

BY SAMUEL P. HERSHEY AND KATHRYN SUTHERLAND-SMITH

## Two Sides of the Same Coin?

### Cryptoassets and Estate Property in Bankruptcy

Recent volatility in the cryptocurrency market has upended years of gravity-defying gains, causing major players in the industry to post significant losses and spark global speculation regarding potential bankruptcy filings. U.S. bankruptcy courts are no strangers to disputes regarding cryptocurrencies, having refereed disputes regarding whether principals of cryptocurrency trading and mining businesses are entitled to a discharge,<sup>1</sup> overseen the sale of cryptomining assets,<sup>2</sup> and adjudicated actions to recover cryptocurrency or its value,<sup>3</sup> as well as fielded requests for chapter 15 recognition, emergency stay relief, discovery, entrustment and associated relief.<sup>4</sup>

Despite this extensive experience, U.S. bankruptcy courts have yet to see a chapter 11 filing by a cryptocurrency exchange. Such a filing would raise novel and complex issues, including the threshold question of whether cryptoassets held by an exchange are “estate property” within the meaning of § 541(a)(1) of the Bankruptcy Code.

In considering these questions, U.S. courts may look to the recent experiences of courts in various foreign jurisdictions that have grappled with analogous issues. While certain U.S. law considerations will no doubt influence how a U.S. court would rule, these foreign case studies illustrate the issues that a cryptocurrency bankruptcy would likely pose and how U.S. courts may respond.

courts have varied in their efforts to classify cryptocurrency, adopting alternative designations such as a security,<sup>6</sup> commodity<sup>7</sup> or currency.<sup>8</sup> However, bankruptcy courts have yet to opine.<sup>9</sup> How cryptocurrency is classified has significant bearing on a number of bankruptcy-related matters, such as whether (1) coins or their value must be returned in a fraudulent-transfer action; (2) the Code’s swap provisions allow parties to a cryptocurrency transaction to enforce the contract irrespective of the automatic stay;<sup>10</sup> and (3) valuation or estimation requires the conversion of cryptoassets into fiat currency (such as U.S. dollars).<sup>11</sup>

Irrespective of these issues, it is clear — and foreign courts have almost universally held — that cryptocurrency is “property” for purposes of administration in bankruptcy.<sup>12</sup> However, the question of whether cryptoassets held by an exchange are *estate* property is more nuanced.

If cryptoassets are not estate property, users of an exchange might not be subject to the automatic stay and will likely be entitled to the return, *in specie*, of their cryptoassets, leaving the debtor with limited ability to effectuate a restructuring, including by hampering its ability to raise new financing to



**Samuel P. Hershey**  
White & Case LLP  
New York



**Kathryn Sutherland-Smith**  
White & Case LLP  
New York

Samuel Hershey is a litigation partner and Kathryn Sutherland-Smith is an associate with White & Case LLP in New York.

### Are Cryptoassets Held by Cryptoexchanges as Estate Property?

“Estate property” is broadly defined by the Bankruptcy Code as “all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>5</sup> Whether this definition encompasses cryptocurrency is unclear: U.S. regulators and civil

6 See, e.g., *Balestra v. ATBCOIN LLC*, 380 F. Supp. 3d 340 (S.D.N.Y. 2019) (digital tokens are considered securities); *SEC v. Shavers*, No. 13-cv-416, 2013 WL 4028182, at \*2 (E.D. Tex. Aug. 6, 2013) (same); “Report of Investigation Pursuant to Section 21(A) of The Securities Exchange Act of 1934: The DAO,” Securities and Exch. Comm’n (2017), available at [sec.gov/litigation/investreport/34-81207.pdf](http://sec.gov/litigation/investreport/34-81207.pdf) (unless otherwise specified, all links in this article were last visited on June 28, 2022).

7 See, e.g., *CFTC v. McDonnell*, 287 F. Supp. 3d 228-29 (E.D.N.Y. 2018) (virtual currencies are commodities subject to Commodity Futures Trading Commission regulatory protections); *CFTC v. My Big Coin Pay Inc.*, 334 F. Supp. 3d 492, 498 (D. Mass. 2018) (same).

8 See, e.g., “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” Fin. Crimes Enforcement Network (March 18, 2013), available at [fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering-treating-crypto-as-virtual-currency](http://fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering-treating-crypto-as-virtual-currency); *United States v. Ulbricht*, 31 F. Supp. 3d 540 (S.D.N.Y. 2014) (finding Bitcoin were monetary instruments within meaning of anti-money-laundering legislation).

