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2023 Bankruptcy Battleground West

Tales from the Crypto: How Scary Is It Going to Get?

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Cryptocurrency Overview: More than Just Bitcoin



Source: Wirex



Cryptocurrency Overview: How Is Crypto Made?

Proof of Work (BTC):

- “The process of verifying transactions on the Bitcoin blockchain by solving mathematical puzzles, for which miners are rewarded with new bitcoin.” –Investopedia
- Uses massive amounts of electricity
 - Embedded power plants
 - Move toward more sustainable sources such as hydroelectricity, solar and wind
- Very sensitive to volatility in prices of both energy and BTC
 - Increased energy prices and depressed BTC prices in 2022 led to financial distress and bankruptcies for miners and data centers
 - *In re Compute North Holdings, Inc.*, Case No. 22-90273 (Bankr. S.D. Tex. Sept. 22, 2022)
 - *In re Core Scientific, Inc.*, Case No. 22-90341 (Bankr. S.D. Tex. Dec. 21, 2022)

Proof of Stake (ETH)

- Different consensus process for validating new blocks on the blockchain – not energy-intensive
- Validators explicitly stake (lock up) capital in the form of 32 ETH into a smart contract on Ethereum

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Cryptocurrency Overview: How Is Crypto Held and Traded?



Source: BlockFi Inc. First Day Presentation

Major crypto exchanges and lenders include:

- Binance
- Coinbase
- Kraken (no longer providing staking services in US per SEC settlement)
- Nexo (exiting US market following SEC settlement)
- Voyager (in bankruptcy)
- Celsius (in bankruptcy)
- FTX (in bankruptcy)
- BlockFi (in bankruptcy)
- Genesis (in bankruptcy)

Other ways to hold crypto:

- Custody
- Cold storage

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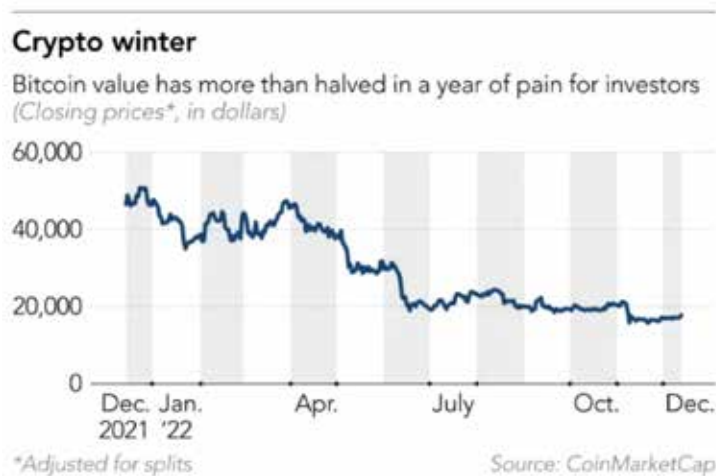
Cryptocurrency Overview: The Business of Crypto

- Energy companies
- Miners
- Data centers
- Software companies
- Money transmitters
- ATMs
 - *In re Cash Cloud, Inc.*, Case No. 23-10423 (Bankr. D. Nev. Feb. 7, 2023)

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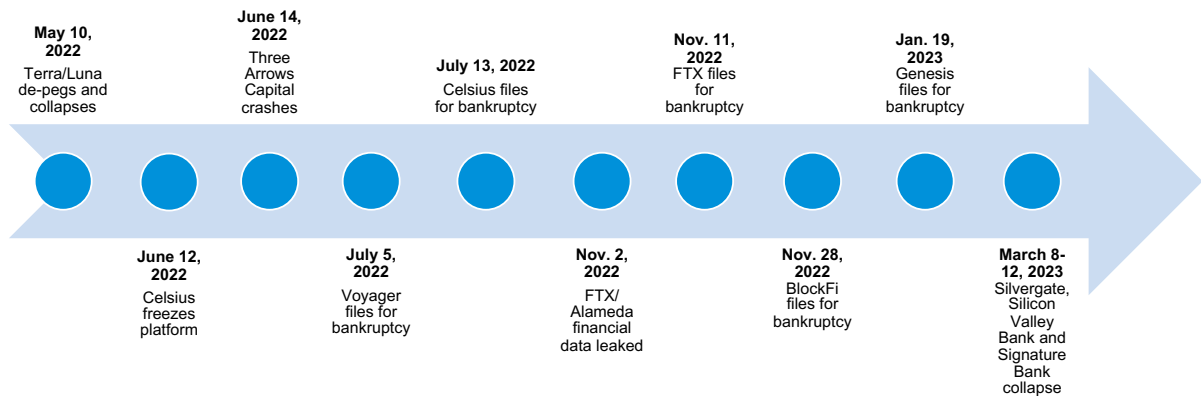
Cryptocurrency Distress: BTC Prices



