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DISTRESSED CRYPTOASSETS: ENFORCEMENT OF SECURITY INTERESTS, RESTRUCTURING, AND BANKRUPTCY

The market for cryptoassets has grown enormously since Bitcoin was launched in 2009, nearly reaching $3 trillion total market capitalization by November 2021 according to CoinMarketCap. In recent months, however, the crypto market has declined by an estimated $2 trillion. Liquidity and solvency concerns have emerged for certain crypto businesses. It is therefore timely for stakeholders and other market participants to assess the legal and practical concerns associated with the treatment of cryptoassets in a distressed scenario.

Key issues

- Cryptoassets Under the UCC
- Creating and Perfecting Security Interests in Cryptoassets
- Enforcement and Foreclosure against Cryptoassets
- Treatment of Cryptoassets under U.S. Bankruptcy Law
- Options for Lenders and Debtors in Distressed Situations

Amidst market volatility, the U.S. government has demonstrated a commitment to further develop the legal and regulatory regime for cryptoassets. For example, in March 2022, President Biden signed an Executive Order titled "Ensuring Responsible Development of Crypto Assets," which affirms the U.S. policy interest in "responsible financial innovation" and the responsible development of digital assets. Further, U.S. senators Kirsten Gillibrand and Cynthia Lummis recently introduced a bill titled the "Responsible Financial Innovation Act" which aims to establish a comprehensive legal and regulatory framework for crypto markets. The Act aims to provide additional legal clarity by treating digital asset exchanges as commodity brokers in bankruptcy. S. 4356, 117th Cong. § 407 (2022). While these regulatory solutions evolve, pragmatic legal approaches have also taken shape to fit the distinctive nature of cryptoassets into existing frameworks for structuring secured transactions and, ultimately, dealing with such assets in a distressed context, even as the ultimate treatment of digital assets in insolvency proceedings remains largely untested.

CRYPTOASSETS UNDER THE UCC

Article 9 of the Uniform Commercial Code (UCC) generally governs secured transactions in the U.S. involving moveable property, general intangibles, investment property, and other personal property assets. Although cryptoassets such as Bitcoin are increasingly accepted as collateral for financings, the UCC in

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most states does not explicitly classify cryptoassets as "personal property." Nevertheless, there is a compelling case that cryptoassets constitute personal property. Specifically, the owner of a cryptoasset has an interest capable of precise definition, i.e., a determinable amount of cryptocurrency or digital tokens for which there is an immutable record on a relevant blockchain. In addition, the asset is capable of exclusive possession and control, including by requiring a private key to move (or instruct another party to move) the asset from its current wallet to another wallet. And a multi-signature wallet with more than one key under some circumstances might be analogized to a lockbox with more than one key, which does not render the property in such a lockbox incapable of being "controlled" under the UCC.

As to other potentially relevant asset categories under the UCC, digital assets do not cleanly fit into the UCC's classifications of "money," "deposit accounts," or "securities." First, cryptocurrencies are not "a medium of exchange currently authorized or adopted by a domestic or foreign government" as defined in UCC § 1-201(b)(24).[1] Practitioners generally view "money" as constituting physical currency that can be exchanged "hand to hand," which would exclude cryptocurrencies. Second, the digital wallets in which cryptocurrencies are held do not qualify as "deposit accounts," which under UCC § 9-102(a)(29) must be maintained "with a bank." Third, most cryptoassets would not constitute securities under UCC § 8-102(a)(15) because they do not represent an obligation of or an interest in an issuer, but rather are standalone assets.

As a result, absent clarifying amendments to the UCC, parties have generally accepted cryptoassets as "general intangibles" under the UCC, falling under a catch-all category under UCC § 9-102(a)(42), which includes personal property other than, among other things, accounts, goods, and money.

CREATING AND PERFECTING SECURITY INTERESTS IN CRYPTOASSETS

The classification of cryptoassets as "general intangibles" under the UCC dictates a creditor's approach to taking and perfecting security interests therein. As with any secured lending transaction, lenders of crypto-collateralized loans must ensure that their security interests have "attached" and are properly "perfected" and, therefore, are senior to competing claims of other creditors. To achieve this result, practitioners have devised novel but practical solutions to structure security interests in cryptoassets.

Attachment

Initially, security interests in cryptoassets may attach and be enforceable under the UCC if: (1) value has been given by the secured party; (2) the debtor possesses rights (or the power to transfer rights) in the collateral (i.e., the cryptoassets); and (3) the debtor has entered into a security agreement that contains an appropriate granting clause and description of the collateral (i.e., an "authenticated" security agreement).

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1 To date, cryptocurrencies have not been widely adopted by governments as legal tender, with the limited exceptions of the endorsement of Bitcoin by El Salvador and, more recently, the Central African Republic.