9 *In re Hashfast Techs. LLC*, 2016 WL 8460756 (Bankr. N.D. Cal.) (observing that cryptocurrencies are either currencies or commodities in bankruptcy context but declining to decide classification issue).

10 See, e.g., 11 U.S.C. §§ 546(g), 560; see also Josephine Shawver, “Commodity or Currency: Cryptocurrency Valuation in Bankruptcy and the Trustee’s Recovery Powers,” 62 *B.C. L. Rev.* 2013, 2039-40 (2021).

11 Joanne Lee Molinaro & Susan Poll Klaessy, “Crypto as Commodity, and the Bankruptcy Implications,” *Law360* (Oct. 17, 2018), available at [law360.com/articles/1093091/crypto-as-commodity-and-the-bankruptcy-implications](http://law360.com/articles/1093091/crypto-as-commodity-and-the-bankruptcy-implications) (subscription required to view article).

12 *Shair.Com Global Digital Servs. Ltd. v. Arnold*, 2018 BCSC 1512 (Can); *AA v. Persons Unknown* [2019] EWHC 3556, [2020] 4 WLR 35 at [57]-[59] (U.K.); *Re Quadriga Fintech Solutions Corp., et al.* (March 1, 2021), Toronto CV-19-627184-00CL (31-2560674), Ont. Sup. Ct. [Comm List]; *Philip Smith and Jason Kardachi in Their Capacity as Joint Liquidators of Torque Grp. Holdings Ltd. (in Liquidation) and Torque Grp. Holdings Ltd. (in Liquidation)*, Claim No. BVIHC (COM) 0031 OF 2021; *cf.*, Louise Gullifer QC, Megumi Hara & Charles W. Mooney Jr., “English Translation of the Mt. Gox Judgment on the Legal Status of Bitcoin Prepared by the Digital Assets Project,” Univ. of Oxford Faculty of Law (Feb. 11, 2019), available at [law.ox.ac.uk/business-law-blog/blog/2019/02/english-translation-mt-gox-judgment-legal-status-bitcoin-prepared](http://law.ox.ac.uk/business-law-blog/blog/2019/02/english-translation-mt-gox-judgment-legal-status-bitcoin-prepared) (Tokyo District Court held that Bitcoin could not be object of ownership, as Japanese law did not recognize intangible forms of property). However, the Tokyo District Court’s decision appears to have been superseded by statute. Payment Services Act, Law No. 59 of 2009, (Japan) art. 2, para. 5 (recognizing proprietary interests in cryptocurrency); art. 63(11), para. 1 (prohibiting comingling of cryptoassets of users and exchange).

1 See, e.g., *In re Reichmeier*, Nos. 18-21427-7, 18-6072, 2020 Bankr. LEXIS 1029 (Bankr. D. Kan. April 15, 2020) (chapter 7 discharge permitted where debtor maintained sufficient records of cryptocurrency trading); *In re Hortman*, Nos. 19-29252, 20-02021, 2022 Bankr. LEXIS 204 (Bankr. D. Utah Jan. 27, 2022) (chapter 7 discharge permitted).

2 See, e.g., *In re Virtual Citadel*, Nos. 20-62725-JWC, 20-06146-JWC, 2021 Bankr. LEXIS 3490 (Bankr. N.D. Ga. Dec. 21, 2021) (determining value of debtor’s cryptocurrency mining assets and data center); *In re Giga Watt Inc.*, No. 18-03197-FPC7, 2020 Bankr. LEXIS 2963 (Bankr. E.D. Wash. Oct. 20, 2020) (cryptocurrency mining facilities sold free and clear where debtor and chapter 11 trustee maintained exclusive control of property).

3 *Cred Inc. Liquidation Tr. v. Winslow Carter Strong*, No. 20-12836 (Bankr. D. Del. 2020) (complaint by liquidating trust to recover alleged fraudulent transfer of Bitcoin); see also *In re Giga Watt Inc.*, No. 18-03197-FPC7, 2021 Bankr. LEXIS 2636 (Bankr. E.D. Wash. Sept. 26, 2021) (contract and tort class-action claims in respect of disbursement funds raised in debtor’s initial coin offering were estate property).

4 See, e.g., *In re Mt. Gox Co. Ltd.*, No. 14-31229-SGJ15 (Bankr. N.D. Tex. 2014); *Cryptopia Ltd. and David Ian Ruscoe*, No. 11688 (Bankr. S.D.N.Y. 2019); *Dooga Ltd.*, No. 30157 (Bankr. N.D. Cal. 2020).

