Tales from the Crypt-O

Market Overview and Emerging Restructuring Issues

American College of Bankruptcy Luncheon
October 19, 2022

Panelists:
Chief Judge Martin Glenn, Southern District of New York
Vincent Lazar, Partner and Co-Chair, Bankruptcy Litigation Practice, Jenner & Block LLP
Mohsin Meghji, Managing Partner, M3 Partners

Table of Contents

Overview of Crypto Landscape

What is Crypto?

Cryptocurrency or "crypto" is any type of ***decentralized***, ***digital*** currency that's based on ***cryptography***

Decentralized

- Not issued by a central authority (e.g., government or bank)
- Created, exchanged, and overseen by a distributed peer-to-peer network

Digital

- Does not exist in a physical format
- Not pegged to any fiat currency or hard asset (e.g., gold)

Cryptography

- Leverages a mathematical process to ensure security and validity of each unit
- Records transactions on a blockchain with a "trustless" verification system
- Trustless means no single third party (company or person) validates data

What is the "blockchain"?

- Blockchains are distributed ledgers that enable crypto systems to operate
- "Blocks" of data containing new records are appended on a "chain" of transactions visible to anyone on the network
- Blockchains use consensus mechanisms to validate transactions, enabling security and avoiding "double spending" (the same digital currency being spent more than once)
- Permissionless systems encourage more participants, strengthening the power of consensus safeguards and making it more costly and difficult to hack

Demystifying Crypto Jargon: Products, Platforms and Protocols

End User ↑ ↓ *Infrastructure*

Category	Description	Examples
Products	Assets such as cryptocurrencies or tokens that interact with the end user Can provide a function in a larger product such as a smart contract or decentralized application	• bitcoin (lowercase) • ether • CEL tokens
Platforms	Provide a middleware for others to create products off a given protocol Typically take the form of a development language and other tools	• Ethereum • Solidity (smart contract language)
Protocols	Building block of a crypto solution Establishes how the blockchain will validate transactions, manage consensus, participation, and economic incentives for participants	• Bitcoin (capital) • Ethereum • Zcash

- Cryptocurrencies are assets that serve an economic purpose to a particular protocol (e.g., bitcoin)
- Tokens are created at the product level and may relate to or enable a particular service (e.g., CEL tokens)
- Stablecoins are designed to maintain a fixed value and are typically based on a reserve asset (e.g., USD, Gold)
    - Algorithmic "stablecoins" attempt to use derivatives and market arbitrage to maintain pricing, however, are exposed to risks of under-collateralization and de-pegging due to market stress and/or attack
    - In May 2022, the algorithmic stablecoin Terra (UST) collapsed, causing over $40B in market losses and losing ~97% of value

Key Sectors of the Crypto Economy

Centralized Exchanges
- Enable trading of cryptoassets through a single authority (the company), processing trades through typical order matching
- Generally, requires users to place funds with company accounts
- Examples include FTX, Binance, Gemini, Voyager Digital

Financial Services
- Provide suite of services to consumer and/or institutional clients such as lending, borrowing, trading
- Capabilities vary by geography as regulatory requirements change
- Examples include BlockFi, Amber, FalconX, Celsius

Wallet/Custody Services
- Provide solutions for institutions or individuals to securely execute crypto transactions and manage digital assets
- Examples include Fireblocks, Prime Trust, Coinbase Wallet

Security
- Offer software and service solutions based on blockchain and crypto protocols
- Services can include analytics, regulatory compliance or diligence (not exhaustive)
- Examples include Chainalysis, Certik, Taxbit

