AMERICAN BANKRUPTCY INSTITUTE

Southeast Bankruptcy Workshop

Crypto Is Coming; Is Bankruptcy Ready?

PLENARY SESSION

Hon. Stacey G.C. Jernigan
U.S. Bankruptcy Court (N.D. Tex.); Dallas

Robert A. Musiala Jr.
BakerHostetler | Columbus, Ohio

Laura L. Smith
O'Melveny & Myers LLP | Dallas

2022

CRYPTO IS COMING

Is Bankruptcy Ready?

Presenters

The Honorable Stacey G.C. Jernigan, *United States Bankruptcy Judge Northern District of Texas*

Robert A. Musiala, Jr., *Baker & Hostetler LLP*

Laura Smith, *O'Melveny & Myers LLP*

What is Bitcoin?

Bitcoin Commercial: What Is It and How Does It Work?

2

What are We Talking About Today?

- What is Blockchain?
- What are some of the key Crypto Market Concepts?
  - What does “mining” for cryptocurrency mean?
  - What are the different types of cryptocurrency?
  - What are NFTs?
  - What is DeFi?
  - What is a DAO?
  - What is a Crypto Exchange?
  - What are Digital Wallets and Keys?
  - Who are some of the other key players?
- What regulatory issues are involved with cryptocurrency?
- What are some of the key/recent bankruptcy cases involving cryptocurrency?
- How can bankruptcy attorneys prepare for cryptocurrency issues in the future?

3

Intro to Blockchain

Intro to Blockchain

A blockchain is a cryptographically secured transaction network and ledger that is shared among and verified by all computer nodes participating in a distributed system.

Key Characteristics of Blockchain Include:

1. **Distributed Network.** Multiple independent computer nodes support the network and verify updates.

2. **Cryptography.** The integrity of information stored on a blockchain is secured by advanced public-private key cryptography.

3. **Immutability.** Every "block" of transactions is linked to the previous "block" of transactions, making it (practically) impossible to alter network data.

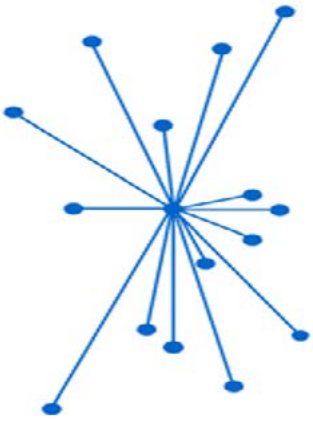
4. **Disintermediation.** Characteristics 1-3 enable trusted peer-to-peer transactions, without using a central authority as intermediary.

5

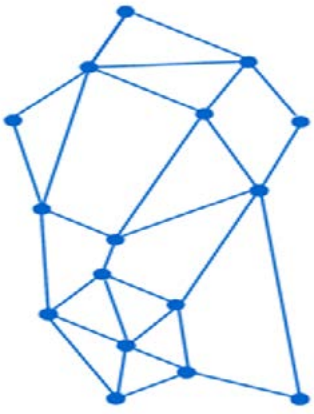
Intro to Blockchain (cont.)

1. **Distributed Network.** Multiple independent computer nodes support the network and verify updates.

Traditional Centralized Network



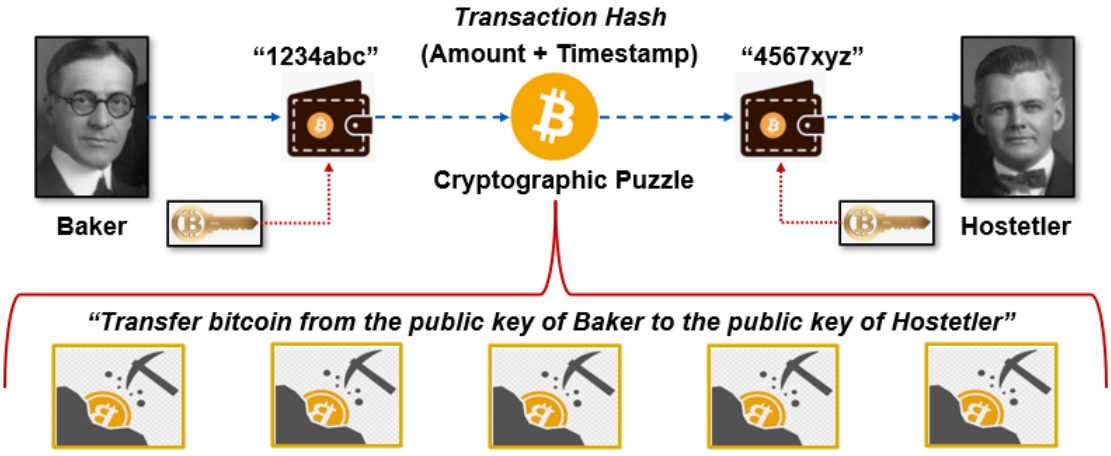
Distributed Network



6

Intro to Blockchain (cont.)

2. **Cryptography.** The integrity of information stored on a blockchain is secured by advanced public-private key cryptography.



7

Intro to Blockchain (cont.)

2. **Cryptography.** The integrity of information stored on a blockchain is secured by advanced public-private key cryptography.

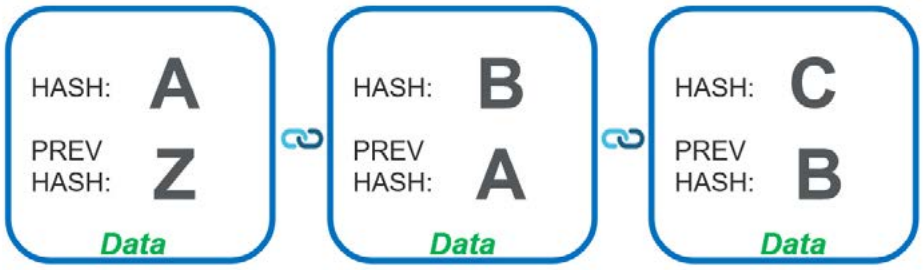
Bitcoin Network Example

- Every 10 minutes, all transactions broadcast to the network are aggregated in a new "block" that is verified by the winning miner.
- Once 51% of all miners verify the "block," the transactions are time-stamped and posted to the public ledger network.
- Each fully verified "block" is linked to the previous block, such that the only way to alter a transaction would be to alter the entire blockchain.
- Each miner retains their own copy of the full blockchain ledger, making it arguably the most secure network the world has ever seen.

