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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
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Celsius Networks' Pre-Bankruptcy Warnings Highlighted Crypto Bankruptcy Risks

By Richard J. Lee, Frederick (Rick) Hyman and Gregory Gennady Plotko*

Due, in part, to the lack of regulation, cryptocurrency platforms, retain wide discretion to use their customers' assets and, among other things, lend those assets to other platforms at higher rates, enter into complex swap and option transactions that bet on price movements, enter into repo or other lending arrangements to increase yield, or invest in other cryptocurrency projects, all without regulatory constraint. The authors of this article discuss cryptocurrency and bankruptcy risk.

Weeks prior to its bankruptcy filing in early July, Celsius Networks ("Celsius") raised cryptocurrency market temperatures by halting all withdrawals, swaps and transfers from and between its customers' accounts on June 12, 2022. Celsius touted a next wave of "unbanking," operating a lending platform allowing the holders of digital assets the opportunity to earn a significantly high returns on those assets. Due, in part, to the lack of regulation, Celsius, and other firms like it, retain wide discretion to use their customers' assets and, among other things lend those assets to other platforms at higher rates, enter into complex swap and option transactions that bet on price movements, enter into repo or other lending arrangement to increase yield, or invest in other cryptocurrency projects, all without regulatory constraint. Indeed, it was this broad discretion that led, in part, to the downfall of similarly situated platforms, Cred, Inc., and Voyager Digital Holdings Inc.

BACKGROUND

Celsius' actions to cease withdrawals led to concerns regarding the company's solvency and the likelihood of recovery for its customers. According to press reports, Celsius' problems began when it was the victim of a large hack of another platform that it had invested in, losing millions of dollars of Bitcoin. They continued to experience losses from a large investment in stETH (a tradeable token received when investors "stake" on the Ethereum blockchain pending the network upgrade). The value of stETH dropped precipitously in

* Richard J. Lee (rlee@crowell.com) is a partner at Crowell & Moring LLP focusing on derivatives, finance, and distressed debt and claims trading. Frederick (Rick) Hyman (fhyman@crowell.com), a partner at the firm and a member of its corporate practice and financial services groups, represents domestic and foreign lenders in connection with in-court and out-of-court workouts and restructurings. Gregory Gennady Plotko (gplotko@crowell.com) is a partner at the firm representing debtors, financial institutions, and other parties in complex and often high profile Chapter 11 bankruptcy cases, out-of-court restructurings, and other distressed situations.

May, precisely at a time when a general market downtown and turmoil in the cryptocurrency markets spurred customer redemptions. As a result, Celsius was unable to satisfy withdrawal requests. According to its "Community FAQ," Celsius took these actions to put it "in a better position to honor, over time, its withdrawal obligations." That vague statement proved ominous.

TERMS OF SERVICE

The Terms of Service ("TOS") governing Celsius' relationship with its customers is dense but explicit. The company's "Earn Service" operated as an "open-ended" loan to Celsius, in return for certain "rewards" in the form of digital assets, including Celsius' own token. Customers grant Celsius "all rights and title to any such assets to use in its sole discretion."

Among other things, the company also offered a custody service. However, this was seemingly not encouraged. In bold, capital letters, the TOS reminded customers that assets held in custody would not be eligible to receive fees, rewards or other compensation. According to the TOS, title to those assets held in custody was to remain with the customer at all times, yet that the company could suspend a customer's access to its wallet "in the event of market disruptions or periods of volatility." Moreover, assets held in custody could be commingled and Celsius disclaimed any responsibility to return the specific assets originally transferred. The customer expressly authorized the company to transfer digital assets to a third-party custodian or custodians as may be selected by Celsius without the need for any further notice or consent.

Insolvency risks were detailed in the TOS and similar to that which caused concern in Coinbase Global Inc.'s 10-Q—it explained that:

> In the event that you, Celsius or any Third-Party Custodian becomes subject to an insolvency proceeding, it is unclear how your Digital Assets would be treated and what rights you would have to such Digital Assets. Celsius does not make any representation as to the likely treatment of Digital Assets in your Celsius Account, including those in a Custody Wallet, in the event that you, Celsius or any Third-Party Custodian becomes subject to an insolvency proceeding whether in the U.S. or in any other jurisdiction. You explicitly understand and acknowledge that the treatment of Digital Assets in the event of such an insolvency proceeding is unsettled, not guaranteed, and may result in a number of outcomes that are impossible to predict reliably, including but not limited to you being treated as an unsecured creditor and/or the total loss of any and all Digital Assets reflected in your Celsius Account, including those in a Custody Wallet.

In its prepetition disclosures, nowhere did Celsius refer to the digital assets as its customers' property, whether those in the Earn Service program or maintained in custodial accounts—instead, it only promised to best position itself to satisfy withdrawal obligations.

ANALYSIS

Indeed, Celsius filed its bankruptcy case on July 13, 2022. The rights of those customers in the Earn Service program are at risk of being treated as general unsecured claims as similar customers were in Cred's bankruptcy case and as they are proposed to be treated in Voyager's filed plan of reorganization. To those customers that understood that they "loaned" their cryptocurrency to Celsius, and that Celsius took title, this should not be a surprise. These digital assets were transferred "with all rights and title" and will likely be treated as property of the debtor's estate. To others that were not aware – and there were many if the customer letters that have been filed on the docket in Celsius' case are any indication – this possible treatment has been a heartbreaking surprise. Like all other assets of a debtor's estate, the U.S. Bankruptcy Code's automatic stay generally protects them from interference from creditors, including the exercise of any contractual withdrawal rights that a customer may otherwise have. In addition, for institutional investors that may have engaged in repo, master lending or other swap-type transactions, it remains unclear how the various safe-harbors for early termination and set-off rights may apply in this context.

Customers that hold cryptocurrency assets in accounts described as "custodial" should have a better chance to improve their recovery rights—although that is far from certain given the state of the law governing crypto custody accounts and the mechanics of the custodial arrangements at various crypto platforms/exchanges. Unfortunately, the established law that protects the custodial rights of securities holders does not exists for holders of crypto and recent guidance by the Securities and Exchange Commission signals that crypto assets held "in custody" for a customer will be treated as assets of the platform in its financial statements (rather than property of a third-party).[1] That is telling but not definitive.

Factors that courts may consider in order to determine the status and priority of a customer's custody account assets are complex and varied. Whether "custodial" funds are commingled and whether customers solely maintain the

[1] *See* Staff Accounting Bulletin No. 121, https://www.sec.gov/oca/staff-accounting-bulletin-121.

private keys to their digital assets may be determinative of legal status. That said, all legal theories have not been tested and customers with "custody" accounts may argue that their assets are subject to the equitable legal theory of "constructive trust" removing it from being property of the estate. Customers might also assert that their crypto is a form of "financial asset" that is being held by an "intermediary" entitled to greater protection under Article 8 of the Uniform Commercial Code. The transfer arrangement might also be classified as a "bailment" under which digital assets are transferred for a particular purpose.[2]

CONCLUSION

While a lot of light has been shed on crypto custodial arrangements, there remains a high level of uncertainty as to what rights customers may actually have and a deeper dive into these arrangements will be necessary. It is important to monitor developments as the risk of bankruptcy continues to grow in the cryptocurrency market, and to work with investors to mitigate risks of a potential bankruptcy filing of a large cryptocurrency platform, and to identify opportunities for institutional investors in a new world of distressed-crypto investing.

[2] These theories are untested in the context of digital assets and explored in great detail in Adam Levitin's thoughtful recent article in Texas Law Review, Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4107019.