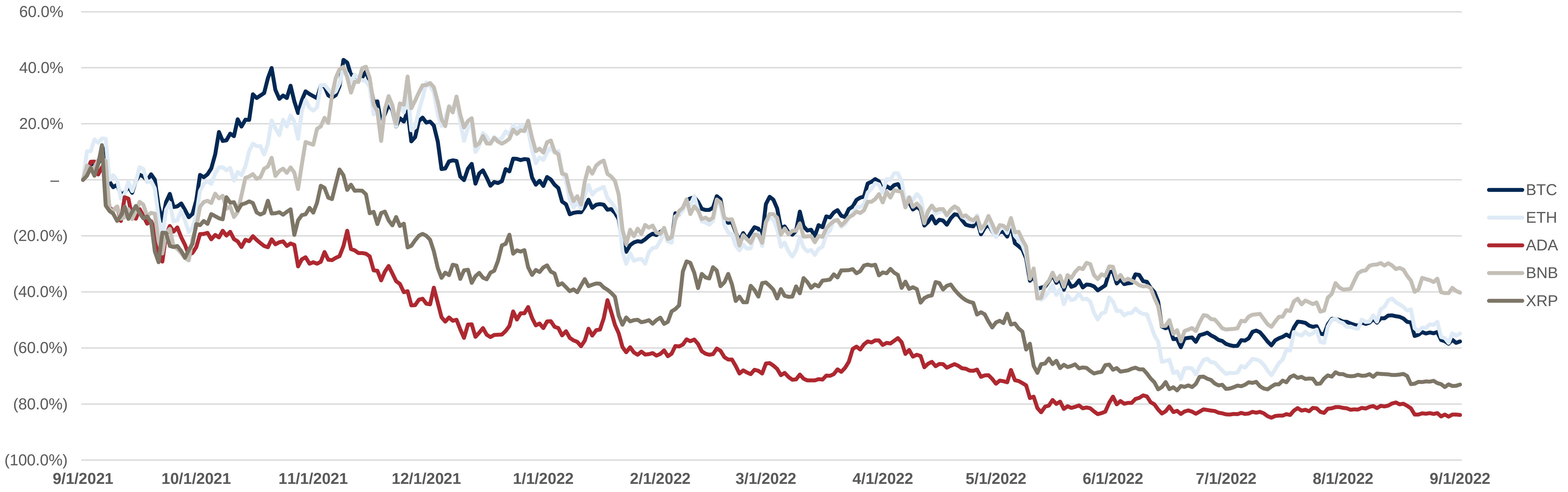
NFTs / Gaming
- “Play to Earn” games reward players with NFT tokens for time spent playing and/or incorporate blockchain and NFT solutions into in-game purchases and trading
- Examples include Forte, Sky Mavis, Mythical

DeFi
- Enable financial services through decentralized technology solution – no single third-party service provider
- Examples include Uniswap, Aave, Index

These areas have been the hardest hit by fall in crypto prices

Crypto Prices and Volatility

Price Change for Top 5 Cryptoassets by Market Cap (Sept 2021 – Aug 2022)



Coin	Symbol	9/1/2022	9/1/2021	% Change	52W Max	52W Min
Bitcoin	BTC	$20,023.55	$47,335.42	(57.7%)	$67,617.02	$19,047.42
Ether	ETH	$1,552.56	$3,440.56	(54.9%)	$4,815.00	$995.25
Cardano	ADA	$0.45	$2.79	(84.0%)	$2.97	$0.42
Binance Coin	BNB	$278.58	$466.33	(40.3%)	$654.63	$197.38
Ripple Coin	XRP	$0.33	$1.24	(73.1%)	$1.39	$0.31

M3 PARTNERS JENNER & BLOCK LLP

Source: Coinmarketcap.com – excludes stablecoins

Growing Distress Across Crypto Segments

There has been an increasing number of bankruptcy filings globally, especially in the lending space

Company	Filing Date	Liabilities	Venue	Business Model
Mt. Gox	Mar 2014	$64MM	Tokyo	Exchange
Cred	Nov 2020	$160MM	Delaware	Lending
Terraform Labs	May 2022	N/A	Singapore	Stablecoin
Three Arrows Capital (3AC)	July 2022	$3.5B	Singapore New York (Ch15)	Hedge Fund
Voyager Digital Ltd	July 2022	$5.7B	New York	Lending
Celsius Network	July 2022	$5B	New York	Lending
Zipmex	July 2022	N/A	Singapore	Exchange
Vauld	July 2022	$400MM	Singapore	Lending
Babel Finance	N/A	$3B	In RX negotiations	Lending
CoinFLEX	Aug 2022	N/A	Seychelles	Lending

Common Causes of Distress

- Hacking activity in exchanges (e.g., Mt. Gox)
- Operational risk – both investment concentration and counterparty
- Changes in the regulatory environment
- Fraud

Additionally, other firms have halted customer withdrawals (e.g., Binance, WazirX, CoinLoan, Hodlnaut) as well as an increase in distressed transactions (e.g., FTX's agreement to acquire BlockFi for $15-240MM)

