By Edward E. Neiger, Kara E. Casteel and Richard "Jay" Reding

Navigating Crypto Issues Within Preference Litigation

Edward E. Neiger
ASK LLP; New York

Kara E. Casteel
ASK LLP; St. Paul, Minn.

Richard "Jay" Reding
ASK LLP; St. Paul, Minn.

Edward Neiger is a co-managing partner with ASK LLP in New York. Kara Casteel and Jay Reding are partners in the firm's St. Paul, Minn., office.

Turmoil in the cryptocurrency industry has led to a flurry of bankruptcies, which will inevitably lead to avoidance litigation, including preference claims. The intersection of cryptoassets and preference law involves many uncharted territories. This article explores some of the key issues involved in bringing or defending crypto-preference claims.

While this is not an exhaustive list, an early understanding of these issues will help both plaintiffs and defendants be better prepared for the major potential disputes in crypto-preference litigation. Because of the plethora of cryptoassets, from traditional coins like Bitcoin to tokens to nonfungible tokens (also called "NFTs"), easy answers are elusive. However, asking the right questions at the outset will help litigants focus their arguments and assess potential success or liability on issues of first impression.

Property of the Estate

A preference[1] requires a transfer of "property of the estate," broadly defined as "all legal or equitable interests of the debtor in property as of the commencement of the case."[2] Although the definition has a wide sweep, the question of whether a cryptoasset is property of the estate might not always be clear. Crypto-assets are held in digital "wallets," which may be held by one party or many, and therefore cannot be neatly categorized as "property of the estate." In a conventional preference case, money transferred from a commingled bank account is considered property of the debtor, absent a transferee successfully tracing the funds as trust assets.[3] For commingled crypto wallets, the rule may the same. Ultimately, the key is the debtors' rights in the cryptoassets.

In *In re Celsius*,[4] the bankruptcy court found that digital assets deposited in the cryptocurrency lending platform's "Earn" accounts were property of the estate, as Earn accountholders agreed to terms of use that provided that Celsius held "all right and title to such Eligible Digital Assets, including ownership rights."[5] However, the court's decision was confined to the specific Earn account program and its terms.

A different decision could result depending on the account type and specific terms involved. For example, a wallet in which the accountholder has all rights to the wallet's assets is less likely to be estate property. Conversely, if a customer has a custodial wallet where the exchange has property rights in the wallet's assets, it is more likely to be considered estate property.

What if an account changes terms and becomes something else? A change of status from estate property to account-holder property via a term change during the 90-day preference period could later be determined to be a preferential transfer, even without a manual withdrawal from the account. Parties in a preference suit must carefully scrutinize contracts to understand the respective rights of the customer and the exchange over time.

The Securities Safe Harbor

Section 546(e) of the Bankruptcy Code creates a safe harbor for a dizzying array of transactions. The section's purpose is to prevent the unwinding of securities transactions from causing uncertainty on the financial markets.[6] There is likely to be significant litigation over whether the § 546(e) safe harbor applies in crypto cases, and if so, when. Crypto is unlike traditional assets; it is alternately a store of value (currency), a vehicle for investment (a security) and sometimes both simultaneously. Inasmuch as cryptoassets might be "securities," the § 546(e) safe harbor may shield them from avoidance as transfers made in connection with a "securities contract."[7] Alternatively, if cryptoassets are considered commodities, § 546(e) might protect them as transfers made in connection with commodities or forward contracts. Some nonbankruptcy courts and

1 Under 11 U.S.C. § 547(b), a plaintiff may, "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property—
(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made ... on or within 90 days before the date of the filing of the petition ...; and
(5) that enables such creditor to receive more than such creditor would receive if —
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title...."

2 11 U.S.C. § 541(a).

3 *In re Sierra Steel Inc.*, 96 B.R. 271, 274 n.5 (B.A.P. 9th Cir. 1989).

4 *In re Celsius Network LLC*, 647 B.R. 631 (Bankr. S.D.N.Y. 2023).

5 *Id.* at 636-37.

6 *In re Tribune Co. Fraudulent Conveyance Litig.*, 946 F.3d 66, 92 (2d Cir. 2019).