Perfection

Assuming that cryptoassets qualify as "general intangibles," a secured party may perfect its security interest in such assets simply by filing a UCC-1 financing statement. In practice, however, lenders seeking to use cryptoassets as collateral often demand greater forms of collateral protection to ensure they are safeguarded in a down-side scenario. To this end, lenders have required their borrowers to agree to categorize crypto-collateral as "investment property" under UCC § 9-102(a)(49) and to have such collateral held by a third-party custodian that qualifies as a securities intermediary in a pledged securities account, similar to securities held by a third-party intermediary as security for a margin loan. Under this approach, cryptoassets may be treated as "financial assets" under UCC § 8 102(a)(9) and the accounts at which such cryptoassets are held treated as "securities accounts" under UCC § 8-501(a). This is the so-called "Article 8 opt-in," which may be effectuated pursuant to an express election in the security documentation.

In the context of an Article 8 opt-in, perfection may be achieved by the lender's "control" of the relevant securities account, which is typically accomplished through an account control agreement entered into among the borrower, the lender, and the intermediary/custodian. The control agreement may take the form of either the "springing" variety that allows the lender to take control upon a triggering event or the "blocked" variety that prohibits the borrower at all times from accessing the account without the consent of the lender. With control of the securities account, the lender obtains greater protection both from a practical perspective (as the lender can easily gain control and, if necessary, liquidate the collateral in the event of default) and from a legal perspective (as control creates a stronger form of perfection against competing claims versus merely filing a UCC-1 financing statement).

Looking forward, it seems likely that this approach will be enshrined in forthcoming amendments to the UCC. The Uniform Law Commission and American Law Institute Joint Committee on the Uniform Commercial Code and Emerging Technologies has proposed a draft amendment that would expressly: (1) regulate the transfer of property rights in "controllable electronic records" or "CERs," a general category intended to capture cryptoassets as well as future blockchain technologies; and (2) provide that a security interest in cryptoassets may be perfected via filing or control, with control being the superior method.

ENFORCEMENT AND FORECLOSURE AGAINST CRYPTOASSETS

In the event of a default, lenders generally have the right to accelerate a loan, terminate their commitments, and exercise other rights and remedies available at law or under the relevant loan and security documents. In the case of crypto-collateralized loans, the practical remedy for lenders is to exercise control over the cryptoassets, including by blocking and sweeping any pledged securities account, and then liquidating the collateral to discharge their claims.

In connection therewith, the UCC generally requires foreclosures to be "commercially reasonable" and lenders to provide stakeholders with advanced notice. However, lenders may be able to avail themselves of favorable exemptions

to such notice requirements so that they may liquidate cryptoassets without delay. In particular, under UCC § 9-611(d), cryptocurrencies such as Bitcoin (1) likely constitute a type of collateral that is "customarily sold on a recognized market" (the "market" exemption); and (2) may also constitute a type of collateral that "threatens to decline speedily in value" (the "drop" exemption). As to the first, a recognized market and robust pricing mechanism exists for major crypto currencies. Most major cryptoassets trade on 24-hour crypto exchanges and, as a general matter, crypto markets do not close. The market price of many cryptoassets, including Bitcoin, should therefore be determinable at any given moment. As to the second, cryptoassets have been subject to rapid price fluctuations in the market. For example, Bitcoin was trading at ~$31,000 in July 2021; rose steadily through the year until peaking at ~$69,000 in November 2021; then dropped to ~$36,000 in January 2022 and to ~$20,000 in June 2022. As a result of these factors, these UCC notice exemptions may allow lenders to act expeditiously in a crypto foreclosure.

TREATMENT OF CRYPTOASSETS UNDER U.S. BANKRUPTCY LAW

The filing of a case under the U.S. Bankruptcy Code creates an "estate" comprised of all of a debtor's legal and equitable interests in property as of the date the case is filed. The filing also gives rise to an automatic stay of certain actions against the debtor and its property, including, for example, acts to obtain possession of, or exercise control over, property of the estate. Among other things, the imposition of the automatic stay means that a lender or other secured party is generally prohibited from taking otherwise permissable enforcement actions against collateral (including crypto-collateral) absent relief from the bankruptcy court. Importantly, however, the value of a secured party's interest in collateral may be entitled to continued protection (referred to as "adequate protection") during the bankruptcy case.

Once in bankruptcy, a trustee or debtor-in-possession has broad powers to use, sell, or lease property of the estate, including outside the ordinary course of business with the bankruptcy court's approval. In certain circumstances, asset sales may be effectuated free and clear of existing liens. In addition, property of the estate may be used for other purposes including, with the court's approval, as collateral for financing to support the debtor's restructuring efforts.

Faced with a borrower that has commenced bankruptcy proceedings, a secured creditor has several options. It could request that the bankruptcy court grant relief from the automatic stay to allow the creditor to exercise enforcement remedies, although the likelihood of succeeding may depend on the relative value of the collateral to the claim and the necessity of the collateral to the debtor's reorganization efforts, among other things. A secured creditor also could petition the court for "adequate protection" against the diminution in value of the collateral during the case, including by way of additional or replacement liens or by cash payments to the creditor, often equal to periodic interest payments due under the loan. In some circumstances, it may also benefit a secured creditor to advance additional post-petition financing to the debtor, which may allow the creditor to "roll up" its pre-bankruptcy debt into a new, post-petition loan while also avoiding

efforts to prime its liens and maintaining some measure of control over the case as the debtor's source of post-petition capital.