Recent Bankruptcies: Voyager Digital and Celsius Network

Voyager Digital – Overview of Business Operations

Voyager Digital Ltd was founded in 2018 as a mobile asset-broker to enable consumer and institutional customers to trade over 100 different crypto assets, growing to $6 Billion in assets by 2021

Key Product / Service Lines

- **Brokerage Service**
  - Voyager operates as a cryptocurrency “agency broker” matching its customers with crypto exchanges and liquidity providers and providing trades through its proprietary algorithm
- **Custodial Services**
  - The deposits of the customers are stored on Voyager’s platform rather than individualized digital wallets and in exchange, the customers earn interests on their deposits
    - PIK Interests: If the users maintain a minimum monthly balance and keep their assets on the platform, they are able to earn PIK interests up to 12% on certain digital currencies
    - Voyager Tokens (“VGX”): VGX, Voyager’s own digital currency, is provided through its loyalty and rewards program, which operates through a tiered reward system
    - Staking: Voyager allows its customers to commit cryptocurrency for a fixed period for a set rewards rate determined by each project or protocol
    - Debit Card: Voyager’s debit card allows investors to spend cryptocurrency without currency conversion fees and provides rewards with each purchase
- **Lending Programs**
  - To provide customers with PIK interests, Voyager lends deposited cryptocurrencies from the customers to third parties
  - Third parties pay Voyager a pre-negotiated interest rate in either cash or PIK

Voyager Digital: Events Leading to Bankruptcy

- **Turbulent Market Conditions**
  - Through the end of 2021, the fear of new COVID-19 variants and potential economic downturn drove the equity market sideways
  - Concerns regarding a potential recession in 2022 and the rising commodity prices due to the Russian invasion of Ukraine contributed to investor pessimism in the traditional markets and cryptocurrency markets
- **"Cryptopocalypse"**
  - Terra USD's "de-peg" and the collapse of LUNA erased over $18B of value and contributed to further sell-offs in the cryptocurrency sector
- **Three Arrows Capital ("3AC")**
  - On June 15, 2022, one of 3AC's founders stated that the cryptocurrency fund incurred significant losses on account of its staked Luna position, and on June 27, 2022, 3AC was ordered by a court in the British Virgin Islands to commence liquidation proceedings
  - Voyager had lent 15,250 BTC and 350MM USDC to 3AC and eventually had to issue a notice of default, not being able to receive the repayment
- **The Alameda Loan and Prepetition Marketing Process**
  - To cope with the situation, Voyager received $200MM in cash and USDC and 15,000 BTC from the Alameda loan facility
  - However, general market pessimism due to the decline in crypto prices along with 3AC loan issues resulted in huge customer withdrawals
  - In late June 2022, Voyager commenced a marketing process looking for either i) a sale of the entire business or ii) capital infusion
  - Ultimately, 22 parties entered into confidentiality agreements with Voyager
- **Pause**
  - In the face of continued BTC price pressure, on June 23, 2022, Voyager reduced its daily withdrawal maximum from $25,000 to $10,000 per user per day
  - On July 1, 2022, Voyager froze all withdrawals and trading activities

Celsius Network LLC – Overview of Business Operations

Celsius provides a range of crypto-related financial services to retail and institutional customers, generating profits principally via spread between PIK interest to customers and various asset deployment strategies, and sale of mined Bitcoin

Key Product / Service Lines (Pre-petition)

- **Asset Gathering and Retail Customer Services**
  - Earn Program: Customers contribute crypto to Celsius in exchange for rewards (e.g., PIK interest/CEL tokens)
  - Custody Program: Crypto custodial services for customers
  - Other Customer Services: facilitate customer crypto purchases, swaps, etc.
- **Borrowing Activities (to support asset deployment activities and hedging operations)**
- **Yield Generating Asset Deployment Activities**
  - Retail and institutional lending
  - Staking
  - Other crypto investing activities via centralized and decentralized exchanges
  - Yield generating investments in operating assets (i.e., crypto asset mining)
- **Hedging Activities**
  - Conducted via spot transactions, borrowing activities and other methods

