Finance Alert

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'Get in Line in Bankruptcy Court': Crypto Assets Could Get Tied Up in Crypto Custodian's Bankruptcy

In its most recent quarterly report to the Securities and Exchange Commission (SEC), cryptocurrency exchange company Coinbase Global Inc. disclosed for the first time that the $256 billion in custodial fiat currencies and cryptocurrencies that the company holds on behalf of customers could be taken from those customers should the company ever enter into bankruptcy proceedings. SEC Chair Gary Gensler has since amplified those concerns.

Coinbase provides a platform for users to buy and sell cryptocurrencies such as Bitcoin, Ethereum and others. In the course of facilitating these transactions, Coinbase serves as a custodian on behalf of its users for investments in crypto, storing crypto for customers after they buy it, although users may move their holdings from Coinbase into crypto wallets or to other cryptocurrency exchanges. For larger, institutional holders, Coinbase also operates a separate entity, Coinbase Custody, which maintains custody of crypto on different terms.

In the company's most recent 10-Q filing, Coinbase stated in the "Risk Factors" section that "because custodially held crypto assets may be considered to be the property of a bankruptcy estate, in the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors."

SEC Chair Gensler emphasized these risks, both as they relate to both Coinbase and to other similar platforms, at the Financial Industry Regulatory Authority (FINRA) Annual Conference a few days after the disclosure: "If the platform goes down, guess what? You just have a counterparty relationship with the platform. Get in line in bankruptcy court."

Coinbase CEO Brian Armstrong has since said that the company has "no risk of bankruptcy" at this time and that the risk outlined in the quarterly earnings report is remote. He noted on Twitter, "This disclosure makes sense in that these legal protections have not been tested in court for crypto assets specifically, and it is possible, however unlikely, that a court would decide to consider customer assets as part of the company in bankruptcy proceedings . . . even if it harmed consumers."

As Gensler noted, this risk factor applies to cryptocurrency custodians generally and not just Coinbase. It is by no means a foregone conclusion that crypto assets held through a custodian would be considered property of the custodian's estate in a bankruptcy. The issue has never been tested in court. But many factors need to be considered in making that determination. For example, a close review of the custodian's customer agreement, particularly as it relates to the manner in which the crypto will be stored, would be required. As noted, Coinbase has different custodial terms for retail customers and institutional customers (through Coinbase Custody). According to Coinbase's standard customer agreement, crypto held in standard Coinbase accounts may be held in shared blockchain addresses, controlled by Coinbase. Commingling of these assets may be problematic. The customer agreement for Coinbase Custody, however, provides that the crypto assets will be held in trust for the institutional holder, which may add some measure of protection.

Another key consideration is the application of state law. Under the United States Bankruptcy Code, whether an asset constitutes property of the estate is determined by reference to state law. Certain states, including New York, have laws specifically addressing the custody of crypto that may offer certain protections, such as a requirement that a crypto custodian maintain a surety bond or trust account for the benefit of its customers in an amount deemed to be acceptable to state regulators. But even determining which state's laws apply may require a complex analysis.

Ultimately, investors big and small need to consider seriously the risk that their crypto assets may become property of the bankruptcy estate of the custodian of those assets, particularly given the warnings from Coinbase and regulators, the lack of regulatory protections for crypto, and the unsettled status of the law.

Unlike traditional bank accounts or brokerage accounts, crypto assets are not backstopped or guaranteed by any governmental or other agency, like the FDIC or SIPC. If Coinbase or another similar platform were to file for bankruptcy, and assets held in custodial accounts were deemed to be the property of the bankruptcy estate, customers could make claims as unsecured creditors to try to recover the value of their assets, but they would not have the protections afforded more traditional investment accounts, and their unsecured claims may be paid at just pennies on the dollar, if at all.

Crypto holders can mitigate these risks by exercising care when deciding how their crypto will be held, carefully reviewing any third-party custodial agreement and applicable state law, and consulting legal advisors to help navigate the thicket of complex issues.

Related Professionals

Anthony Pirraglia . . . . apirraglia@loeb.com
Daniel B. Besikof . . . . dbesikof@loeb.com
Hannah Schechter . . . . hschechter@loeb.com

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