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Cryptocurrency Distress: Timeline



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Crypto Winter Spillover

Silvergate Bank, Silicon Valley Bank and Signature Bank

- Silvergate announced on March 8 that it would voluntarily liquidate
- SVB was taken over by regulators on March 10
- Signature Bank was taken over by regulators on March 12
- To an extent, all three experienced a classic “run on the bank” triggered by rising interest rates and overexposure to long-term low-yield Treasury bonds
- But also subject to specific business cycle risks
 - Silvergate and SVB focused on crypto and VC-funded tech startups
 - Downturn caused customers to start drawing down deposits
 - Silvergate in turmoil since the collapse of FTX; also cited regulatory scrutiny
 - Crypto firms and investors exposed to SVB include Circle (issuer of USDC stablecoin), BlockFi, Avalanche, Yuga Labs and Proof.
 - Signature ran Signet, a payment network that allowed commercial crypto clients to make real-time payments in dollars at any time, seven days a week

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Not Your Keys, Not Your Coins



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Not Your Keys, Not Your Coins

How do different platforms hold cryptocurrency, and what are the risks?

Various types of holdings

Custody by the platform

- Individual wallets
- Omnibus wallets

Custody by third-party provider

Interest account

Loan collateral

Loans to counterparties

Gray areas (terms of service unclear)

Risks

Legal risk

- How will terms of service be interpreted?

Security risk

- Hacks
- Loss of keys

Market risk

- Run on the bank
- Contagion

Risk of malfeasance

- Fraud
- Misuse of customer funds
- Failure to maintain reserves
- Ponzi scheme



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Not Your Keys, Not Your Coins

What happens when a crypto platform files for bankruptcy?

Property of the Estate (11 U.S.C. § 541)

- *In re Celsius Network LLC*, 647 B.R. 631, 660 (Bankr. S.D.N.Y. 2023) (finding that assets deposited by customers in Celsius' "Earn Rewards" program constitute property of the estate and not of the customers)

Preference Claims (11 U.S.C. § 547)

- "As an initial matter, transfers made by customers on the Voyager platform were ordinary course transactions—in fact, these transactions are the core purpose of the Debtors' business model. . . Further, cryptocurrency trades would satisfy the contemporaneous exchange defense and ordinary course defense provided in section 547(c). Accordingly, the Debtors believe that the consideration paid for such actions is properly valued at \$0. . ." —Voyager Digital Holdings (Oct. 18, 2022)
- Avoidance actions against customers have value and claims should be preserved and pursued against more than 32,000 current and former customers. —Also Voyager Digital Holdings (March 1, 2023)

Potential Defenses

- Ordinary course of business / ordinary business terms
- Subsequent new value
- Contemporaneous exchange
- Section 546(e) safe harbor

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Not Your Keys, Not Your Coins

What can you expect to get back?

Section 502(b)

- Claim valued as of petition date
- What happens if the coins appreciate in value? Windfall to equity?
- What if petition date price of coins is alleged to have been manipulated?
 - See *In re Celsius Network LLC*, Case No. 22-10964 (Bankr. S.D.N.Y. March 1, 2023) [Docket No. 2151] (plan term sheet seeking to reduce value of claims for holders of Celsius' native CEL token by approximately 75% from actual petition date prices)

Voyager Plan

- Sale to Binance
- Anticipated recoveries around 73%
- Significant regulatory pushback

Celsius Plan

- Creation of new hedge fund
- Some distributions in liquid crypto, remainder in tokenized securities

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**“It ain’t what you don’t
know that gets you into
trouble...”**

- Mark Twain

(Actually, it is.)

