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## On the Edge

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### Ownership Issues in Crypto Cases



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Since the so-called “crypto winter” hit the industry in May 2022, several major crypto companies have filed for bankruptcy.<sup>2</sup> Given the unique nature of digital assets such as cryptocurrencies, bankruptcy courts have been grappling with new legal issues, and the proceedings have garnered the interest and involvement of several states and federal regulators.<sup>3</sup>

In a recent decision in the bankruptcy of crypto exchange platform Celsius Network LLC,<sup>4</sup> the U.S. Bankruptcy Court for the Southern District of New York considered whether cryptocurrency assets deposited in certain interest-bearing accounts were owned by the crypto-platform debtor, and thus were property of its bankruptcy estate or of the account-holder creditors.<sup>5</sup> Celsius account-holders and other consumers might have been surprised by the *Celsius* court’s conclusion that they did not own their accounts.<sup>6</sup>

#### Basic Principles of Cryptocurrencies and Bankruptcy Proceedings

Cryptocurrencies, such as Bitcoin and Ethereum, are decentralized digital currencies based on blockchain technology and provide a medium of exchange to transact on a blockchain.<sup>7</sup> At its core, a blockchain is a peer-to-peer distributed ledger that

digitally stores and records transactional data, such as ownership of a digital asset.<sup>8</sup> However, digital wallets are blockchain-based applications that facilitate transactions by generating and storing a user’s private and public keys.<sup>9</sup> Public keys are shared with others to receive funds,<sup>10</sup> whereas private keys provide others with access to a user’s digital assets stored on their wallet.<sup>11</sup>

Wallets can be custodial or noncustodial.<sup>12</sup> Custodial wallets are externally hosted wallets that are managed by third-party custodians that hold and safeguard private keys on behalf of the cryptocurrency’s users.<sup>13</sup> Noncustodial wallets provide an interface that enables users to transact with others, but does not store a user’s private keys.<sup>14</sup> Relatedly, crypto exchanges are platforms where buyers and sellers can trade crypto, and they can be centralized or decentralized.<sup>15</sup> Decentralized exchanges, also called “DEXs,” allow users to trade tokens with one another while remaining in control of their private keys.<sup>16</sup> Centralized exchanges are trading platforms that are operated by third parties.<sup>17</sup> Most exchanges are centralized.<sup>18</sup>

When a debtor files for bankruptcy, all of its legal and equitable interests in property as of the commencement of the case become property of the bankruptcy estate unless an exception to the general rule applies.<sup>19</sup> One such exception is when assets are held in trust by a custodian for the benefit of customers of the custodian or

<sup>1</sup> Mr. Bernbrock is a 2022 ABI “40 Under 40” honoree.

<sup>2</sup> See, e.g., Farran Powell & Benjamin Curry, “Crypto Winter Is Here: What You Need to Know,” *Forbes* (Sept. 2, 2022), available at [forbes.com/advisor/investing/cryptocurrency/what-is-crypto-winter](https://forbes.com/advisor/investing/cryptocurrency/what-is-crypto-winter) (unless otherwise specified, all links in this article were last visited on March 7, 2023); *In re Three Arrows Capital Ltd.*, Case No. 1:22-bk-10920 (Bankr. S.D.N.Y. July 1, 2022); *In re Voyager Digital Holdings Inc., et al.*, Case No. 1:22-bk-10943 (lead case) (Bankr. S.D.N.Y. July 5, 2022); *In re Celsius Network LLC, et al.*, Case No. 1:22-bk-10964 (Bankr. S.D.N.Y. July 13, 2022); *In re FTX Trading Ltd.*, Case No. 1:22-bk-11068 (Bankr. D. Del. Nov. 11, 2022); *In re BlockFi Inc., et al.*, Case No. 22-bk-19361 (lead case) (Bankr. D.N.J. Nov. 28, 2022).