7 The transfer must still be made by or to (or for the benefit of) certain qualifying entities, but several courts have noted the overly broad scope of this statute. *See, e.g., In re Tops Holding II Corp.*, 646 B.R. 617, 688 (Bankr. S.D.N.Y. 2022).

continued on page 64

from page 14

the Commodity Futures Trading Commission (CFTC) have treated cryptoassets such as Bitcoin as commodities.[8]

Other safe-harbor provisions may also apply. Section 546(g) insulates "swap" agreements from avoidance, which may apply if crypto-trading is considered trading one currency for another. These safe harbors' impact may depend on the cryptoasset and how it is traded. The CFTC classifying Bitcoin as a "commodity" might not be legally binding, but it suggests that regulations might impact avoidance litigation. Given that § 546(e) and similar statutes are broadly worded,[9] the safe harbor is likely to be a major issue in crypto avoidance actions.

Valuing Cryptoassets

Section 550(a) of the Bankruptcy Code allows a trustee to recover either the asset transferred or the asset's value. However, many cryptoassets wildly fluctuate in value, peaking and then crashing down at a breakneck pace, which presents a quandary: Does the trustee sue to recover a potentially worthless asset, or does the trustee have the right to obtain the asset's *value* at some point in time? Adding to this complication is precisely *when* to value the asset. Is the value of the asset determined at the date of the transfer or at the petition date? May the trustee recover the highest post-transfer value? Guidance on these issues is unclear and might depend on the circumstances of each case and the nature of the asset itself.[10]

Section 550(a) implies that the estate has the right to recover the full value of the asset transferred, including the time value of money lost putting the estate in the same economic position as if the transfer had not taken place.[11] Trustees are likely to argue that this means the highest value that the asset had post-transfer, while defendants will argue for using the value at the time of the transfer without appreciation. Understanding cryptoassets' value over time is key, which may be a complicated task, especially with the bewildering variety of cryptoassets. Nonetheless, parties should be prepared to understand and argue valuation issues both at the outset and in motion practice.

Solvency

A preference plaintiff enjoys a rebuttable presumption that the debtor was insolvent during the 90 days prior to a bankruptcy filing.[12] In many cases, a debtor's insolvency is in little doubt. However, in the crypto context, a virtual "bank run" on assets can render an otherwise-solvent firm insolvent in a matter of hours. In that situation, artful defendants might be able to challenge the insolvency presumption by arguing that transfers taking place prior to a bank run were not made during the debtor's insolvency.

"Insolvency" is defined under § 101(32) as when an entity has a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation." Determining insolvency under the Bankruptcy Code can be challenging, as the so-called "balance-sheet test" for insolvency uses the fair valuation of assets rather than the book value listed on the balance sheets.[13] This analysis is especially challenging given the overall difficulty in determining the "fair value" of cryptoassets. For example, what is the "fair valuation" of a token minted by an exchange itself? Parties will need to consider more than just what is listed on a debtor's books and records; they need to consider the real-world marketability and value of cryptoassets.

New Value

The new-value defense is often one of the more straightforward defenses in a preference case. Section 547(c)(4) permits a preference defendant to reduce its preference exposure if it provided the estate with new value subsequent to an avoidable transfer. However, in the crypto context, this is another instance of where valuation becomes a major concern. For example, if a customer deposits coins with an exchange subsequent to the customer's receipt of an avoidable transfer, is that new value? How should the parties quantify the value given? If the value of the coin diminishes, does that diminish the amount of new value? Just as the parties will need to consider the value of the property transferred for § 550 purposes, so too will the value of deposits need to be evaluated.

Ordinary Course of Business

"Ordinary course" is a common defense in a preference action. Section 547(c)(2) contains both a "subjective" ordinary-course-of-business test and an "objective" ordinary-course-of-business test, and a defendant may defeat avoidance by demonstrating either. The subjective test looks to see whether the transfers in the preference period were consistent with those made prior based on a historical look-back period.[14] The objective test looks at the payment timing in the creditor's industry as a whole to determine whether the transfers in the preference period comport with industry norms.[15]

The ordinary-course-of-business analysis can be fiendishly complicated, and crypto adds further complexity. For example, many crypto-exchanges (with FTX being the prime example) had recordkeeping ranging from shoddy to nonexistent. This presents a problem for trustees, as § 547(b)(5)

8 *Commodity Futures Trading Comm'n v. McDonnell*, 332 F. Supp. 3d 641 (E.D.N.Y. 2018); *see also* "Bitcoin Basics," U.S. Commodity Futures Trading Comm'n, *available at* cftc.gov/sites/default/files/2019-12/oceo_bitcoinbasics0218.pdf (last visited April 25, 2023).

9 *In re Tops Holding II Corp.*, 646 B.R. at 688.