The Crypto Twist

As cryptoassets are relatively new, many laws—including the Bankruptcy Code—have not yet been updated to specifically address cryptoassets and related issues that might arise in connection with crypto-financings. As a result, issues that may be generally understood and well-settled (such as ownership of assets and perfection of security interests) may be subject to dispute or challenge in a bankruptcy case when cryptoassets are involved.

As one example, a prominent custodian recently disclosed in a securities filing that in a potential bankruptcy case concerning the custodian, "custodially held crypto assets may be considered to be the property of a bankruptcy estate" and that the custodian's customers "could be treated as . . . general unsecured creditors." Although the disclosure came as a surprise to many customers, the possibility is very real. Cryptoassets held by a custodian may not be kept segregated from other property, but may instead be held in omnibus wallets and commingled with assets belonging to other customers or with proprietary assets of the custodian itself. In some instances, a custodian may even loan customer cryptoassets to a third party. The consequences can be significant. Customers that believe themselves to be the owners of custodially-held digital assets that would be returned to them in specie may instead be treated in bankruptcy as general unsecured creditors.[2]

Perhaps recognizing these risks, some crypto service providers have included in their custody agreements or terms of service an "opt-in" to Article 8 of the UCC. By treating cryptoassets as "financial assets" under the UCC, these service providers may assert that, pursuant to UCC § 8-503(a), the cryptoassets they hold are not property of the service provider and should not be subject to the claims of their creditors. However, this proposition has not yet been tested in a crypto bankruptcy and is subject to some uncertainty given the official comments to UCC § 8-503, which provide that: (1) UCC § 8-503 "does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings"; and (2) "the applicable insolvency law [rather than UCC § 8-503] will determine how the intermediary's assets are to be distributed."

Future Amendments to the Bankruptcy Code?

In light of these uncertainties, section 407 of the the recently introduced Lummis-Gillibrand Responsible Financial Innovation Act would provide clarity for customers of a crypto exchange by amending the definition of "commodity broker" under the Bankruptcy Code to include a "digital asset exchange" and by including "digital assets" in the definition of "customer property" under subchapter IV of chapter 7 of the Bankruptcy Code. Under the Act, digital assets of a failed exchange would then be treated as customer property under 11 U.S.C. § 761(10) and generally would be distributed ratably to customers of the exchange and in

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[2] Although the Bankruptcy Code includes protections for certain types of "customer property" (including cash, securities, and other property) in the liquidation of a "stockbroker" or "commodity broker," most crypto custodians or exchanges would not fall within those terms as defined in the Bankruptcy Code. Protections for customer property also exist in the liquidation of a registered broker-dealer under the Securities Investor Protection Act (SIPA), but most crypto custodians and exchanges likewise are not registered broker-dealers and would not be liquidated under SIPA.

priority to other claims against the exchange under 11 U.S.C. § 766(h). However, the prospects for passage of the Act remain uncertain, and the ultimate treatment of cryptoassets in a U.S. bankruptcy case concerning a crypto exchange remains as yet untested.

OPTIONS FOR LENDERS AND DEBTORS IN DISTRESSED SITUATIONS

Given the significant recent volatilities in cryptoasset values, participants in the cryptoasset market would be well advised to review and consider the terms of their existing agreements and steps that can be taken to protect themselves in the event of future price fluctuations, inevitable distress among market participants, and potential insolvency proceedings. Loan and security agreements, custody arrangements, and applicable terms of service and other relevant contracts should be carefully scrutinized to understand the existing contractual frameworks, applicable governing law, and availability of likely enforcement remedies in a distressed scenario. This could include, among other things, confirming the enforceability of security packages and addressing perfection issues, checking UCC Article 8 rights (and potentially exercising opt-in measures), and identifying the extent to which cryptoassets held by a custodian may be maintained separately from (or commingled with) other custodial or proprietary cryptoassets held by the custodian.

Companies exposed to the cryptoasset markets should likewise keep themselves apprised with respect existing cryptoasset exposures, the terms of any new contracts or agreements, and ongoing developments in the cryptoasset markets. While legislative developments may ultimately provide useful clarity with respect to the treatment of cryptoassets under both the UCC and the Bankruptcy Code, it may take months or years before these are enacted and have become effective, if ever. In the meantime, distress in the cryptoasset markets may force companies to seek bankruptcy relief in the U.S. against the backdrop of an untested statutory framework, in which case courts may be called upon in the first instance to decide matters under applicable UCC and Bankruptcy Code provisions that were never enacted or envisioned to address specifically the treatment of cryptoassets.

CONCLUSIONS

The combination of significant capital invested in digital asset markets and the lack of formal clarity in the law governing cryptoassets has led market participants to largely adopt practical but untested means of structuring cryptoasset transactions in the context of existing legal frameworks. With recent price volatility and signs of distress at some cryptoasset institutions, it remains to be seen whether legislation that has been proposed to clarify the law surrounding cryptoassets will be enacted in time to address the legal and practical concerns of such market participants. Therefore, significant care must be exercised when dealing with cryptoassets in a distressed scenario.

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