8

Intro to Blockchain (cont.)

3. **Immutability.** Every "block" of transactions is linked to the previous "block" of transactions, making it (practically) impossible to alter network data.

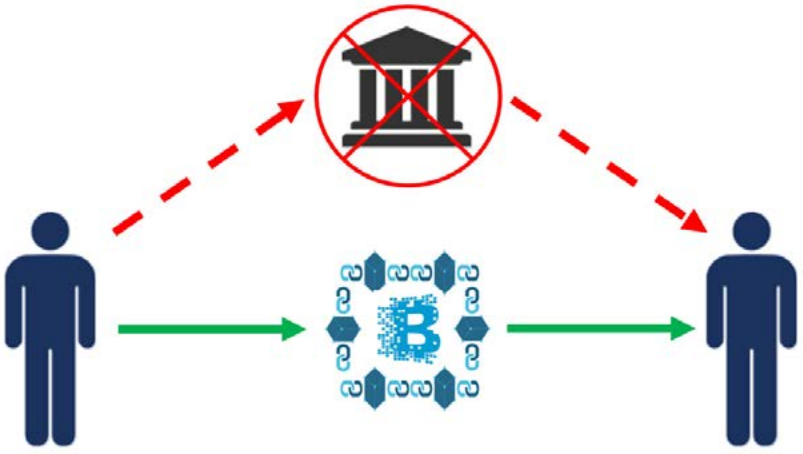


Sample Hash From the Bitcoin Blockchain:
00000000000000000098983c6e67bec9488da5f55f2842e2f01cf7188f33912

9

Intro to Blockchain (cont.)

1. **Disintermediation.** Characteristics 1-3 enable trusted peer-to-peer transactions, without using a central authority as intermediary.



10

Intro to Blockchain (cont.)

Top Cryptocurrencies by Market Cap:

1	Bitcoin BTC Buy	$19,792.18	▲0.75%	▲1.71%	▼2.78%	$377,675,035,809
2	Ethereum ETH Buy	$1,084.40	▲0.64%	▲3.74%	▼6.35%	$131,827,432,280
3	Tether USDT Buy	$0.9994	▲0.01%	▲0.01%	▲0.03%	$65,910,144,071
4	USD Coin USDC Buy	$1	▼0.01%	▼0.02%	▼0.02%	$55,332,068,982
5	BNB BNB Buy	$225.62	▲0.37%	▲1.32%	▼5.15%	$36,791,896,100

11

https://coinmarketcap.com/

Intro to Blockchain (cont.)

More Introductory Resources …

Blockchain University Podcast Series:

https://www.bakerlaw.com/podcasts?SeriesID=181632

Blockchain Monitor Weekly Blog:

https://www.theblockchainmonitor.com/

12

Crypto Market Concepts

Crypto Market Concepts

- **Crypto Mining Market**
  - Mining rigs use massive amounts of power.
  - Mining rig warehouses tend to spring up in places where energy is cheap—where there are plants with excess capacity to unload—and where it is cool so there is not as much cost with keeping the rigs cool. There are open air warehouses in sub-Arctic regions in Canada, Russia, and China.
  - **June 2021** – China officially bans cryptocurrency mining and begins taking enforcement action against miners, prompting a mining exodus.
  - **October 2021** – The U.S. officially overtakes China as the world's largest Bitcoin mining hub.
  - **February 2022** – Intel unveils its new energy-efficient BMZ1 blockchain accelerator chips and a 3600-watt mining rig.
  - **March 2022** – The government of Kazakhstan announced it was cracking down on illegal crypto miners; over 100 mining companies have ceased operations.
  - **March 2022** – Bitmain, the world's biggest manufacturer of crypto mining rigs, recently announced a new energy-efficient mining rig that uses liquid coolant to manage heat released from the rig.

14

Crypto Market Concepts (cont.)

- **What are some of the different types of cryptocurrency?**
  - Coins (e.g., Bitcoin, Ether, Litecoin, Binance)
  - Tokens
  - Stablecoins
- **What are NFTs?**
  - A Non-Fungible Token, also known as a NFT, is a type of digital token or asset. A common analogy is to think of these as digital trading cards or digital paintings. When you buy an NFT, you are buying the rights to that specific asset.
- **What is DeFi?**
  - A blockchain-based form of finance that does not rely on central financial intermediaries such as brokerages, exchanges, or banks to offer traditional financial instruments, and instead utilizes smart contracts on blockchains, the most common being Ethereum.
- **What is a DAO?**
  - A DAO, or a Decentralized Autonomous Organization, is a company set up to run by code on the blockchain. The people who own tokens associated with the DAO are responsible for voting on changes and proposing new ideas to keep the DAO up and running and improving.

15

Crypto Market Concepts (cont.)

- **What is a Crypto Exchange?**
  - a platform to buy and sell cryptocurrency
- **What are Digital Wallets/Keys?**
  - Crypto wallets keep your private keys – the passwords that give you access to your cryptocurrencies – safe and accessible, allowing you to send and receive cryptocurrencies like Bitcoin and Ethereum. They come in many forms, from hardware wallets like Ledger (which looks like a USB stick) to mobile apps like the Coinbase Wallet, which makes using crypto as easy as shopping with a credit card online.
- **Who are some of the Other Key Players?**
  - Crypto Hedge Funds
  - Crypto Lenders

16

Cryptocurrency Regulatory Issues

Cryptocurrency Regulatory Issues

In the U.S., various federal agencies and courts have defined cryptocurrencies as falling into a variety of legal asset classes, depending on the situation. Similarly, international legal frameworks are inconsistent and constantly evolving.