<sup>3</sup> See, e.g., Limited Obj. of the Coordinating States, *Celsius*, No. 1:22-bk-10964, ECF No. 1492 at 3; Second Joint Stip. and Agreed Order Between the SEC and the Debtors to Extend the Deadline for Filing, *Celsius*, No. 1:22-bk-10964, ECF No. 1858).

<sup>4</sup> *Celsius Network LLC, et al.*, Case No. 22-10964 (MG) (Bankr. S.D.N.Y.).

<sup>5</sup> *In re Celsius Network LLC, et al.*, 647 B.R. 631, 636-37 (Bankr. S.D.N.Y. 2023).

<sup>6</sup> *Id.* at 660.

<sup>7</sup> See, e.g., generally, Ethereum Whitepaper, available at [ethereum.org/en/whitepaper](https://ethereum.org/en/whitepaper); Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System,” available at [bitcoin.org/bitcoin.pdf](https://bitcoin.org/bitcoin.pdf).

<sup>8</sup> *Id.*

<sup>9</sup> See, e.g., Loïc Lesavre, Priam Varin & Dylan Yaga, “Blockchain Networks: Token Design and Management Overview,” at 22 (February 2021), Nat’l Inst. of Standards and Technology, U.S. Dep’t of Commerce, available at [doi.org/10.6028/NIST.IR.8301](https://doi.org/10.6028/NIST.IR.8301).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 12-15.

<sup>13</sup> *Id.* at 13.

<sup>14</sup> *Id.* at 12.

<sup>15</sup> *Id.* at 72.

<sup>16</sup> *Id.* at 25.

<sup>17</sup> See, e.g., Benedict George, “What Is a CEX? Centralized Exchanges Explained,” *CoinDesk* (Feb. 11, 2022), available at [coindesk.com/learn/what-is-a-cex-centralized-exchanges-explained](https://coindesk.com/learn/what-is-a-cex-centralized-exchanges-explained).

<sup>18</sup> *Id.*

<sup>19</sup> 11 U.S.C. § 541(a)(1).

another third party.<sup>20</sup> In this circumstance, the assets are owned by the customer and are not part of the debtor's bankruptcy estate.<sup>21</sup> In determining whether the custodian exception applies, courts look to applicable state law governing property interests and analyze the relationship between the debtor and those who transferred funds to the debtor, along with the terms under which the transfers were made.<sup>22</sup>

Whether the custodian exception applies to customer assets stored on crypto exchanges and in crypto wallets is a critical question given the string of recent crypto bankruptcy filings and the potential that more may follow.<sup>23</sup> Where the custodian exception applies, customers remain the beneficial owners of their deposits and the funds do not become part of the bankruptcy estate.<sup>24</sup> Where the custodian exception does not apply, these crypto assets become part of the bankruptcy estate, commingled with other estate assets, and the debtor has the right to use, control and dispose of those assets without any input from the customer.<sup>25</sup> In the latter case, customers who deposited the assets become general unsecured creditors, and they can expect to recover pennies on the dollar.<sup>26</sup>

### Celsius Court's Analysis

On July 13, 2022, Celsius Network LLC filed for chapter 11 in the Southern District of New York.<sup>27</sup> Celsius, like other prominent crypto lenders, sought to stanch a liquidity bleed in the wake of the Terra-Luna and Three Arrows Capital crashes, which precipitated an industry-wide "bank run."<sup>28</sup>

Prior to its bankruptcy filing, Celsius centered much of its business model around its "earn account" offering, which allowed customers to receive as much as 18 percent interest annually on digital assets deposited on the Celsius platform.<sup>29</sup> The question of who owns the digital assets stored in earn accounts, and on the crypto-debtor's platform in general, has featured prominently in Celsius's bankruptcy case, serving as a preview of the issues that are likely to arise in other crypto bankruptcy cases in the coming months.<sup>30</sup>