5 11 U.S.C. § 541(a)(1).

fund its chapter 11 case. This result is analogous to a broker-dealer bankruptcy under the Securities Investor Protection Act (SIPA),<sup>13</sup> in which the broker-dealer is liquidated and investor assets are held in trust rather than assimilated into estate property. However, while the Securities and Exchange Commission (SEC) attempts to regulate cryptoexchanges as broker-dealers, cryptoexchanges have generally not accepted this designation and have not registered as such with the SEC or Securities Investor Protection Corp., making their susceptibility to a bankruptcy proceeding under SIPA uncertain.<sup>14</sup>

Alternatively, if cryptoassets are estate property, they will likely be available for the debtor's use in the chapter 11 case, and exchange users will be required to wait until the conclusion of the case to receive a *pro rata* distribution on account of their cryptoassets. This result would likely dismay cryptocurrency owners, who would vigorously dispute an exchange's right to use and control their property in bankruptcy. While U.S. law on this issue remains unclear, two foreign precedents have provided guidance on the issue of how cryptoassets may be administered in bankruptcy.

## New Zealand Determines Cryptoassets Are Property, but Not Estate Property

Cryptopia was formed in 2014 as a cryptocurrency exchange designed to allow users to trade, deposit and withdraw an array of cryptocurrencies for a fee.<sup>15</sup> Users stored their digital assets in a wallet, which was held on the Cryptopia exchange network.<sup>16</sup> Following the hack of its servers in January 2019, resulting in the theft of approximately NZD 30 million in cryptocurrency, Cryptopia commenced liquidation proceedings in New Zealand.<sup>17</sup> In administering Cryptopia's insolvency, the court was called upon to consider whether the cryptoassets were "property" and, if so, whether they were held in trust. The court held that the answer to both of these questions was "yes."<sup>18</sup>

Notably, the court grounded its decision in the terms and conditions of the exchange. Although the court found that Cryptopia exercised effective control over the coins in users' wallets and had commingled those coins with its own assets, it also found that its terms of use gave rise to an express trust. Specifically, the terms of the exchange used language throughout that was consistent with the user's beneficial ownership of the coins,<sup>19</sup> including that "each user's entry in the general ledger of ownership of Coins is held by us [in] trust for that user."<sup>20</sup> As a result, the court held that the account-holders were entitled to the return of their coins rather than a distribution alongside unsecured creditors (although the account-holders in the affected trusts would share *pro rata* in the losses arising from the theft).<sup>21</sup>

13 15 U.S.C. §§ 78aa, *et seq.*

14 It is an open question as to whether cryptoexchanges will be eligible for chapter 11 relief in light of the attempts to regulate them as broker-dealers. 11 U.S.C. § 109(a) (excluding commodities brokers and certain banking institutions from list of entities that qualify as "debtor").

15 *Rusco v. Cryptopia Ltd. (in Liquidation)*, CIV-2019-409-000544 [2020] NZHC 728 (Gendall, J.) at 1-10.

16 *Id.* at 22.

17 *Id.* at 12-13.

18 *Id.* at 209.

19 *Id.* at 174-78.

20 *Id.* at 27, 172.

21 *Id.* at 196, 204-205.

## Cryptoassets Controlled by the Exchange Are Estate Property, While Those Controlled by Users Are Not

*Torque Group Holdings Ltd.* in the Eastern Caribbean Supreme Court of the British Virgin Islands (BVI) provides similar guidance. Torque was a BVI-headquartered cryptoexchange that commenced BVI liquidation proceedings in February 2021. Its platform provided for cryptoassets to be held in two different types of digital wallets: personal and trading.<sup>22</sup>

The personal wallets formed part of the hosting service offered by Torque and provided users with the ability to trade, deposit and withdraw a variety of cryptocurrencies.<sup>23</sup> Trading wallets were used to conduct automated trades with external exchanges to generate profits for Torque's customers through cryptoarbitrage and scalping strategies.<sup>24</sup> Those profits were distributed to customers who used Torque's trading wallets in the form of "TORQ" tokens, a native currency of the Torque system.<sup>25</sup> While users of personal wallets retained exclusive access to and knowledge of the private key necessary to access the cryptoassets in the user's personal wallet (notwithstanding that such keys were generated by the exchange platform), Torque had exclusive means for controlling the trading wallets.<sup>26</sup>