1. **FinCEN** – Cryptocurrencies are "money"
2. **IRS** – Cryptocurrencies are "property"
3. **CFTC** – Cryptocurrencies are "commodities"
4. **SEC** – Cryptocurrencies are "securities"

18

Executive Order on Digital Assets

On March 9, 2022, "Executive Order on Ensuring Responsible Development of Digital Assets"

- Orders interagency reports addressing **CBDCs**, **economic opportunities and risks** of digital assets, and **approaches to illicit activity**.
- The EO also provides definitions of the following terms: **blockchain**, **central bank digital currency**, **cryptocurrencies**, **digital assets** and **stablecoins**.
- **Cryptocurrencies** refers to a digital asset, which may be a *medium of exchange*, for which generation or ownership records are supported through a distributed ledger technology that relies on cryptography, such as a blockchain.
- **Digital Assets** refers to all CBDCs, regardless of the technology used, and to other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology. For example, *digital assets include cryptocurrencies, stablecoins, and CBDCs*. Regardless of the label used, *a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product*.

19

https://www.theblockchainmonitor.com/2022/03/executive-order-launches-comprehensive-us-policy-and-action-plan-for-digital-assets/

Crypto Bankruptcy Case Studies

MtGox Co., Ltd.

- **MtGox, a Japanese company, was one of the first Bitcoin exchanges (formed in 2011).**
- **One could buy and sell Bitcoin on it and also exchange Bitcoin for traditional fiat currencies like the U.S. dollar.**
- **Handled over 80% of all Bitcoin traded worldwide at one time.**
- **MtGox earned revenue whenever it facilitated the exchange of fiat currency for Bitcoin or vice versa, earning a floating rate fee.**
- **It filed Chapter 15 (with its main insolvency proceeding filed first in Tokyo) after the disappearance of 744,408 of Bitcoin belonging to customers, plus another 100,000 of MtGox's own Bitcoin, collectively valued then at $473 million.**
- **The initial bankruptcy paperwork stated: "The cause of the theft or disappearance is the subject of intensive investigation. It is believed to have been caused [by] . . . a defect or 'bug' in the bitcoin software algorithm, which was exploited by one or more persons who had 'hacked' the bitcoin network."**
- **It soon suspended all trading. Eventually the trustee was able to recover approximately 200,000 of the missing Bitcoin from an "offline old-format wallet."**
- **MtGox debacle caused the price of Bitcoin to plummet, creating a disruptive effect that temporarily devastated the industry.**

21

MtGox Co., Ltd. (cont.)

- **<u>The Founder, Mark Karpeles (a.k.a Magical Tuxedo).</u>**
  - **Founder was a young Frenchman named Mark Karpeles who was not trusted by the time of the bankruptcy.**
  - **Tokyo BK case was commenced as the equivalent of Chapter 11 but was soon converted to Japan's equivalent of Chapter 7. The Japanese Trustee was the Foreign Representative for MtGox in the US Chapter 15.**
  - **Mark Karpeles was arrested by Tokyo police for embezzlement and was held in jail many months (but never convicted). A Russian citizen named Alexander Vinnik managing another cryptocurrency exchange was arrested and indicted in the U.S. (N.D. Cal.) for money laundering and is now believed to have some involvement with the MtGox hacking. He is now serving time in prison in France for other cybercrimes.**
  - **As of today, none of the missing Bitcoin (except the 200,000 initially found in the offline wallet) has been retrieved. But the Japanese Trustee subpoenaed the U.S. Attorney in N.D. Cal. late last year in the hopes of seeing their information compiled in their indictment of Vinnik.**

22

MtGox Co., Ltd. (cont.)

- **Why the U.S. Chapter 15 Case?**
  - **MtGox only had some servers in the U.S. (in Texas).**
  - **MtGox mainly filed its U.S. bankruptcy case to stay certain U.S. litigation against it.**
  - **It also had a potential avoidance action against the U.S. government regarding a prepetition seizure of $5.2 Million U.S. Dollars from MtGox's U.S. bank accounts by the U.S. Secret Service and Department of Homeland Security.**
  - **The U.S. Attorney ultimately agreed to return half of the seized funds, pursuant to a bankruptcy court-approved compromise.**

23

MtGox Co., Ltd. (cont.)

- **The Japanese Main Case**
  - **First goal was attempting to preserve electronic data on the Debtor's servers.**
  - **Then identifying and transferring the Debtor's cash from different accounts around the world into the Bankruptcy Trustee's bank account in Tokyo.**
  - **Over $12 million dollars in fiat currency was located in bank accounts around the world.**
  - **Then forensic investigations began. The Trustee retained Deloitte Touche Tohmatsu LLC (and affiliates) and ReEx Accounting Firm to search for missing Bitcoin.**
  - **Next, the trustee began efforts to sell assets, ultimately reaching a deal with Payward Japan, KK—the operator of the Bitcoin exchange named "Kraken"—whereby it would purchase MtGox's hard assets (i.e., the servers and PCs located in Japan, after data was extracted), for monetary consideration which equaled the equivalent of only $250,000 U.S. dollars, and as further consideration, Payward would provide support to the Trustee as follows: (a) 500 hours of free consulting in connection with analyzing the lost Bitcoin; (b) assistance with an online proof of claim system; and (c) unlimited assistance to the Trustee if he decided to make creditor distributions in the form of Bitcoin.**

24

MtGox Co., Ltd. (cont.)