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Diligence Questions for Funds and Direct Investments

- **If investing in a fund that invests in digital assets, or doing so directly, what are the selection criteria?**
 - BTC, ETH
 - Altcoins, stablecoins
 - Proprietary tokens
 - NFTs
- **If investing in a fund that invests in companies operating in the digital space, or doing so directly:**
 - What types of companies? What is their actual business case?
 - Who is the management team? What are their qualifications and experience?
 - What diligence is the fund performing with respect to the companies it invests in? Can copies of diligence materials be provided? (Don't rely blindly on someone else's homework!)
 - Are any of companies related to the fund or those running it? How are boundaries maintained?

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Diligence Questions for Crypto Lenders/Exchanges

Read the fine print. All of it.

- What do the terms of service say about transfer of title?
- If title doesn't transfer, how are customer assets segregated/safeguarded?
- If a third party custodian is used, who holds the keys? What are the custodian's own TOS?

If it's a lender that rehypothecates customer assets:

- Who are the borrowers?
- What due diligence has the lender done on the borrowers?
- What are the collateral requirements and what proof can the lender provide that the requirements are followed?
- Are margin calls automatic or discretionary?
- What reserves does the lender hold? Have the reserves been audited, and does the auditor have sufficient experience to be able to identify red flags such as potential manipulation?

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Risk Management Best Practices for Digital Assets

Diversification

- Given the interconnectedness of the space, true diversification may be difficult to achieve or even assess

Proper asset storage

- If self-custodying, must have robust security measures in place to protect against cyber threats and other risks to digital assets.

Risk monitoring

- Have processes in place to monitor and actively manage risk on an ongoing basis, including:
 - Regularly reviewing holdings and exposures
 - Monitoring market conditions and trends
 - Reviewing and understanding regulatory actions (assistance of counsel may be needed)
 - Implementing risk controls as needed

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The Future of Digital Assets Pending Federal Legislation

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June 2022, Responsible Financial Innovation Act

Wyoming Republican Sen. Cynthia Lummis and New York Democrat Sen. Kirsten Gillibrand

**Creates a standard for determining which digital assets are
commodities and which are securities**

**Determined by looking at the purpose of the asset and the rights or
powers it conveys the consumer**

**Creates definitions - no common set of definitions for digital assets
today**

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June 2022, Responsible Financial Innovation Act

Wyoming Republican Sen. Cynthia Lummis and New York Democrat Sen. Kirsten Gillibrand

Creates requirements for stablecoins:

- Establishes 100% reserve
- Detailed disclosure requirements
- Framework for banks to issue payment stablecoins
- Authorizes a special depository institution charter under both state law and the *National Bank Act* for payment stablecoin issuance
- Directs the CFTC and the SEC to study and report on the development of a self-regulatory organization (SRO)
- Creates a structure for the taxation of digital assets
- 2023 seeking to introduce to the Senate a "slimmed-down" but "stronger" iteration

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August 2022, Digital Commodities Consumer Protection Act

Senate Agriculture Committee Chairwoman Debbie Stabenow (D-MI) and John Boozman (R-AR)

- Was backed by SBF
- Defines digital commodities as fungible digital forms of personal property that can be transferred person-to-person without an intermediary
- Includes digital assets that act like commodities—such as BTC and ETH
- Excludes digital commodities used solely for the purchase or sale of a good or service.

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Digital Commodity Platforms

Brokers, custodians, dealers, and trading facilities in digital assets:

- Must register with the commission
- Comply with risk management rules
- Recordkeeping requirements

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December 2022, Digital Asset Anti-Money Laundering Act

Senators Elizabeth Warren (D-MA) and Roger Marshall (R-KS)

- Extends Bank Secrecy Act (BSA) responsibilities, including Know-Your-Customer requirements, to digital asset wallet providers, miners, validators, and other network participants

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Crypto-Asset Environmental Transparency Act

Senator Edward J. Markey (D-MA), and Representative Jared Huffman

Require cryptomining companies to disclose their emissions for operations that consume more than five megawatts of power

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Financial Crimes Enforcement Network (FinCEN)

- Proposed rule regarding certain transactions involving convertible virtual currency or digital assets with legal tender status
- Required to submit reports
- Verify the identity of customers involving wallets not hosted by a financial institution

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March 2022, Treasury Department

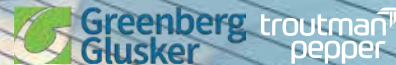
- Treasury Department urged all virtual asset service providers (VASPs), including crypto exchanges, to follow Bank Secrecy Act rules.

