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# Are customers' crypto safe in a custodian's bankruptcy filing?

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If a crypto custodian files bankruptcy and is in custody of its customers' crypto, would that crypto be considered property of the bankruptcy estate? The answer is not clear and there are many considerations that would need to be addressed in reaching an answer.

Coinbase Global, Inc. (Coinbase) sent a chilling message to institutional and individual investors and customers, alike, on May 10, 2022, when it filed its first quarter report with the Securities and Exchange Commission, disclosing that, in case of bankruptcy, cryptocurrencies and other digital assets that Coinbase holds for its customers' accounts potentially could become property of its bankruptcy estate — and its customers treated as general unsecured creditors.

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Brian Armstrong, Coinbase's Chief Executive has since tweeted that Coinbase has no risk of bankruptcy, but was required to make the disclosure based on new SEC staff accounting guidance.[1]

This guidance raises significant, novel issues of bankruptcy law: whether crypto assets that a debtor holds as custodian for its customers constitute property of the custodian's bankruptcy estate in the event of a bankruptcy filing. If so, customers would become unsecured creditors and potentially lose the value of their crypto assets or recover just pennies on the dollar.

The law is far from settled, there are many considerations that would need to be addressed in coming to an answer. This article examines several important considerations.

## Bankruptcy basics

Section 541 of the Bankruptcy Code provides that upon commencement of a bankruptcy case, an estate is created that is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."

What constitutes property of the estate is determined by reference to applicable non-bankruptcy law (usually state law). The governing state law may significantly alter the outcome of whether crypto assets constitute property of the bankruptcy estate.

Property that is part of the bankruptcy estate is subject to the control of the debtor-in-possession or operating trustee who act as fiduciaries of the estate as a whole. Thus, the debtor or trustee — which has a duty to maximize assets for the estate — may have interests differing from its customers, whose interests are to recover their crypto assets in full.

If crypto assets are property of the estate, the automatic stay will preclude customers from trying to recover their crypto assets. Worse yet, customers would become creditors with unsecured claims for the value of their crypto assets. Unsecured claims are often paid just pennies on the dollar, if at all, in bankruptcy cases.

Although the Bankruptcy Code defines what constitutes property of the estate very broadly, there are several exclusions.

For example, under Bankruptcy Code section 541(b)(1), the estate does not include "any power that the debtor may exercise solely for the benefit of an entity other than the debtor." This includes the "power" to distribute assets of a trust that must be distributed to the trust's beneficiaries. As a result, property held in trust is excluded from the debtor's bankruptcy estate.

Another exception is that, under Bankruptcy Code section 541(d), the estate excludes any property in which the debtor has only "legal title" in property, in contrast to an "equitable interest." Legal title is generally bare ownership title to the property while equitable title is the ability to use the property.

## The laws of different states will result in different outcomes

Whether the crypto assets are property of the custodian's estate will be governed by applicable non-bankruptcy law — primarily state law. Bankruptcy courts could come to different results depending on which state's laws apply. Of course, foreign law issues may further complicate the analysis.

## Certain states have crypto-specific laws that affect the analysis

Some states have regulations essentially providing that crypto custodians do not have an equitable interest in the crypto assets that they hold on their customers' behalf. These state laws afford greater protection to customers and suggest that the crypto assets may be excluded from the bankruptcy estate.

*Bankruptcy courts could come to different results depending on which state's laws apply.*

For example, in New York State, anyone that "conduct[s] any virtual currency business activity through an agent or agency arrangement" is "prohibited from selling, transferring, assigning, lending, hypothecating, pledging, or otherwise using or encumbering" any virtual currency that the licensee stores, holds, or otherwise maintains for its customer, except at the customer's direction.[2]

This regulation is favorable to customers and could help to prevent crypto assets from becoming property of the bankruptcy estate where New York law applies.

Other states have not yet put any regulations in place. For example, California Governor Gavin Newsom issued an executive order on May 7, 2022, directing various state agencies to devise crypto regulations.[3]

## Certain states also have money transmitter laws that may affect the analysis

State money transmitter laws may also be outcome determinative, although, this analysis can be complicated.