- **Proof of Claim Process.**
  - **POC process in Japan much slower than is typical in the U.S.—ironically it worked to the creditors benefit here, because of the significant increase in value of Bitcoin later.**
  - **POC deadline established, was about 15 months after the Japanese case was filed. Japanese Trustee filed and posted a "Notice" on the MtGox website, explaining 3 ways to file a POC.**
  - **First, there was a mechanism to do so online, on the MtGox website.**
  - **Second, there also was a mechanism to file POCs online through Payward/Kracken (the asset buyer).**
  - **Third, people had option of filing POCs in writing.**
  - **In addition to the posting POC filing details on the MtGox website, former customers were sent email notices of the POC procedures. No physical hard copy service was determined to be needed.**
  - **On the POC form, creditors were given the option to indicate whether they preferred distributions on their claims in Bitcoin or fiat cash. But it was not firmly decided early on whether Bitcoin or fiat cash would be distributed.**
  - **24,750 persons filed POCs; over 25% of which were in the U.S. The total dollar amount of claims filed, using a conversion to U.S. dollars, equaled $2.3 trillion. The Trustee negotiated these claims down to $500 million.**

25

MtGox Co., Ltd. (cont.)

- **Timing of Distributions?**
  - **Japanese Trustee, who had 200,000 of Bitcoin (in addition to $12M+ of fiat cash) eventually began strategically selling off the Bitcoin of MtGox. He was known in cryptocurrency circles as the "Tokyo Whale" because of the large amount of Bitcoin he controlled.**
  - **Through these liquidations of Bitcoin, he accumulated about $500M of fiat currency before he even liquidated all of the 200,000 in Bitcoin (because of rebound in price of Bitcoin during case). Thus, he had enough to make all creditors more than whole (using the price of Bitcoin as of the bankruptcy filing date). So this crazy fact led to a new strategy in the BK proceedings.**
- **The Surge in Bitcoin Prices and the Newest Rehabilitation Proceedings for MGox.**
  - **Specifically, after the price surge, in late 2017, one of the creditors of MtGox essentially filed a new bankruptcy case—i.e., he filed an involuntary petition for a new civil rehabilitation proceeding in the Tokyo Court.**
  - **By doing so, this *Petitioning Creditor sought to supersede the previously-existing liquidation case with a new civil rehabilitation proceeding (the equivalent of Ch 11) because he wanted the creditors to be able to capture the increase in value of Bitcoin that occurred between 2014 (when the original case was filed) to the current time, and avoid having MtGox's ultimate equity owner, Mark Karpeles, realize that increased value through an equity dividend.***

26

MtGox Co., Ltd. (cont.)

- To understand this, in a Japanese liquidation case, a Trustee is required to value the claims of creditors who held Bitcoins as of the petition date. On the petition date, the market price of Bitcoin was $483 U.S. dollars. So, in the liquidation case that had been pending for 4 years, the maximum amount that could be distributed to a customer who had had one Bitcoin on deposit with MtGox would be $483 U.S. dollars—even if the market price of one Bitcoin at the date of distribution was (hypothetically) $4,000 U.S. dollars. In late 2017, on the date of the filing of the Petitioning Creditor's new involuntary Rehabilitation Petition, the market price of Bitcoin was, in fact, $8,201.46 U.S. dollars. It of course later rose much higher.
- To be clear, under Japanese law, in their Chapter 11-equivalent, a trustee is not required to value Bitcoin-based claims at the Petition Date. There is flexibility on how to distribute and allocate value in a plan. So, the Petitioning Creditor sought to avail itself of this flexibility and hopefully there would be a revaluing of claims as of the Petition Date of the new rehabilitation case or as of the date of confirmation of a rehabilitation plan—so as to capture the dramatic increase in Bitcoin market price and allocate value to Bitcoin creditors accordingly—including through a distribution of Bitcoin in kind. Again, absent the institution of a new rehabilitation proceeding, the Tokyo Court would have had no choice but to provide the criminally indicted former equity owner, Mark Karpeles, the value in the estate created by the increase in Bitcoin prices, after the payment of creditors' claims valued as of the Petition Date.

27

MtGox Co., Ltd. (cont.)

- The Japanese Court allowed this new rehabilitation proceeding to go forward and supersede the liquidation case, and this new proceeding was then recognized in the U.S. Chapter 15 Case, but, notably, an escrow was set up with fiat currency in an amount well in excess of what would be needed to pay in full all the traditional creditors (the non-Bitcoin customer creditors), plus interest.
- A plan was filed and confirmed in November 2021 that allowed the Bitcoin customers to realize the value increase of Bitcoin and gave them the option to take at least part of their distribution in Bitcoin. Notice went out July 6, 2022, that the Japanese Trustee was preparing to soon begin plan distributions.
- Also, a new POC bar date was established, because it was thought that maybe some customers had not bothered to file POCs the first time around because of plummeting prices back in 2014 and 2015.
- Fortune magazine summarized the MtGox case as follows:
  - "Between the time MtGox shut down [in Feb 2014] and when it entered liquidation in April 2014, the price of Bitcoin had plummeted more than 20% to $483. It would be over two and a half years before Bitcoin [rebounded to] its previous high point . . . Then by late May 2017, it was trading at nearly $2,200, making MtGox's remaining Bitcoins—202,185 to be exact—worth more than everything it owed in claims. When the Bitcoin price peaked at $20,000 in December 2017, the value of MtGox's assets . . . ballooned to $4.4 billion—nearly 10 times the amount MtGox said it lost in the first place. The fact that you have a bankruptcy where the only asset that it owns goes up by 5,000%, that's unprecedented."