In response to a request for direction by Torque's liquidators, the court held that the cryptoassets stored in the trading wallets were property of the estate, but the cryptoassets stored in the personal wallets were not.<sup>27</sup> The decision turned on whether Torque had access to the private key necessary to control the cryptoassets.<sup>28</sup> The court reactivated the personal wallets to allow customers to withdraw the cryptoassets held there,<sup>29</sup> but the contents of the trading wallets remained subject to the liquidators' control pending a *pro rata* distribution to creditors at the conclusion of the liquidation.<sup>30</sup>

## The Looming Choice that U.S. Courts May Soon Face

Should the U.S. cryptocurrency markets continue on their current trajectory, the issues presented in *Cryptopia* and *Torque* may soon evolve under U.S. law from theoretical to precedential. Because it is a fundamental rule under the U.S. Bankruptcy Code that the estate succeeds only to the title and rights in the property that the debtor possessed,<sup>31</sup> the terms and conditions governing the exchange will likely play a key

22 *Torque* at 9.

23 Liquidators' Preliminary Report to Creditors Pursuant to Section 226 of the Act, at 6 (May 7, 2021), available at [kroll.com/-/media/kroll/pdfs/borrelli-walsh/torque-4th-circular-to-creditors-ot.pdf](http://kroll.com/-/media/kroll/pdfs/borrelli-walsh/torque-4th-circular-to-creditors-ot.pdf) (the "Liquidators' Report").

24 *Id.* at 6.

25 *Id.*

26 *Torque* at 29-32.

27 *Id.*

28 *Id.* at 27. By contrast, in the *Mt. Gox* decision, the Tokyo District Court indicated that Bitcoin could not be the subject of exclusive control by the person holding the private key as Bitcoin is transferred by mining, which involves third parties. Gullifer, *et al.*, *supra* n.12.

29 *Torque* at 19-20.

30 *Id.* However, following the decision, the liquidators announced that they were investigating the existence of subaccounts within certain trading wallets pursuant to which Torque may hold assets in trust for customers' personal trading. If any trusts are found to exist by the liquidators or the court, the relevant assets will be returned to the relevant users and will not form part of the *pro rata* distribution to creditors. See Liquidators' Report, *supra* n.23.

31 5 *Collier on Bankruptcy* ¶ 541.28 (16th 2022); 11 U.S.C. § 541(a)(1), (d).

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role in determining whether the estate is deemed to incorporate those assets, as it has in foreign cases.

If the terms of a cryptocurrency exchange are clear that the platform serves as custodian or trustee in respect of cryptoassets, an express trust is likely to be found.<sup>32</sup> However, where the exchange's terms do not give rise to an express trust, courts may impose other forms of trust, such as a resulting trust based on the actual intent of the parties<sup>33</sup> or a constructive trust to prevent unjust enrichment of the platform.<sup>34</sup>

<sup>32</sup> *Restatement (Third) of Trusts* § 1 (Am. L. Inst. 2003) (express trust is created where settlor manifests intention to create it, by written or spoken words or by conduct).

<sup>33</sup> 85 *Am. Jur. Proof of Facts* 3d 221 §2 (2005); *Restatement (Third) of Trusts* § 7 (Am. L. Inst. 2003).

Where an exchange's terms of use are ambiguous or silent as to the nature of its relationship with its users, both U.S. trust law<sup>35</sup> and foreign precedent demonstrate that an exchange that exercises exclusive control over cryptoassets is more likely to hold those assets as estate property in bankruptcy. **abi**

<sup>34</sup> *Restatement (Third) of Trusts* § 1(d) (Am. L. Inst. 2003). The party seeking to establish such a trust must do so by clear and convincing evidence. *In re Taylor*, 133 F.3d 1336, 1341 (10th Cir. 1998).

<sup>35</sup> Julie Elizabeth Hough, "Bare Legal Title' — or Property of the Bankruptcy Estate?," XXXI *ABI Journal* 9, 18, 80, October 2012, available at [abi.org/abi-journal](http://abi.org/abi-journal) ("Cases often turn on whether the debtor has control over the property, has contributed to the purchase or upkeep of the property or has received any benefit from the property (such as using it to obtain credit)") (citations omitted); Robert J. Keach, "The Continued Unsettled State of Constructive Trusts in Bankruptcy: Of *Butner*, Federal Interests and the Need for Uniformity," 103 *Com. L.J.* 411, 423 (1998) (describing dominion or control as "critical factor" in cases involving constructive trusts).

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