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California State Regulation

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May 2022, Governor Newsome Issued Executive Order N-9-22

- Harmonize federal and state laws relating to crypto assets and related financial technologies
- Requires the state agencies to provide a report to the Governor's Office on the relationship of crypto assets to priorities in energy, climate, and preventing criminal activity

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June 2022, California Assembly Bill 2269 – Digital Financial Assets Law

- Would have required companies “engaging in digital financial asset business activity,” including investing, lending or trading cryptocurrencies, to register with the state’s Department of Financial Protection and Innovation (“DPFI”)
- Vetoed by governor on 9/23/22
- DPFI does not currently seem to assert jurisdiction over crypto

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Uniform Commercial Code

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Proposed Changes Include New and Existing Articles

- Revisions to existing UCC Articles to address digital assets
- Introduces Article 12, which defines and governs digital assets specifically

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Proposed Changes Include New and Existing Articles

Amendments went to the States for consideration in the Fall of 2022

Bills introduced in:

- California
- District of Columbia
- Indiana
- Maine
- North Dakota
- Nebraska
- New Mexico
- Oklahoma
- Washington

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Article 8

- Existing Article 8 recognizes that if the contractual relationship between the exchange and its customers is defined as one that is “custodial,” the crypto assets held by the exchange should remain property of the customer
- Section 8-503(a) provides that a customer with a financial asset on an exchange retains ownership of that asset if:
 1. the exchange is a securities intermediary
 2. the securities intermediary has agreed with the customer to treat the asset as a financial asset; and
 3. the securities intermediary has credited the financial asset in a securities account
- This retention of ownership prevails even if the securities intermediary holds the financial assets in fungible, or commingled form

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Article 9

Does not provide adequate guidance on how to create or perfect a security interest in digital currencies:

- For a security interest to be effective it must initially "attach" to collateral
- Then, to be effective against third parties, must be "perfected"
- 12 different buckets of personal property
- UCC §9-108(b)(3) provides a safe harbor for that collateral description if the asset is described by its correct category type
- Methods of perfection varies depending on the collateral classification

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Article 9

- **Most likely classification:** Money, deposit accounts, investment property and general intangibles
 - UCC §1-201(b)(24) defines "money," in part, as "a medium of exchange currently authorized or adopted by a domestic or foreign government"
 - UCC §9-102(a)(29) defines "deposit account" in part as a "demand, time, savings, pass-book, or similar account maintained with a bank"
 - UCC §9-102(a)(49) defines "investment property," in relevant part, as a "security, whether certificated or uncertificated, security entitlement, ... or securities account"
 - Most obvious category for virtual currency would be the catchall category of "general intangibles"
 - UCC §9-102(a)(42), a general intangible is essentially any personal property that does not fit within any other specific collateral classification
 - Has included intellectual property and software

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Amendments to Article 9

- Provide that a security interest in a (controllable electronic record) **CER** can be perfected by filing a financing statement, or by obtaining “control” of the CER
- Under new 9-105A, a lender will be deemed to have “control” of electronic money
 - If “a record attached to or logically associated with the electronic money or a system in which the electronic money is recorded” gives the lender the “exclusive power” to control its transfer
 - The underlying blockchain—or “system in which the electronic money is recorded” — enables the lender “readily to identify itself” as the party in control (i.e., via “name, identifying number, cryptographic key, office, or account number”)
 - Under current blockchain technology, a secured party normally would obtain “control” of a cryptocurrency that is a CER if the secured party has the private key

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New Article 12

- Intentionally broad definition—rather than couching Article 12 in familiar technologies, like distributed ledgers, blockchain, and bitcoin—to account for technology not yet developed
- CERs:
 - controllable accounts (accounts where the account debtor undertakes to make payment to the person in control of the CER), and
 - controllable payment intangibles (payment intangibles where the account debtor undertakes to make payment to the person in control of the CER)