On Sept. 15, 2022, Celsius filed a motion, which was subsequently amended on Nov. 11, 2022, seeking the bankruptcy court's permission

to sell a portion of the cryptocurrency held in the earn accounts in order to fund its bankruptcy case.<sup>31</sup> Through this motion, Celsius asserted the position that the earn program's terms of use plainly state that Celsius holds any and all right and title to cryptocurrency assets that customers deposited into earn accounts.<sup>32</sup> This motion received opposition from two main camps. First, several state regulatory authorities objected to the proposed sale of earn account assets, arguing that any determination regarding asset ownership should wait for the court-appointed examiner to complete an investigation into, and report on, various issues relating to Celsius's pre-petition operations.<sup>33</sup> Second, a number of earn account-holders argued that the earn account program's terms of use were ambiguous and misleading such that they did not form a binding contract by which Celsius obtained ownership over deposited crypto assets.<sup>34</sup>

On Jan. 4, 2023, the bankruptcy court issued a highly anticipated decision resolving the dispute over ownership of the assets stored in the earn accounts, finding that these assets are presumptively property of the bankruptcy estate and not owned by earn account-holders.<sup>35</sup> The opinion explained that the ownership issue boiled down to ordinary principles of contract law.<sup>36</sup> According to the bankruptcy court, each of the requisite elements for contract formation under New York law were present: (1) Celsius offered its earn account product to customers through its terms of use; (2) substantially all earn account-holders accepted this offer through a "clickwrap" agreement; (3) Celsius offered interest and other rewards to earn account-holders that served as valid consideration; and (4) no evidence presented to the court suggested that either Celsius or earn account-holders lacked intent to be bound by the terms of use.<sup>37</sup>

While the underlying principles of contract law upon which the bankruptcy court based its analysis may be ordinary, their application in the context of crypto lending led to a groundbreaking result. On the date of its bankruptcy filing, Celsius had approximately 600,000 earn accounts with an aggregate value of nearly \$4.2 billion in cryptocurrency assets.<sup>38</sup> The practical effect of the *Celsius* decision is that tens of thousands of earn account-holders must now wait at the end of the line and until the end of the case before receiving payment, if any, in satisfaction of their claims against the crypto lender's bankruptcy estate.<sup>39</sup>

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20 See 11 U.S.C. § 541(b)(1).

21 *Id.*

22 See, e.g., *In re Scanlon*, 239 F.3d 1195, 1197-98 (11th Cir. 2001); *In re Lenox Healthcare Inc.*, 343 B.R. 96, 100-01 (Bankr. D. Del. 2006).

23 Refer to previous citations listing several recent crypto bankruptcy proceedings.

24 See 11 U.S.C. § 541(b)(1).

25 See 11 U.S.C. § 541(a)(1).

26 See *Celsius*, 647 B.R. at 658.

27 Chapter 11 Voluntary Petition for Non-Individual, *Celsius*, No. 1:22-bk-10964, ECF No. 1.

28 Cheyenne Ligon, "Celsius Bankruptcy Filings Hint Retail Customers Will Bear Brunt of Its Failure," *CoinDesk* (July 18, 2022), available at [coindesk.com/business/2022/07/18/celsius-bankruptcy-filings-hint-retail-customers-will-bear-brunt-of-its-failure](https://coindesk.com/business/2022/07/18/celsius-bankruptcy-filings-hint-retail-customers-will-bear-brunt-of-its-failure).

29 Zeke Faux & Joe Light, "Celsius's 18% Yields on Crypto Are Tempting — and Drawing Scrutiny," *Bloomberg* (Jan. 27, 2022), available at [bloomberg.com/news/articles/2022-01-27/celsius-s-18-yields-on-crypto-are-tempting-and-drawing-scrutiny](https://www.bloomberg.com/news/articles/2022-01-27/celsius-s-18-yields-on-crypto-are-tempting-and-drawing-scrutiny) (subscription required to view article).

30 *Celsius*, 647 B.R. at 636-37.