28

Quadriga CX

*On **Jan. 31, 2019**, Canadian cryptocurrency exchange QuadrigaCX filed for protection in Nova Scotia under the Companies' Creditors Arrangement Act, which allows companies to restructure in order to avoid bankruptcy.*

- **Company claimed it was unable to repay approximately $190 million owed to approximately 92,000 clients due to the recent alleged death of its founder, 30-year-old Gerald Cotten.**
- **Cotten allegedly was the only person who had the private keys needed to access approximately $147 million in cryptocurrency assets held on behalf of the company in off-line "cold storage" accounts.**
- **According to the company, Cotten died "due to complications with Crohn's disease on December 9, 2018, while travelling in India, where he was opening an orphanage to provide a home and safe refuge for children in need."**
- **12 days before his apparent death, Cotten signed a will leaving all of his assets to his wife, Jennifer Robertson, and making her the executor of his estate.**
- **Multiple reports questioned whether Cotten's death may have been part of a fraudulent "exit scheme" and suggested that the company was using customer deposits to pay out other customer withdrawals in an apparent Ponzi scheme.**

29

Quadriga CX (cont.)

The exchange subsequently filed for creditor protection and a Canadian court appointed a Big Four auditing firm as a Monitor to oversee the case.

- **The Monitor issued a report describing how it had taken control of Cotton's laptops, encrypted USB keys and cellphones in order to recover client funds.**
- **The Monitor stated that while it had located more than $900,000 in cryptocurrency held by Quadriga, $500,000 in bitcoin was later "inadvertently" transferred by Quadriga to its inaccessible cold wallets.**
- **Blockchain analytics companies and internet sleuths used this news of the transfer, along with other information, to track down the addresses for the wallets. A number of these addresses were published and appeared to comport with some of the details in the auditor report.**
- **The Monitor reported that six cold wallets supposedly holding $100 million of customer cryptocurrencies for 115,000 accounts at the exchange held only $400,000 in digital assets.**

30

Quadriga CX (cont.)

A subsequent report by the Monitor found that QuadrigaCX's late founder/CEO transferred roughly $200 million USD in cryptocurrency out of customer accounts into his personal accounts on other exchanges.

- **The funds were reportedly used to furnish the late founder's luxury travel, real estate investments and trading habits.**
- **The late founder also allegedly created fake accounts on QuadrigaCX, credited them with nonexistent fiat amounts and used the nonexistent fiat to purchase actual cryptocurrency from customers.**
- **The report also detailed QuadrigaCX's deficient accounting practices and failure to maintain a contingency plan for the loss of funds or its founder.**
- **At the time of the sudden death of QuadrigaCX's founder, the exchange was supposedly holding over almost $200 million in customer funds and cryptocurrencies.**

31

Quadriga CX (cont.)

*On **June 11, 2020,** the Ontario Securities Commission (OSC), one of Canada's provincial securities regulators, issued a report finding that QuadrigaCX (Quadriga), which went into bankruptcy a few months after founder and CEO Gerald Cotten was reported to have died in India, **"was an old-fashioned fraud wrapped in modern technology."***

- **$169 million asset shortfall resulted from Cotten's fraudulent conduct.**
- **There was no segregation of assets. From at least 2015, Quadriga did not maintain boundaries between its own assets and those of its clients. This enabled Cotten to use client funds to pay operating expenses including contractor fees. Client assets were also used by Cotten to cover the trading losses he generated on the platform, and to engage in speculative trading on other platforms. Clients were not told their money was being used to pay for platform operations or otherwise spent by Cotten for business and personal expenses.**
- **Books and records were not properly maintained. While the platform tracked some information including funding of client accounts, trades, withdrawals, and balances, from 2016 onward, no accounting ledger existed and there were no other records regarding the assets Quadriga controlled.**

32

Quadriga CX (cont.)

The OSC report found that Cotten was, in essence, trading with an unlimited credit facility because Quadriga clients bore the risks, and eventually the impact, of Cotten's trading losses.

- **<u>Cotten traded using fake aliases and fictitious money.</u> Cotten traded with Quadriga clients using numerous alias accounts, which he credited with fictitious assets through manual adjustments to Quadriga's internal ledger. These adjustments were reflected in Quadriga's records as an "administrative adjustment," "in-person payment" or "bank wire." For example, in 2017, Cotten credited one of his fake accounts with deposits totaling $150 million – fictitious funds that he used to trade with Quadriga clients.**
- **Cotten accumulated significant trading losses totaling over $115 million over the life of the platform. He used other clients' platform assets to pay out clients with whom he traded.**
- **Cotten was operating Quadriga like a Ponzi scheme in that a portion of client withdrawals were being funded with other clients' deposits.**
- **Between 2016 and 2018, Cotton transferred approximately $24 million of client funds to himself and his spouse and purchased several luxury vehicles, a yacht, a plane, and multiple properties.**

33

Quadriga CX (cont.)

Netflix Documentary

34

Cred, Inc.

- Founded in 2018, Cred Inc. (“Cred”) described itself as a “global financial services platform” and “licensed lender” that delivered lending and borrowing services to customers in approximately 140 countries.
- Cred’s most notable product offering was CredEarn, where customers lent crypto to Cred with the promise of being repaid plus interest in the same type of crypto as the original investment. Cred then loaned the crypto to MoKredit, a Chinese micro-lending platform owned by Cred co-founder Hua. And MoKredit then lent those funds to its own customers (who were supposedly thousands of gamers who borrowed small amounts at interest rates as high as 35%).
- Cred’s dealings with MoKredit were entirely in stablecoin, but Cred’s debts to its CredEarn customers were in different types of cryptocurrencies, leaving the company exposed to crypto price increases.
- In October 2020, Cred published a cryptic letter saying it had experienced "irregularities" in the handling of "specific" corporate funds by a "perpetrator of fraudulent activity." In response, Cred said it had been advised by legal counsel to temporarily suspend inflows and outflows of funds relating to its CredEarn program.
- Cred and certain of its affiliates then filed for chapter 11 bankruptcy in Delaware on November 7, 2020, in front of Judge Dorsey.

35

Cred, Inc. (cont.)

