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Potential preference exposure for withdrawing crypto

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Crypto customers who withdraw their crypto assets from an exchange or custodian within 90 days of the exchange or custodian's bankruptcy filing may be sued to return those crypto assets as preferential transfers under section 547 of the Bankruptcy Code. There are a number of considerations relevant to whether those claims will succeed. This article briefly identifies certain of those considerations.

Preference law basics

The purpose of the preference provisions of Section 547 is to ensure that all similarly situated creditors are treated equally, and that no creditor is "preferred" to others in the run-up to a bankruptcy filing. In practice, many question whether preference litigation results in anything more than additional fees for professionals, but there is little doubt that preference litigation will continue.

If the withdrawn crypto assets were not the debtor's property, then the withdrawal of those assets will not be a preference. The analysis of whether the crypto assets are property of the debtor or the customer is complex, and the law is unsettled.

A debtor seeking to establish a prima facie case for avoidance and recovery of an allegedly preferential transfer must establish that the transfer:

(1) was a transfer of the debtor's property;

(2) was made on account of a debt existing as of the time of payment;

(3) was made while the debtor was insolvent (*i.e.*, the debtor's debts were greater than its liabilities);

(4) was made within 90 days before the bankruptcy filing date; and

(5) enabled the creditor to receive more than it would have received in a Chapter 7 case, if the transfer had not been made.

To the extent a creditor is required to repay a preferential transfer, that creditor is granted a claim against the debtor for the amount repaid pursuant to section 502(h) of the Bankruptcy Code, which effectively places the creditor in the same position it would have been in had there been no transfer.

There are numerous defenses to repayment of preferences. For example, payments made in the ordinary course of business (either between the parties or in the creditor's industry) are insulated from avoidance as preferences. The provision of new value after receipt of an otherwise preferential transfer is also a defense. The Bankruptcy Code's securities safe harbor provisions provide a defense to preference liability for certain transactions involving securities. The application of these defenses is a fact-intensive analysis and can be complex. They are also totally untested in the context of crypto bankruptcies. The creditor bears the burden of proof, making it easier for plaintiffs to assert claims.

Preference law in crypto bankruptcies

The key issues in the context of crypto withdrawals are likely to be: (i) whether the transfer was of property of the debtor; (ii) whether the debtor was insolvent at the time of the transfer; and (iii) whether any defenses apply.

A. Was the withdrawal a transfer of the debtor's property?

If the withdrawn crypto assets were not the debtor's property, then the withdrawal of those assets will not be a preference. The analysis of whether the crypto assets are property of the debtor or the customer is complex, and the law is unsettled. Our previous article (https://bit.ly/3bMYqk2) for this publication explained the relevant considerations in detail and is summarized briefly below.

The terms of the customer agreement, and the manner in which the crypto assets are actually held, are key data points. If the crypto assets are to be held (and are actually held) in trust for the customer, the assets may not be debtor property. Conversely, if the agreement provides for transfer of ownership of the crypto assets to the exchange and for those assets to be commingled, there may be a different result.

State law may also inform this analysis. Bankruptcy law looks to state law to determine property rights. If the applicable state law provides for custodied crypto assets to be held in trust for the customer, it is possible the crypto may be excluded from the bankruptcy estate. Certain states have money transmitter or other laws that govern the relationship between customers and exchanges/custodians as well, which also bear on this analysis.

This high-stakes issue is likely to be litigated in the bankruptcy case, potentially long before any preference actions are commenced. Accordingly, customers with potential preference exposure need to be alert and seek to participate in the case to the extent they would like to have a voice on this issue.

B. Was the debtor insolvent?

Pursuant to section 547(f) of the bankruptcy code, the debtor is presumed to be insolvent in the 90-day period before the bankruptcy filing. Most debtors rely on this presumption — or the absence of evidence rebutting this presumption — to prove this element. However, that presumption can be overcome if the customers can establish that the debtor was not insolvent (as defined in section 101(32) of the Bankruptcy Code) — *i.e.*, that the value of the debtor's assets exceeded the debtor's aggregate indebtedness.

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Challenging the insolvency of the debtor is a significant undertaking and generally requires the retention of valuation experts, substantial discovery and complex litigation. The costs can be substantial. In many cases, this burden is too large for a creditor to undertake, and insolvency is left unchallenged.

In the context of a crypto bankruptcy, however, challenging the debtor's solvency presumption might make sense. Potentially tens of thousands of customers could be sued for preference. These customers could pool their resources, either through the retention of common counsel, or by suggesting that their individual counsel coordinate with counsel for other defendants (or both), to reduce the costs associated with expert retention and litigation.

Substantively, the issues presented in a crypto bankruptcy pose interesting valuation issues. The crypto assets themselves are very volatile, with dramatic swings possible from day to day, meaning that a debtor's solvency could also change from day to day.

C. Affirmative defenses

Even if the debtor succeeds in establishing a prima facie case, customers can assert certain defenses. For example, as noted above, transfers are not avoidable as preferences when they are made in the ordinary course of business. Whether the transfer was made in the ordinary course of business is fact-intensive, and the law has not been applied in this context. However, considerations will likely include, among other things, the length of the relationship between the customer and the debtor, the terms of the customer agreement, and the nature of the transactions between the customer and the debtor.

The provision of new value to the debtor after withdrawal of an otherwise preferential transfer can serve to insulate the preferential withdrawal to the extent of such new value. New value, in this context, is likely to take the form of new deposits into the customers' crypto accounts.

Finally, the Bankruptcy Code also has securities safe harbor provisions that insulate certain transactions involving securities and market participants from challenge and avoidance. Whether the securities safe harbor provisions will apply in the context of a crypto exchange is unknown. Their application may depend on the specific type of crypto assets maintained by the customer, since the Securities and Exchange Commission has stated that it considers certain crypto assets (but not all) to be securities.

Conclusion

It is not yet known whether any preference lawsuits will be commenced in connection with the existing crypto bankruptcy cases — Voyager Digital and Celsius Network (both pending in the Bankruptcy Court for the Southern District of New York) — or in future cases. In the event any of the exchanges liquidate, preference suits are likely.

Customers who received money in the 90 days before the filings should seek assistance in advance to help them evaluate their risks and plan a strategy to retain as much value as possible.

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