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New Article 12

- **CER excludes:**
 - any digital assets that are not subject to “control”
 - those that are already subject to other commercial laws such as E-SIGN, the Uniform Electronic Transactions Act or other articles of the UCC
- **Does not address the regulation of any digital assets**
 - e.g., how they are taxed
 - implications for banking regulations
 - whether such assets constitute securities

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New Article 12

Control of a CER exists if the electronic record:

- **Gives a person:**
 - i. the power to avail itself of substantially all the benefit from the electronic record
 - ii. the exclusive power to prevent others from doing so
 - iii. the exclusive power to transfer control to another person, and
 - iv. enables such person to readily identify itself as having these previously enumerated powers (including through the use of a cryptographic key or account number)

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New Article 12

- **Amendments allow for negotiability of CERs**
 - similar in concept to the negotiability of negotiable instruments
- **Take Free rule:**
 - a buyer of a CER can take free of the property claims of others if the buyer obtains control of the CER (e.g., holding the private key), gives value, and does not have notice of the property claims of others
 - “take-free” rule applies to the CER but not to other rights tethered to such CER:
 - NFTs, this might mean that the good faith purchaser might own the NFT free of any claims but would not necessarily enjoy any rights granted under any license to the content associated with the NFT
 - The rights regarding such tethered rights are governed by law other than Article 12

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New Article 12

- **Higher priority for a secured party that perfects its security interest in CERs by control rather than by filing of a UCC financing statement**
- **Choice of law:**
 - Local law of the CER’s jurisdiction governs matters covered by Article 12
 - CER’s “jurisdiction” can be specified in the CER
 - If the jurisdiction is not so specified, then the default rule is that the CER’s jurisdiction is the District of Columbia

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Questions?

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Faculty

Daniel B. Besikof is a partner with Loeb & Loeb LLP in New York and a strategic partner in the firm's Real Estate Investments and Transactions Department. He represents debtors, secured and unsecured creditors, indenture trustees, landlords, equityholders, distressed investors and other stakeholders in connection with complex chapter 11 bankruptcy proceedings, corporate restructurings and liquidations. In addition, he represents clients in high-stakes bankruptcy-avoidance litigation, including fraudulent-transfer and preference litigation, and other commercial litigation matters. Mr. Besikof advises borrowers and lenders in connection with the structuring, negotiation and documentation of secured and unsecured financing transactions. He has served as counsel in connection with a variety of industries, including crypto, health care, retail, oil and gas, media, technology and real estate, including in troubled projects involving EB-5 financing. Mr. Besikof has published numerous articles on issues relating to crypto bankruptcies and provided his insight to major media outlets, including CNN, CNBC, ABC, Reuters, Bloomberg, MarketWatch, Blockworks and Coindesk, among others. Prior to joining Loeb & Loeb LLP, he was an associate at Luskin, Stern & Eisler LLP. Mr. Besikof has been named a "New York Metro Rising Star" in Bankruptcy & Creditor/Debtor Rights by Thomson Reuters and is rated AV-Preeminent by Martindale-Hubbell. He is admitted to the U.S. District Courts for the Southern and Eastern Districts of New York, as well as the Second Circuit Court of Appeals and the U.S. Supreme Court. Mr. Besikof received his B.S. in 2000 in personal finance from the University of Wisconsin and his J.D. in 2004 from Brooklyn Law School, where he received the *American Bankruptcy Law Journal* Student Prize. Following law school, he was a judicial intern for Hon. Elizabeth Stong of the U.S. Bankruptcy Court for the Eastern District of New York.

Brian L. Davidoff is chair of the Bankruptcy, Reorganization & Capital Recovery Practice Group at Greenberg Glusker Fields Claman & Machtinger LLP in Los Angeles and has provided reorganization and bankruptcy counsel for more than 30 years. He helps middle-market companies and their principals, guides lenders, creditors and vendors seeking to maximize their recoveries, and represents buyers and sellers of distressed assets. Mr. Davidoff's early experience as a corporate attorney allows him to address both the insolvency and business needs of his clients. Frequently, he acts as general counsel to both distressed and thriving businesses, advising them on their business growth, financings and M&A activity. Mr. Davidoff is a frequent writer and speaker on cryptocurrency bankruptcies and has been involved in different aspects of cryptocurrency cases. He has provided media commentary to *Law360*, *The Guardian*, Bloomberg Law, *Forbes*, *Daily Journal*, *Los Angeles Business Journal*, *The Deal*, PUCK, WGN Radio Legal Face-Off and KNX In Depth. Mr. Davidoff has been recognized by *Chambers USA* each year since 2016, was selected as an *L.A. Times* Banking & Finance Visionary in 2022, and is selected annually to the *The Best Lawyers in America* and *Southern California Super Lawyers* lists. He received his law degree from the University of Witwatersrand in South Africa in 1978 and his LL.M. from the University of Miami in 1982.