31 Debtors' Motion Seeking Entry of an Order (I) Permitting the Sale of Stablecoin in the Ordinary Course and (II) Granting Related Relief, ECF No. 832, and Notice of Hearing on Debtors' Amended Motion for Entry of an Order (I) Establishing Ownership of Assets in the Debtors' Earn Program, (II) Permitting the Sale of Stablecoin in the Ordinary Course and (III) Granting Related Relief, ECF No. 1325.

32 ECF No. 1325 at 9.

33 *Celsius*, 647 B.R. at 643-44.

34 *Id.* at 644-46.

35 *Id.* at 660.

36 *Id.* at 637.

37 *Id.* at 652-56.

38 *Id.* at 636.

39 *Id.* at 658.

The bankruptcy court clarified that earn account-holders are not without recourse. As unsecured creditors, earn account-holders may utilize the claims-allowance process to determine the amounts of their claims, which may include damages based on breach of contract, fraud or other theories of tort liability.<sup>40</sup> However, given the uncertainty surrounding Celsius's prospects for continuing as a going concern and the company's dubious value in the event of a liquidation, the bankruptcy court's assurances are unlikely to leave earn account-holders feeling confident in their prospective recoveries.

On Jan. 18, 2023, a group of *pro se* earn account-holders filed a notice of appeal asking the U.S. District Court for the Southern District of New York to treat the earn account ruling as an immediately appealable final order or, alternatively, to treat their filing as a motion for leave to appeal.<sup>41</sup> The earn account-holders argue that given the novelty of crypto bankruptcies, the earn account ruling warrants review as it raises controversial issues of first impression regarding estate property that have never before been appealed in the Second Circuit.<sup>42</sup>

Celsius filed a response in the district court on Feb. 1, 2023, asserting that the earn account ruling is interlocutory in nature, and that delays inherent in an appellate review would be value-destructive to creditors and the bankruptcy estate.<sup>43</sup> Celsius further countered that an appeal does not present issues of first impression because while property rights for crypto deposits may be an unexplored area of law, the bankruptcy court based its decision on well-established doctrines of contract formation and interpretation.<sup>44</sup> As of late February 2023, the district court has yet to take any action with respect to the account-holders' appeal, and whether the earn account ruling will be subjected to further judicial review remains to be seen.

## Things to Consider When Using a Crypto Platform

### Terms of Use Should Be Closely Examined

As demonstrated by the *Celsius* decision, courts will closely examine the language in the terms of use to determine the rights of the parties and to see whether the parties presumptively have a valid, enforceable contract, although other equitable considerations, such as fraud, may ultimately change its determination.<sup>45</sup> If the plain language of the terms of use unambiguously provides that the crypto assets are the property of the crypto platform and otherwise creates a valid contract, a court could find that the crypto is presumptively owned by the crypto platform, although equitable considerations (*i.e.*, fraud) or other contract defense may ultimately change the determination.<sup>46</sup> However, in the bankruptcy context, even if the plain language of the terms of use states that the user retains an ownership interest in the crypto assets, there are bankruptcy laws that suggest otherwise in certain situations.

One aspect that could affect a determination of ownership in bankruptcy is whether a user's assets are commingled with assets owned by other account-holders or by the platform itself. There are long-held bankruptcy doctrines where commingling of an asset (like nondebtor cash in a debtor bank account) gives the debtor a colorable argument that the nondebtor asset is owned by the debtor.<sup>47</sup> This is particularly the case where the asset in question is fungible and not individually titled (*e.g.*, cash as opposed to a vehicle).<sup>48</sup> Thus, an argument can be made that segregation of accounts for each customer will render the crypto in the segregated accounts nondebtor assets (in the absence of a countervailing contractual provision between the exchange and the customer).