- According to initial papers filed with the bankruptcy court, the primary driver of Cred’s unfavorable financial situation was the rise in BTC’s price, which spiked 200% in USD terms from a low of $4,944.70 on March 16, 2020, to $14,783.98 as of November 9, 2020. This negatively impacted Cred’s balance sheet since customer deposits, in the form of cryptocurrency like Bitcoin, were a liability on Cred’s balance sheet. Second, Cred suffered a hack, leading to the freezing of customer cryptocurrency funds while law enforcement worked to recover the lost assets. Third, was the “material loss [of funds] connected with the onboarding of a fraudulent asset manager,” James Alexander, and his misappropriation of 800 BTC ($15.6 million as of December 3, 2020).
- After the allegations of mismanagement and fraud surfaced upon Cred’s descent into bankruptcy, and despite urgings from parties in interest for the appointment of a chapter 11 trustee, the bankruptcy court appointed an examiner pursuant to section 1104(c) of the Bankruptcy Code, and tasked the Examiner with investigating allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of Cred or by its current or former management.
- Over the course of three months, the Examiner analyzed approximately 13,000 documents and over 55 gigabytes of data and conducted 23 witness interviews.
- On March 8, 2021, the Examiner issued a 103-page report (the “Examiner Report”).

36

Cred, Inc. (cont.)

- **Although the Examiner Report found that the events partially responsible for Cred's bankruptcy filing were a "flash crash" in cryptocurrency trading value in March 2020 combined with a run-up in April and May 2020—resulting in over $24 million in losses—it ultimately concluded that "the firm's failure [was] more aptly attributed to dereliction in corporate responsibility." Cred's most fundamental failures, as identified by Examiner, included:**
  - ***un-systemic, chaotic and, in some instances, nonexistent diligence, accounting, and compliance functions; (ii) allowance for currency migration to non-Cred entities operating in mainland China. . . , without legal or practical capacity to repatriate capital as and when requested/needed by Cred; and (iii) allocation of important managerial and operating functions to an individual with an extremely worrisome past.***
- **The Examiner Report primarily found that "Cred failed to incorporate and maintain internal compliance policies, including due diligence policies." Specifically, it noted that Cred's diligence process was "informal and appeared, in places, to be cursory," and that "no compliance program had been created, let alone implemented." Specifically, Cred made investments in MoKredit and an imposter posing as Quantcoin, and relied on James Alexander, its Chief Capital Officer, who was a fugitive in the United Kingdom unbeknownst to Cred.**

37

Cred, Inc. (cont.)

- **On March 11, 2021, the bankruptcy court confirmed Cred's modified first amended combined plan of liquidation (the "Plan"). The Plan was premised on the creation of a liquidating trust, which would succeed to all rights, interests and property of Cred, and to which Cred would transfer its assets, including causes of action of Cred's estates. A liquidating trustee, who was selected by members of the Official Committee of Unsecured Creditors, would then be tasked with monetizing Cred's assets and making distributions to holders of allowed claims.**
- **One of the more recent lawsuits that has been filed by the liquidating trustee alleges damages in connection with a fraudulent transaction in which Cred paid consultant and "crypto whale" Winslow Carter Strong over 516 bitcoin (worth about $4.8 million at the time of sale and $21 million today) in exchange for an essentially worthless bond.**

38

In re Hashfast Technologies LLC

- **Adversary Proceeding addressing the nature of Bitcoin (sort of).**
- **Hashfast was *a Bitcoin mining company* based in San Jose, California, that was placed into an involuntary Chapter 7 bankruptcy case (consented to by company and converted to Chapter 11) in the ND Cal. in 2014.**
- **HashFast had pioneered a technology that purported to allow Bitcoin miners to outpace their competitors.**
- **HashFast enlisted the help of Dr. Marc Lowe, an early proponent of Bitcoin who had a large online following, to help market the technology.**
- **In exchange for his assistance, HashFast promised to pay Dr. Lowe a certain commission, which amounted to $308,000. But instead of paying this commission in U.S. currency, HashFast paid Dr. Lowe using 3,000 Bitcoin.**
- **When HashFast later found itself in bankruptcy, the Chapter 11 trustee sought to avoid the payment as a fraudulent transfer.**
- **By that time, Dr. Lowe's 3,000 Bitcoin had more than tripled in value to over $1 million. Accordingly, the trustee sought to recover either the Bitcoin itself, or the current value of the Bitcoin. *See* 11 U.S.C. § 550.**

39

In re Hashfast Technologies LLC (cont.)

- **In opposing the trustee's avoidance action, Dr. Lowe asked the bankruptcy court to treat the Bitcoin as currency, thereby limiting the trustee's recovery to a maximum of approximately $300,000.**
- **A motion for partial summary judgment was filed—asking for a ruling only on the section 550 aspect of the original complaint.**
- **Section 550(a) of the Bankruptcy Code permits a trustee, once a transfer has been avoided, to recover, for the benefit of the estate, either the property transferred or the value of the property.**
- **Typically, when currency is transferred, there is no question over the form of recovery: avoidance of a $100 transfer leads to a $100 recovery.**
- **However, when other types of property are transferred, the form of recovery becomes relevant, since the property could increase or decrease in value following the transfer. The Liquidating Trustee, thus, argued that the Bitcoin were property, and that the estate was entitled to recover either the 3,000 Bitcoin or their current appreciated value of $1.2 million.**
- **Specifically, the Liquidating Trustee argued that Bitcoin are a commodity, like gold, silver or pork bellies, that fluctuates in price based upon market conditions—making the point that this was the position of the CFTC and IRS.**

40

In re Hashfast Technologies LLC (cont.)