Richard H. Golubow is a founder and the managing partner of Winthrop Golubow Hollander, LLP in Newport Beach, Calif., and devotes his practice to and has experience in the areas of financial restructuring, insolvency law, complex bankruptcy and business reorganizations and related litigation, liquidations, out-of-court workouts, acquisitions and sales of distressed assets, UCC Article 9 foreclosure sales, general assignments for the benefit of creditors, and receiverships. His clients

include debtors, creditors, creditor committees, trustees, assignees for the benefit of creditors, receivers and asset-purchasers in a wide range of industries. Mr. Golubow frequently lectures on or serves as moderator for bankruptcy and bankruptcy alternative topics for local, national and international organizations. He has published numerous articles on bankruptcy-related topics and is the author of *Local Bankruptcy Rules: California* (C.D. Cal.), an extensive Practice Note summarizing selected local rules of the U.S. Bankruptcy Court for the Central District of California, published by Thomson Reuters. Mr. Golubow has been frequently honored or recognized as the recipient of bankruptcy or financial restructuring attorney of the year awards by several leading international organizations and financial publications, including a 2017 “Deal of the Year” Award by The M&A Advisor. He is rated AV-Preeminent by Martindale-Hubbell and has frequently been listed as a *Southern California Super Lawyer*, including being selected a “Top 50 Orange County Super Lawyer” for 2017-2023. In addition, he is recognized in *The Best Lawyers in America* for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law. Mr. Golubow is a member of the International Network of Boutique Law Firms (INBLF), an invitation-only network of lawyers from single-discipline boutique law firms with the highest level of knowledge, experience, reputation and credentials comparable or superior to what can be found at the highest-ranking full-service law firms. He previously clerked for Hon. John J. Wilson in the U.S. Bankruptcy Court for the Central District of California in Santa Ana. Mr. Golubow received his B.S. in 1985 from the State University of New York at Albany and his J.D. in 1992 from Southwestern University School of Law in Los Angeles.

Deborah Kovsky-Apap is a partner with Troutman Pepper Hamilton Sanders LLP in New York, where she provides clients with practical and business-oriented advice on bankruptcy, out-of-court workouts and distressed M&A transactions. She represents debtors, creditors, creditors’ committees, trustees and purchasers in bankruptcy cases across the country, and currently represents ad hoc committees in the Celsius Network and BlockFi chapter 11 cases. An experienced litigator, Ms. Kovsky-Apap served as special litigation counsel to the City of Detroit in its bankruptcy, represented the defendant in an SEC enforcement action arising out of the Delphi bankruptcy that culminated in a three-month jury trial, and has investigated and successfully pursued numerous D&O and insider claims on behalf of creditors’ committees. She regularly lectures on bankruptcy topics to national and regional organizations. In addition, she co-authored the “Creditors” Committees in Reorganization Cases” chapter for the *Collier Bankruptcy Practice Guide*, co-wrote the “Alternatives to Bankruptcy Under Federal and State law” chapter in *Navigating Today’s Environment*, and authored “Defense Strategies for Depositors in Crypto Ch. 11 Litigation,” published in *Law360*. Ms. Kovsky-Apap is admitted to practice in Michigan, New York and New Jersey, and before the Sixth Circuit Court of Appeals; the U.S. District Courts for the Eastern and Western Districts of Michigan, the Southern District of New York and the District of New Jersey; and the U.S. Supreme Court. She received her A.B. *magna cum laude* in 1996 in literature from Harvard College, and her J.D. in 2003 from Columbia Law School, where she was a Harlan Fiske Stone Scholar and associate editor of the Columbia Law Review.