In addition, if a contract purports to provide the creditor with a security interest in certain property, unless the security interest is perfected under applicable nonbankruptcy law prior to the debtor's bankruptcy filing, a bankruptcy trustee can assert "strong-arm" powers under § 544(a) of the Bankruptcy Code to avoid the lien and security interest against the estate.<sup>49</sup> Under the Uniform Commercial Code (UCC), security interests in personal goods are typically perfected by recording the security interest with the secretary of state where the assets are located.<sup>50</sup> Amendments to the UCC were recently approved to govern the transfer of property rights in cryptocurrencies and other digital assets.<sup>51</sup>

## Nature of the Products and Services Offered

Depending on the types of products and services being offered, a crypto platform may or may not claim ownership of users' crypto assets in its terms of use. For example, a custodial wallet may want to structure its terms differently than a crypto exchange, whereas a crypto exchange may want to claim ownership of user assets and/or segregate the assets of user accounts given that exchanges need massive amounts of token liquidity to maintain a stable price of assets and to support the exchange of tokens.<sup>52</sup> Thus, while a crypto exchange would benefit from claiming ownership of a user's deposited crypto assets in its terms of use for interest-bearing accounts, a custodial crypto-wallet company might, for purposes of meeting client expectations, benefit from stating the opposite in its terms of use for its non-interest-bearing custodial accounts (*i.e.*, by stating that users retain ownership rights of their crypto assets).<sup>53</sup>

## Impact of Celsius on Other Bankruptcies

While it was a trailblazing judicial foray into the many novel legal issues posed by crypto bankruptcies, the *Celsius* decision was issued by a federal trial court, meaning that it will not be binding on other courts. However, it may still have persuasive value and can be cited by the parties and

40 *Id.* at 659.

41 Notice of Appeal, Celsius, ECF No. 1894; Amended Notice of Appeal, ECF No. 1952.

42 ECF No. 1894 at 21.

43 Debtors' Response in Opposition to Appellants' Motion for Leave to Appeal, No. 1:23-cv-00523-JPO, ECF No. 3.

44 *Id.*

45 *Celsius*, 647 B.R. at 660.

46 *Id.*

47 *See, e.g., In re Bonham*, 229 F.3d 750, 764 (9th Cir. 2000).

48 *See, e.g., In re Advent Mgmt. Corp.*, 104 F.3d 293, 296 (9th Cir. 1997); *In re Drexel Burnham Lambert Grp. Inc.*, 142 B.R. 633, 637 (Bankr. S.D.N.Y. 1992).

49 11 U.S.C. § 544(a).

50 U.C.C. § 9-301.

51 "2022 Amendments to the Uniform Commercial Code," Uniform Law Comm'n, available at [uniformlaws.org/committees/community-home?communitykey=1457c422-ddb7-40b0-8c76-39a1991651ac](http://uniformlaws.org/committees/community-home?communitykey=1457c422-ddb7-40b0-8c76-39a1991651ac).

52 *See, e.g., Benedict George & Toby Bochan*, "Centralized Exchange (CEX) vs. Decentralized Exchange (DEX): What's the Difference?," *CoinDesk* (Nov. 15, 2022), available at [coindesk.com/learn/centralized-exchange-cex-vs-decentralized-exchange-dex-whats-the-difference](https://coindesk.com/learn/centralized-exchange-cex-vs-decentralized-exchange-dex-whats-the-difference).

53 *See, e.g., Celsius*, 647 B.R. at 659.

courts in other cases. In addition, the finding is limited to the specific accounts and terms of use at issue in Celsius; thus, a court could decide otherwise with respect to different accounts and the governing terms of use.<sup>54</sup>

Overall, the *Celsius* decision indicates that future disputes over digital-asset ownership, in the context of bankruptcy proceedings and beyond, will likely turn on close analysis of contractual language in the terms of agreements governing crypto transactions. Companies transacting and lending through decentralized finance platforms, customers who are investing in digital assets and other parties of interest in the digital-asset industry need to be thoughtful about the terms of the agreements under which they are transacting. **abi**

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<sup>54</sup> *Id.* at 651.