- The defendant, in turn, argued that Bitcoin were not property for purposes of Section 550(a), but rather the equivalent of U.S. dollars that retained their lower "face" value. He cited authority from FinCEN, the CFPB, the SEC, and various court opinions in money laundering cases involving crypto assets that had treated Bitcoin the same way as currency.
- On 2/22/16, Bankruptcy Judge Dennis Montali issued an order that stated that Bitcoin ***was not to be considered U.S. currency in determining its value under 11 U.S.C. § 550(a)***.
- The court held as follows: "The court does not need to decide whether bitcoin are currency or commodities for purposes of the fraudulent transfer provisions of the bankruptcy code. Rather, it is sufficient to determine that, despite defendant's arguments to the contrary, bitcoin are not United States dollars. If and when the Liquidating Trustee prevails and avoids the subject transfer of bitcoin to defendant, the court will decide whether, under 11 U.S.C. § 550(a), he may recover the bitcoin (property) transferred or their value, and if the latter, valued as of what date."
- Thus, it appears that the court was opining that bitcoin was not currency, although maybe he was only minimally holding that Bitcoin were property that could be subject to an avoidance action.
- The matter later settled.

41

Recent Filings

Three Arrows Capital, Ltd.

- Three Arrows Capital, Ltd. ("TAC") was formed in 2012 under BVI law.
- TAC operated as a regulated fund manager until last year, when it shifted its domicile to the BVI, as part of a global corporate plan to relocate operations to Dubai.
- TAC's business ultimately collapsed in the wake of extreme fluctuations in cryptocurrency markets and on June 27, 2022, TAC commenced a liquidation proceeding before the BVI Court.
- Foreign representatives for TAC then filed a chapter 15 petition on July 1, 2022, in the Southern District of New York.
- Russell Crumpler and Christopher Farmer of Teneco (BVI) Ltd., the joint liquidators in the fund's insolvency proceeding in BVI, were appointed as foreign representatives to pursue the chapter 15 filing by the BVI court.
- The chapter 15 filing was precipitated by Cryptocurrency platform Voyager Digital Ltd.'s announcement on June 27, 2022, that it issued a notice of default to TAC for its "failure to make the required payments on its previously disclosed loan of 15,250 BTC and $350 million USDC." In a separate release, Voyager said it was "actively pursuing all available remedies for recovery from 3AC, including through the court-ordered liquidation process in the British Virgin Islands."

43

Three Arrows Capital, Ltd. (cont.)

- Reviewing the connections to the United States and New York that supported the chapter 15 filing, Crumpler pointed to a retainer paid to Dan Tan Law, TAC's counsel, and TAC's status as a borrower under certain loan agreements for loans to be made in U.S. dollars or bitcoin, which included forum selection clauses designating arbitration in New York. One of these loan agreements, with TAC's "largest known creditors," is the subject of a temporarily stayed proceeding that was initially scheduled to consider an emergency freeze of TAC's assets on July 5, 2022.
- The foreign representatives said that chapter 15 recognition of the BVI proceedings was necessary to prevent creditors from exercising "self-help remedies in the United States and elsewhere, in contravention of the BVI Commercial Court's order."
- The joint liquidators also stated that they have only "recently started" their efforts to investigate "the details of the Debtor's transactions leading up to its insolvency, as well as its outstanding obligations," and that additional time was needed to complete these investigations and take "possession of the Debtor's liquid and illiquid assets . . . located in and/or potentially subject to the laws of a number of different jurisdictions."
- Following these steps, Crumpler said the liquidators hope to "make recoveries to the extent possible," including by potentially bringing "claims against any third parties that are subject to suit and may have damaged or owe money to the Debtor in the United States."
- On July 12, 2022, the bankruptcy court granted the foreign representatives' motion for emergency provisional relief. The recognition hearing is scheduled for July 28, 2022.

44

Voyager Digital Holdings, Inc.

July 6, 2022 – Crypto Lender Voyager Digital Files for Bankruptcy

- **Voyager issued a notice of default to Singapore-based crypto hedge fund Three Arrows Capital for failing to make payments on a crypto loan totaling over $650 million.**
- **Voyager filed for Chapter 11 bankruptcy protections in the U.S. Southern District Court of New York, estimating that it had more than 100,000 creditors and somewhere between $1 billion and $10 billion in assets. It also recorded the same range for its liabilities.**
- **Voyager also claimed in a blog post that it had $110 million in cash, $350 million in cash at Metropolitan Commercial Bank, $1.3 billion in crypto and was owed $650 million from Three Arrows. It did not say what specifically the liabilities are.**
- **Voyager shares were halted from trade on the Toronto Stock Exchange.**

45

Voyager Digital Holdings, Inc. (cont.)

- **"Customers will receive a combination of the following, with the ability to select the proportion of crypto and common equity they receive, subject to certain maximum thresholds: pro-rata share of crypto; pro-rata share of proceeds from the 3AC recovery; pro-rata share of common shares in the newly reorganized company and pro-rata share of existing Voyager tokens."**
- **Customers with U.S. dollars in their accounts will be able to access funds after a "reconciliation and fraud prevention process is completed with Metropolitan Commercial Bank."**
- **Signs that Voyager and its clients were experiencing headwinds came after the lending platform entered into a $500 million loan agreement with trading firm Alameda Research to cover losses from its exposure to crypto venture capital firm 3AC.**
- **A day later, the platform lowered its daily withdrawal limit to $10,000 and then, on July 1, announced that it would be suspending trading, deposits, withdrawals and loyalty rewards distributions.**

46

Voyager Digital Holdings, Inc. (cont.)

- **Between March 2021 and March 2022, Voyager lent out cryptocurrency with an aggregate market value of $5.15 billion, according to court filings.**
- **Voyager's loan book is estimated to be nearly 60% composed of loans to crypto hedge fund Three Arrows Capital, which the Voyager CEO blamed for most of his company's woes.**
- **In its previous advertising, Voyager appeared to be saying that its own customers would be protected by the FDIC, pointing to its accounts at New York-based Metropolitan Commercial Bank. Metropolitan put up a statement on its website refuting the Voyager claim.**
- **An FDIC spokesperson said Voyager is not a bank or savings association, and therefore not qualified for FDIC insurance.**

47

Voyager Digital Holdings, Inc. (cont.)