By way of background, many states require non-bank entities to obtain a money transmitter license in order to act as a custodian and transmit customer funds. Over 20 states have expanded their money transmitter laws to expressly apply to crypto custodians (such as Coinbase) or broadly interpret their money transmitter laws to cover crypto assets.[4]

For example, in Texas, a money transmitter is statutorily required to hold in trust all money received for transmission and the money transmitter is prohibited from commingling the money with the money transmitter's own money or property.[5]

Thus, money transmitter laws may be relevant if the applicable state law provides that crypto custodians are governed by the money transmitter licensing laws, as these laws may affect whether a debtor is holding crypto assets in trust — or whether the crypto custodian must hold certain funds aside in the event of a bankruptcy filing.

## How to determine what state law applies?

The analysis of which state's laws will apply is complicated and difficult to predict. Ordinarily, a court looks to the nature of the dispute and then applies choice of law principles specific to that type of dispute to determine the governing law.

For example, in disputes regarding securities — another intangible asset — courts usually look to the laws where the seller is located. For tort claims, courts look to where the injury occurred.

Crypto assets do not lend themselves to this type of analysis because they do not fall into any traditional choice of law category. While crypto assets have similarities to securities, they have an innate value more similar to hard currency. The decentralized nature of the assets adds additional uncertainty.

Of course, customers and their crypto custodians are free to select the governing law in their contracts, and many have done so.

For example, Coinbase's standard User Agreement with U.S.-based customers provides that California law governs.[6] Likewise, Coinbase Custody — a New York limited purpose trust company that provides crypto custodial services for institutional investors — offers standard custodial trust agreements that provides for New York's law to govern.[7]

Coinbase Custody is a related, but distinct entity from Coinbase, serving institutional investors, only.

Courts are not, however, required to apply contractually chosen law in certain circumstances. Because this issue is entirely untested, no concrete guidance can be given on whether the choice of law provisions in the Coinbase agreements will be respected.

## Once the applicable state law is determined, ownership rights in the crypto assets may be determined by analogizing crypto assets to other intangible property

Because most states do not have a directly applicable law, a court deciding whether crypto assets constitute property of the estate may make such a determination by analogizing crypto assets to other non-tangible property, such as investments, securities, or commodities.

In the event that an uninsured depository bank files for bankruptcy, the money that it holds on behalf of its customers would become property of the bankruptcy estate.

Of course, in the scenario of a failed insured bank, the customers are not totally out of luck, as most banks are insured by the Federal Deposit Insurance Corporation, up to $250,000 per depositor. Absent a parallel state regulatory scheme applicable to crypto assets, no such insurance is available for crypto customers.

Likewise, securities and commodities held on behalf of customers have also been held to be property of the estate.

For example, in the MF Global bankruptcy, customer property held in investment accounts were considered property of the estate. Like bank deposits, securities broker customers' accounts may also be protected up to $500,000 by insurance issued by the Securities Investor Protection Corporation. This protection, too, is unavailable to crypto customers.

## The parties can and should contract for crypto assets to be held in trust

Even if crypto assets are governed by state law that may cause those assets to be considered property of the estate, customers and custodians may enter into agreements that, if properly drafted, could cause the crypto to fall outside of the bankruptcy estate.

For example, Coinbase Custody's custodial services agreement, which is only available to institutional investors, provides that "Digital Assets in Client's Custodial Account are not treated as general assets of [Coinbase]. Rather, [Coinbase] serves as a fiduciary and custodian on Client's behalf, and the Digital Assets in Client's Custodial Account ... remain Client's property at all times."

*Customers and crypto custodians need to be careful in structuring their crypto custodial arrangements in order to determine ... what would happen to customers' crypto assets in the event of the crypto custodian's bankruptcy.*

Such language could potentially impact whether crypto assets fall outside of the bankruptcy estate, though the manner in which those crypto assets are actually held will be critically important.

Under the laws of some states, regardless of the contractual terms, if the customers' crypto assets are commingled with the assets of the custodian, the written trust relationship may be meaningless, and the crypto assets are more likely to be property of the estate.

