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COMMENTARY & ANALYSIS

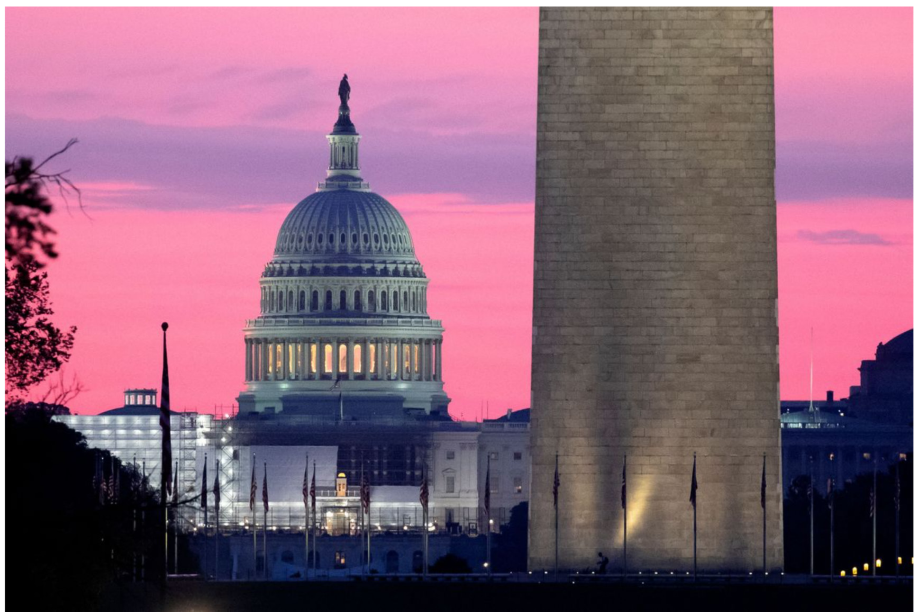
Viewpoint: How Congress Can Minimize the Cryptopocalypse

A specialized liquidation framework for cryptoasset exchanges or intermediaries could prioritize customer claims over other creditors

By Paul H. Zumbro and David L. Portilla

Volatility in the cryptoasset market has affected investors, service providers, and exchanges and other intermediaries, with cryptoasset broker Voyager Digital, hedge fund Three Arrows Capital and lending firm Celsius Network recently filing for bankruptcy. Given the drop from a peak cryptoasset market capitalization of $3 trillion in November 2021 to below $1 trillion less than one year later, the looming question is how courts will treat customer assets in a cryptoasset exchange or intermediary bankruptcy.

We believe a specialized liquidation framework—like that which applies to stock and commodity brokers—should apply to cryptoasset exchanges or intermediaries, to prioritize customer claims over other creditors. In other words, Congress should make cryptoasset exchanges and intermediaries ineligible for reorganization under chapter 11 of the bankruptcy code. This approach would provide enhanced protection of customer rights, facilitating the further development of a robust and well-functioning cryptoasset market, and is consistent with the bankruptcy code's treatment of stock and commodity brokers.



The U.S. Capitol stands beyond the Washington Monument in Washington.
PHOTO: MICHAEL REYNOLDS/SHUTTERSTOCK

When faced with insolvency, stock and commodity brokers, instead of reorganizing, must liquidate customers' assets to return them as quickly as possible.

In many ways, cryptoasset exchanges and intermediaries function like traditional securities and commodity brokers. These firms act as centralized platforms where customers can trade fiat currency for cryptoassets and trade cryptoassets for other cryptoassets. The firms monitor and facilitate transactions and hold customers' assets in custodial accounts. Some exchanges also offer hybrid services, such as decentralized self-custody wallets where customers can store and trade their cryptoassets in unmonitored accounts.

Also like stock and commodity broker customers, crypto customers have an expectation that they own their cryptoassets held through the exchange or intermediary. In fact, many cryptoasset exchange user agreements explicitly assure customers that assets are held for customers and are not property of the exchange. These customers, and the cryptoasset markets that rely on such expectations, should be protected.

The special bankruptcy code frameworks for the liquidation of stock and commodity brokers provide for special treatment of customer property. Specific customer assets are returned to customers in kind and general customer property is liquidated as quickly as practicable to distribute value ratably among customers. These frameworks are complex, but certain key concepts would be beneficial to adopt for a cryptoasset exchange or intermediary liquidation.

The most important aspect we propose be adopted is that cryptoassets held through an exchange or other intermediary would be designated as customer property, and the customers would have priority claims to them. The line between specific and general customer property could be drawn by distinguishing whether customers have direct access to the cryptoassets, such as in segregated wallets with private keys, or whether

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they have a claim to assets held in omnibus accounts, to which exchanges or intermediaries hold omnibus keys. Regardless of this distinction, the critical point is that customers would have a priority claim to all cryptoassets.

This framework is preferable to customers being treated as unsecured creditors without priority, as many commentators have said might be the case under chapter 11, and it avoids the complex ownership issues that may arise when customer cryptoassets are commingled.

Congress also should consider allowing a customer to request return of her bitcoin or other cryptoassets in cryptoasset form, rather than in fiat currency. This would align with the stock and commodity broker liquidation frameworks, which provide customers with the right to reclaim specifically identifiable property.

For customer property that hasn't been returned in cryptoasset form, the framework would provide for a quick liquidation to fiat currency. Efficient liquidation would return value to customers as close as possible to the value of their cryptoassets on the bankruptcy filing date. This would mitigate concerns about cryptoassets being tied up in the bankruptcy process and declining in value. Admittedly upside potential is lost, but we believe that in the event of the insolvency of a cryptoasset exchange, minimizing customer losses is the paramount concern (and customers could of course redeploy returned funds in cryptoassets or other investments).

There are many technical details that would need to be addressed in adopting a liquidation framework for cryptoasset exchanges and intermediaries. But the basic framework for stock and commodity broker liquidations should work well in this area. For example, the existing frameworks give the liquidating trustee discretion to dispose of assets in ways that don't disrupt otherwise orderly markets. Given the volatility of cryptoassets, that is another important feature that could be replicated.

The time for Congress to act is now. Congress shouldn't wait for a comprehensive regulatory solution for cryptoassets before amending the bankruptcy code. A cryptoasset liquidation framework would instill confidence in investors, which would encourage the further development of the increasingly important cryptoasset markets, while protecting these markets from disruption.

(Paul H. Zumbro is head of financial restructuring and reorganization and David L. Portilla is a partner in financial institutions at Cravath, Swaine & Moore LLP. This commentary represents the personal views of the authors and not the views of Cravath or its clients. Cravath has clients in the cryptoasset sector.)