Celsius Network: Events Leading to Bankruptcy

- **Turbulent market conditions across asset markets**
  - Asset markets have experienced dislocation YTD, reflecting a variety of macroeconomic factors including supply chain issues, elevated inflation, tightening monetary policy, geopolitical issues and weakening consumer sentiment, among other factors
  - Disproportionate impact on crypto and DeFi markets, with major price declines in leading cryptocurrencies
  - Crypto collapse exacerbated by market failures, including the collapse of algorithmic stablecoin Luna and collapse of hedge fund, 3AC
- **Severe and increasing pressure on crypto-related investors and lending businesses, driven by losses and growing investor fears**
  - Significant decline in valuations for crypto-focused businesses
  - Growing market concerns regarding market contagion, driven by increasing counterparty risks and the potential for a "run on the bank"
  - Coinbase May 2022 disclosure regarding potential treatment of customer deposits in Ch. 11 cases further heightened investor concerns
  - A number of crypto lending businesses have sought rescue capital, restricted withdrawals and/or sought restructuring counsel
- **Growing market contagion results in significant withdrawals from Celsius, risking a "run-on-the-bank"**
  - Accelerating investor withdrawals
  - Decline in crypto asset prices
- **Celsius' assets decline by $17.8bn to $4.3bn between March 31, 2022, to July 14, 2022, driven by declines in crypto market value and withdrawals**
  - Decline in market value of holdings ($12.3bn), User Withdrawals ($1.9bn), Liquidated by third-parties ($0.9bn), Investment Losses ($0.1bn), Loan Redemption/Liquidations ($1.9bn)
- **On June 12, 2022, Celsius implemented a "Pause" on customer withdrawals and certain other activities to mitigate growing pressures**
- **Faced with continued pressure, on July 13, 2022, Celsius files for Ch. 11 protection**

Emerging Issues in Crypto Restructurings

Should Crypto Be Treated as Cash?

Context and Recent Examples

- Section 345 requires, among other things, debtors in possession to deposit or invest estate funds in approved depositories
- Whether and which crypto assets are property of the estate has been disputed in recent crypto bankruptcies
  - Terms of service, documentation, and customer disclosures have varied over time and product as features and capabilities expanded
  - Customers in Voyager Digital and Celsius Network have asserted ownership of crypto assets claimed as property of the estate
  - Maturity of business processes, including account segregation and traceability, vary and can be lacking
- While large financial institutions are entering the crypto space, most custodians are not approved depositories
- Often cryptoassets are illiquid, where monetization may not be possible, could lead to considerable discounts, or further affect creditors (e.g., staked assets, Debtors' token(s))

Emerging Questions

- **Should cryptoassets be considered cash under section 345?**
- **Under what circumstances are assets property of the estate or individuals?**
- **How can cryptoassets provide new sources and forms of liquidity (e.g., coin-based DIP, DeFi borrowing)? Are assets encumbered?**
- **What security measures are needed to ensure protection (e.g., custodian and reporting requirements, restrictions on deployment or trading)?**

How May a Changing Creditor Landscape Impact Precedent?

Context and Recent Examples

- The bankruptcy system is grounded in transparency, but recent crypto cases have cited §107 (b) and (c) to maintain privacy
  - Both Cred and Voyager sealed customer and parties in interest information in schedules, statements and retention applications
  - In Celsius, multiple parties argued to have customer information sealed citing privacy and commercial information requirements
- Customers and consumers have comprised the majority creditors by volume and value in recent restructurings
- Along with this, informal communication and potential misinformation channels have grown (e.g., Twitter, Telegram, Reddit)
  - Crypto investors may be more skeptical of “financial establishment” and court-based negotiations
  - Media has cited “customers banding together” in the Celsius case to develop reorganization plans, activity existing beyond the actual Ch11 proceedings

Emerging Questions

- **How can courts uphold the goals of transparency and assure fair treatment of creditors if information on creditor identity or claim amounts aren’t public?**
- **How have new communication channels affected how judges approach case logistics or communicating with counsel and the public?**
- **What could be done to minimize confusion (e.g., in noticing, ballots) and assure a value-maximizing outcome?**

How Should Claims be Valued and Recoveries Distributed?