Key Details of Bankruptcy Filings

- **Reasons for Filing For Chapter 11 Protection:**
  - **Prolonged volatility in global cryptocurrency markets**
  - **Default on $650 million loan by Three Arrows Capital**
  - **Suspension of customer trading, deposits and withdrawals**
- **Total Liabilities: $6 billion**
- **Secured Liabilities: $75 million**
  - **$75 million in USD Coin provided by Alameda Ventures Ltd.**
- **Unsecured Liabilities: $5.9 billion**
  - **$5.9 billion in various cryptocurrency assets held in customer accounts.**
- **Richard Morrissey, representing the U.S. Trustee's Office, said the case was entering "uncharted territory," including considering whether Voyager can spend and distribute cryptocurrency like debtors in other Chapter 11 cases spend cash.**

48

Voyager Digital Holdings, Inc. (cont.)

The Fallout

- At its height, Voyager Digital boasted 3.5 million users (roughly what Coinbase boasted in 2015) and $5.9 billion in assets, comparable to a small regional bank or respectable wealth management firm.
- Ninety-seven percent of Voyager's clients stored less than $10,000 on the platform, indicating a broad base of individual investors.
- Voyager was one of several retail-facing crypto institutions that generated interest on deposits by loaning crypto assets out to traders and institutions. Investment firms and hedge funds like Three Arrows Capital relied on these loans to make big trades. They take in capital from lenders, long or short a cornucopia of (risky) assets, invest in early-stage companies – and if all goes well, earn massive returns relatively quickly … Until something goes wrong.

49

What if a Crypto Exchange Files for Bankruptcy?

- **Could a crypto exchange be ineligible to file Chapter 11?**
  - The Bankruptcy Code sets a specific list of entities that are not eligible for relief (i.e., banks, insurance companies), *see* 11 U.S.C. § 109).
- **What is the status of parties who have stored crypto on the exchange?**
  - The Bankruptcy Code provides that upon commencement of a bankruptcy case, an estate is created that is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case," *see* 11 U.S.C. § 541.
- **Can customers get their cryptocurrency back?**
  - It is likely that the automatic stay would prevent exchange customers from withdrawing their cryptocurrency from their account since the exchange would have a possessory interest in any cryptocurrency held on the exchange. Parties can still move to lift the automatic stay for "cause."
- **Are there claims that may exist belonging to an exchange against customers?**
  - Potential Preferences/Fraudulent Transfers

51

What are Some Other Issues in Any Bankruptcy Case Involving Crypto?

- **Is cryptocurrency treated as a commodity versus currency?**
  - Impacts under section 550 of the Bankruptcy Code
- **How does a trustee locate and control a debtor's cryptocurrency?**
- **Can a DAO potentially bid on distressed assets?**

52

Questions???

Faculty

Hon. Stacey G. C. Jernigan is Chief U.S. Bankruptcy Judge for the Northern District of Texas in Dallas, initially appointed on May 12, 2006. Prior to her appointment, she practiced for 17 years in the Business Reorganization and Bankruptcy Practice Group of Haynes and Boone LLP in Dallas, where she represented debtors, committees and purchasers in large, complex chapter 11 cases and out-of-court workouts, particularly with regard to energy companies, regulated entities, real estate businesses and public companies. She was also an advisor to the California Legislature in Sacramento in connection with the California utility financial crisis in 2001. Judge Jernigan is Board Certified in Business Bankruptcy Law by the American Board of Certification, a Fellow of the American College of Bankruptcy and a Fellow of the Texas and Dallas Bar Foundations. She is a frequent author and has been recognized by *Chambers USA*, *D. Magazine* and *Texas Monthly Law & Politics*. Judge Jernigan received her B.B.A. *magna cum laude* from Southern Methodist University in 1986 and her J.D. from the University of Texas Law School in 1989.

Robert A. Musiala, Jr. is the co-leader of the Blockchain Practice at BakerHostetler in Columbus, Ohio. He has been working in the blockchain and cryptocurrency market since 2012 and has extensive experience in cryptocurrency investigations and regulatory compliance, including having worked with a U.S. national security community client, advising blockchain clients on compliance with the Bank Secrecy Act, GDPR, SEC and CFTC regulations, alternative trading system applications, and as the court-appointed receiver to investigate and secure assets related to a cryptocurrency fraud scheme. Mr. Musiala invented one granted blockchain patent and another pending blockchain patent. In his practice, he works directly with technical teams to design solutions that meet legal and regulatory requirements. Mr. Musiala received his B.A. in creative writing (with honors) and international studies from Northwestern University in 2000, his J.D. from Notre Dame Law School in 2003 and his M.S.A. from the University of Illinois at Chicago Liautaud Graduate School of Business in 2011.

Laura L. Smith is counsel in the Dallas office of O'Melveny & Myers LLP, where she concentrates her practice on commercial bankruptcy. She regularly represents debtors, lenders, creditors and trustees under chapters 11 and 7. Ms. Smith's practice also includes litigation and adversary proceedings. She has experience representing lessors, landlords, financial institutions, official committees and trustees in chapter 11 and chapter 7 bankruptcy cases. Ms. Smith is chair of the International Womens' Insolvency & Restructuring Confederation and a member of The Honorable John C. Ford American Inn of Court and the DFW Association of Young Bankruptcy Lawyers. She previously clerked for Hon. Stacey G. C. Jernigan of the U.S. Bankruptcy Court for the Northern District of Texas. Ms. Smith received her B.S. *summa cum laude* from Boston University and her J.D. *cum laude* from Southern Methodist University, where she competed on its Duberstein Bankruptcy Moot Court team.