

\(^{106}\) Whether that bankruptcy should be under chapters 7 or 11 is a point that could be addressed at a later date.
SIPC and the FDIC are not looking out for their interests in this context. Robinhood’s disclosures, noted earlier, provide a start, but should be placed much more forcefully. More directly, we might simply mandate a disclosure that a customer of a crypto exchange is entering into a debtor-creditor relationship with the exchange—along with all that entails.

For example:

[The broker] is not a member of SIPC or FINRA. Cryptocurrencies are not stocks and your cryptocurrency investments are not protected by either FDIC or SIPC. If [the broker] fails, it will likely become a debtor under the Bankruptcy Code and you might become an unsecured creditor in that bankruptcy proceeding. Unsecured creditors often do not receive full payment in bankruptcy proceedings.”

But that has little to do with the Bankruptcy Code itself and businesses known for flouting regulatory requirements may ignore a disclosure mandate such as this one.

CONCLUSION

Crypto may or may not be an issue a decade from now. In the meantime, relatively small changes to the Bankruptcy Code will address the unique concerns raised by crypto, without radically reinventing the system for a “currency” that might or might not be little more than an unfortunate fad.