No doubt, customers with an agreement similar to the Coinbase Custody agreement will argue that their crypto assets fit within Bankruptcy Code section 541(b)(1)'s exception that the "power" to distribute crypto assets is "solely for the benefit of an entity other than the debtor" — *i.e.*, that the assets are held in trust for the debtor's customer.

Customers will also argue that the debtor would have no equitable title to the crypto because the agreement expressly provides that the crypto assets are the customer's property, held in trust.

Neither of these arguments has been tested in court. It is impossible, at this juncture, to determine how a bankruptcy court might rule when confronted with these arguments. However, customers should pay close attention and take steps to protect their assets.

## Certain state law protections that a customer might consider

Even if a crypto custodian files for bankruptcy, and the crypto currencies that it holds for its customers becomes property of the estate, state law may provide other protections, such as by requiring crypto companies to hold a surety bond or trust account for the benefit of its customers in an amount acceptable to state regulators.

For example, in New York State, crypto companies are required to maintain a surety bond or trust account in United States dollars for the benefit of its customers in such form and amount as is acceptable to the superintendent of New York State regulators for protection of the licensee's customers.[8]

Customers should be careful, however, because other states, including Florida, have proposed or enacted legislation more protective of the custodian than the customer, which may enhance the odds of crypto assets being considered property of the estate.

Additionally, some states require that a licensed money transmitter hold different amounts of security or "permissible investments" in trust for the customers that may protect a customer's crypto in the event of a bankruptcy filing.

For example, in Texas, money transmitters that have a net worth of less than $5 million dollars are required to hold the aggregate 100% of the face amount of the money transmitter's average outstanding transmission obligations as a "permissible investment."

A money transmitter with a net worth of $5 million or more is required to hold 50% of its average outstanding transmission obligations in a "permissible investment."

Under Texas law, a permissible investment is expressly considered to be held in trust for the money transmitter's customers and "may not be considered an asset or property of the license holder in the event of bankruptcy, receivership, or a claim against the license holder unrelated to any of the license holder's obligations under this chapter."[9]

## Practice pointers

Customers and crypto custodians need to be careful in structuring their crypto custodial arrangements in order to determine or, at least, be able to predict with some amount of certainty, what would happen to customers' crypto assets in the event of the crypto custodian's bankruptcy.

Some things to consider:

- Instead of "custodying" crypto at a debtor, which includes storing the "private key" necessary to authorize any crypto transaction with that custodian, hold the crypto in a "cold," or "hardware," "wallet." A cold or hardware wallet is a device that the owner connects to the internet only when effecting a crypto transaction. Although the custodian bankruptcy risk is alleviated, there is a loss of convenience and risk of losing the wallet or key, in which case, the crypto may be difficult to recover; somewhat like the difference between holding a stock in certificate form, rather than in a brokerage account (a lost stock certificate can be replaced, albeit, at a cost).
- Determine what state law applies. Carefully review the custodial agreement to determine whether a governing state law is designated. Review the law of that state to determine whether it is protective of crypto customers.
- Carefully review the custodial agreement between the customer and the crypto custodian to ensure it provides for the customers' crypto assets to be held in a trust or in the

 

possession of a third-party. To the extent possible, verify that the crypto assets will not be commingled with the assets of the custodian.

- A customer who is concerned that its crypto asset holdings are custodied in a manner that could cause them to become property of the estate should take steps to mitigate that risk. For example, assets could be moved to a different custodian, or a party with sufficient bargaining power might be able to negotiate a different arrangement with its existing custodian, including to hold the crypto assets in a non-commingled trust.

## Notes

[1] https://bit.ly/395qLRr

[2] 23 NYCRR 200.9(c).

[3] https://bit.ly/3NVMjyu

[4] https://bit.ly/3GZU3Nv

[5] Tex. Fin. Code § 151.404(a) and (c).

[6] https://bit.ly/3O1AMhh

[7] https://bit.ly/3aLQ3o3

[8] 23 NYCRR 200.9(a).

[9] *See* Tex. Fin. Code § 151.001, *et seq*.

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