Context and Recent Examples

- Bankruptcy Code §502(b) states that the court shall determine the amount of a claim "in lawful currency of the United States as of the date of the filing of the petition."
- Volatility and expansion of cryptoassets can materially affect claim and recovery value
  - In Mt. Gox, the estate's bitcoin assets grew to $1.3B, far in excess of $64MM claims estimated at filing
    - Price appreciation and volatility can vary significantly by coin type
  - FTX's purchase offer of Voyager would "dollarize" all claims based on the value of assets at petition date
  - Voyager and Celsius have asserted they have no plans to dollarize claims
- The bankruptcy system is historically cash-focused – e.g., trustees paid as a percentage of cash distributed – whereas stakeholders in crypto-related cases often have a higher desire for in-kind recoveries

Emerging Questions

- **With limited precedent, what leeway exists for advisors or judges to create outcomes based on stakeholder goals?**
- **Does §502(b) apply to customer property held in trust or otherwise recoverable by customers?**
- **Should customers simply be entitled to recover their property (or its pro rata share thereof assuming a shortfall)?**
- **What distribution mechanisms enable equitable treatment when there is a mismatch of asset types between claims and assets or multiple asset types within a claim class (e.g., BTC, ETH, USDC)?**
- **How can claimholders be protected from abuse in claims trading?**

Appendix: Proposed US Regulation

Proposed US Regulation

- Numerous proposals from both Democrats and Republicans to regulate digital assets and digital asset markets
- Most proposals focus on regulating:
  - Stablecoin (requiring stablecoin to be pegged to high-quality assets)
  - Crypto Exchanges
- Crypto exchange regulation is needed. However:
  - All of the proposals are light on details concerning digital asset custodians
    - Many exchange failures resulted from custody hacks
  - None of the current proposals squarely address digital asset lending
    - Two of the major U.S. crypto cases (to date) have involved digital asset lending programs

U.S. Legislation under Consideration

Digital Commodities Consumer Protection Act of 2022 (S. 4760, introduced by Sen. Stabenow)

- Would make digital assets a commodity and give CFTC the jurisdiction to regulate:
  - Digital Commodity Trading Facilities
    - Many types of regulations now applicable to commodity exchanges would apply to digital commodity trading facilities
  - Digital Commodity Dealers and Brokers
  - Digital Commodity Custodians
- "Digital Commodity" includes a loan of a digital commodity or similar activity
- Would prohibit a digital commodity trading facility from participating in its own markets
- Customer property would be required to be segregated
- Commodity broker liquidation provisions of the Bankruptcy Code would apply to a digital commodity trading facility bankruptcy

U.S. Legislation under Consideration (cont.)

Lummis-Gillibrand Responsible Financial Innovation Act (S. 4356)

- Would make most digital assets a commodity and generally give CFTC the jurisdiction to regulate Digital Asset Exchanges (but registration would be voluntary)
- Gives CFTC spot market jurisdiction over fungible digital assets that are not securities
- Specifies which "ancillary" digital assets are securities and requires updates to the SEC's Rule 15c3-3 custody rules
- Stablecoin issuers would be required to maintain 100% reserves of high-quality assets
- Customer property would largely be required to be segregated
- Clarifies tax treatment of digital asset transactions
- Commodity broker liquidation provisions of the Bankruptcy Code would apply to a registered digital asset exchange

U.S. Legislation under Consideration (cont.)

Digital Commodity Exchange Act of 2022 (H.R. 7614, introduced by Rep. Thompson)

- Would make most digital assets a commodity and generally give CFTC the jurisdiction to regulate:
  - Digital commodity exchanges
  - Digital commodity custodians
  - Stablecoin issuers ("fixed-value digital commodity operators")
- Customer property must be segregated and held at a qualified custodian
- Contemplates trading through futures commission merchants (*i.e*. commodity brokers)
- Would prohibit an exchange from participating in its own markets
- Insolvency Provisions:
  - Commodity broker liquidation provisions would apply to a digital commodity exchange bankruptcy
  - A non-bankruptcy trustee would be appointed in the event a stablecoin issuer or digital commodity custodian collapses or does not comply with applicable law

U.S. Legislation under Consideration (cont.)

Stablecoin TRUST Act of 2022 (draft introduced by Sen. Toomey)

Stablecoin Innovation and Protection Act of 2022 (draft introduced by Rep. Gottheimer)

- Both bills propose to impose bank-like obligations on stablecoin issuers
- Both bills would limit the types of collateral that can back stablecoin
- The Toomey proposal would add FDIC insurance for stablecoin customers

Stablecoin Transparency Act (S. 3970, introduced by Senator Hagerty)

- Requires all stablecoin to be backed by government securities or non-digital currency

Ongoing discussions between U.S. Dept of Treasury and Rep. Waters (Chair, House Financial Services Committee)