10 *See, e.g., In re Integra Realty Res. Inc.*, 354 F.3d 1246, 1266-67 (10th Cir. 2004) (noting that § 550(a) does not indicate at what time value is to be determined, and that time appropriate for measurement depends on facts and circumstances of each case); *Pritchard v. Brown (In re Brown)*, 118 B.R. 57, 60 (Bankr. N.D. Tex. 1990) (determining that trustee was entitled to value of oil and gas lease at time of transfer, rather than lease itself or its value at petition date or trial, as it had substantially reduced in value); *Cooper v. Ashley Commc'ns Inc. (In re Morris Commc'ns NC Inc.)*, 75 B.R. 619, 629 (Bankr. W.D.N.C. 1987), *rev'd on other grounds by Cooper v. Ashley Commc'ns Inc. (In re Morris Commc'ns)*, 914 F.2d 458 (4th Cir. 1990) (ordering return of transferred stock, rather than its value, which had appreciated since transfer).

11 *See Foreman Indus. Inc. v. Broadway Sand and Gravel (In the Matter of Foreman Indus. Inc.)*, 59 B.R. 145, 155 (Bankr. D. Ohio 1986).

12 11 U.S.C. § 547(f).

13 *Lids Corp. v. Marathon Inv. Partners (In re Lids Corp.)*, 281 B.R. 535, 540 (Bankr. D. Del. 2002).

14 11 U.S.C. § 547(c)(2)(A); *In re Hechinger Inv. Co. of Delaware Inc.*, 489 F.3d 568, 578 (3d Cir. 2007).

15 11 U.S.C. § 547(c)(2)(B); *Pereira v. UPS Inc. (In re Waterford Wedgwood USA Inc.)*, 508 B.R. 821, 828 (Bankr. S.D.N.Y. 2014).

now contains a "due diligence" requirement that includes an obligation to examine potential affirmative defenses prior to filing suit. Trustees may have to satisfy due-diligence requirements by contacting potential preference defendants prior to suit and inviting them to clarify the records of withdrawals and deposits to determine whether any ordinary-course-of-business or new-value defenses are reasonably determinable.

Despite the addition of due-diligence requirements in the preference statute, defendants bear the burden of proof on their affirmative defenses.[16] Regular and routine withdrawals from a cryptoaccount could be subjectively ordinary, but that fact pattern is likely rare. Instead, both plaintiffs and defendants will have to contend with determining the ordinary course in an extraordinary industry. Numerous cases have held that the historical look-back period for the subjective ordinary-course defense should be based on a time when the debtor was financially healthy,[17] but many crypto companies were never truly financially healthy.[18] For defendants, establishing a historical baseline and demonstrating that the preference period was consistent with that baseline might require significantly more legwork than in the normal preference claim.

Further, a single tweet might cause depositors to panic and withdraw assets. Depending on whether those transfers were transfers of property of the estate, such "bank runs" have a substantial likelihood of being treated as preferences, as they by nature allow the people lucky enough to withdraw before the crash a benefit at the expense of those that were not so fortunate.

Settling Crypto-Preference Cases

Valuation issues continue into a preference suit's end game. It is common for parties to agree to claim waivers as part of a preference settlement, which may include a defendant's waiving its secured or administrative claims or relinquishing its right to file a § 502(h) claim.[19] The point of a preference suit is to try to put the estate in the same position it would have been in had the transfer never occurred. However, valuation of a settlement may be complicated.

For a plaintiff, what is a claim waiver's value? Are claims to be paid in crypto, or in a cash equivalent at a particular point in time — and how should the estate value a claim if the value of the coin has dropped precipitously? For a defendant, how should one value a § 502(h) claim? A claim paid in cryptoassets could be worthless, but a claim paid out in cash may scarcely resemble the asset's purchase price.

Conclusion

The issues involved in crypto avoidance actions are in their infancy, meaning that there are far more questions than settled answers at this stage. There is significant value in asking those questions early before they become surprises. While the flood of crypto avoidance cases has yet to appear, it is only a matter of time as major cases make their way through the bankruptcy courts. abi

16 11 U.S.C. § 547(g).

17 *Davis v. R.A. Brooks Trucking Co. (In re Quebecor World (USA) Inc.)*, 491 B.R. 379, 387 (Bankr. S.D.N.Y. 2013) (collecting cases).

18 Further, the ordinary-course-of-business defense may be inapplicable in cases where the debtor operated as a Ponzi scheme. *See, e.g., Floyed v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 432 (Bankr. S.D. Tex. 1997).

19 Under § 502(h), a claimant is entitled to file a claim arising from the recovery of property under § 550 (*i.e.*, a settlement or judgment resulting from, among other things, avoidance of a preference), which is treated as though such claim arose pre-petition.