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## United States: Are All Crypto Entities Eligible To File For Bankruptcy Under Chapter 11?

04 August 2022

by [Jeff Robins](#), [Alison M. Hashmall](#), [Flie J. Worenklein](#), [Michael C. Godbe](#), [Ezra Newman](#), [Lily D. Vo](#)  
and [Justice H. Walters](#)

Debevoise &amp; Plimpton



In light of recent volatility in crypto markets and news of several crypto entities filing for bankruptcy,<sup>1</sup> market participants are increasingly scrutinizing the credit of crypto intermediaries and considering whether there will be an influx of additional filings. In thinking through credit risk, one critical preliminary set of questions that market participants should ask is which bankruptcy regime is likely to apply to a crypto intermediary, what are crypto asset-holder rights likely to be under that regime, and what are creditor rights more broadly. For certain common types of crypto intermediaries, a regime other than the U.S. Bankruptcy Code (the "Code")<sup>2</sup> may be the most likely. For others, while the crypto entity may qualify to be a debtor under the Code, chapter 11 restructuring may not be available and a chapter 7 liquidation may be the only option. As will be discussed in more detail below, this can be a fact-specific analysis that may depend on the nature of the entity's crypto activities and the legal characterization of the relevant crypto assets. The classification of the crypto entity will impact the applicable insolvency regime and the likely outcome for creditors and customers.

Section 109 of the Code enumerates the requirements for an entity to be eligible to be a debtor. Of particular interest to the crypto industry, section 109(b) lists entities that are *not* eligible to be a debtor, including a variety of domestic and foreign banking institutions.<sup>3</sup> Thus, an entity whose crypto activities might be deemed to involve a type of banking that may fall within the exclusion in section 109(b) may not qualify as a debtor under the Code and may need to consider another insolvency regime.<sup>4</sup> An example of another insolvency regime is the Office of the Comptroller of the Currency ("OCC") receivership regime, under 12 CFR part 51, for uninsured national banks, which may apply if a crypto entity is a trust bank chartered by the OCC.

Moreover, even an entity that qualifies to be a debtor under the Code may not be eligible for a chapter 11 reorganization case. Section 109(d) of the Code provides that only certain entities may commence a chapter 11 reorganization and specifically excludes "stockbrokers" and "commodity brokers" as potential debtors for chapter 11 cases.<sup>5</sup> Such entities are only eligible for liquidation proceedings under chapter 7.<sup>6</sup> Thus, whether or not a crypto entity is considered a stockbroker or a commodity broker determines how it may proceed with a potential bankruptcy case. Sections 741 – 753 of the Code specifically govern the liquidation of stockbrokers, while sections 761 – 767 of the Code govern the liquidation of commodity brokers.

The Code defines the term "stockbroker" as a "person with respect to which there is a customer . . . and that is engaged in the business of effecting transactions in securities for the account of others or with members of the general public, from or for such person's own account."<sup>7</sup> For a crypto intermediary, the primary considerations in determining whether it qualifies as a stockbroker are whether it facilitates the purchase and sale of crypto assets, whether it may receive or hold such crypto assets for or from its customers, and whether any of the entity's crypto assets qualify as "securities." Whether crypto assets qualify as securities is an unresolved question that is the subject of pending court cases and proposed legislation in Congress.<sup>8</sup> As of this time, the Securities and Exchange Commission (the "SEC") has not promulgated any binding guidance specifically on the subject. In its non-binding 2019 *Framework for "Investment Contract" Analysis of Digital Assets*, the Division of Corporation Finance at the SEC outlines its methodology for analyzing whether a certain crypto-asset or product would be considered a "security."<sup>9</sup> In doing so, the SEC staff primarily applied the *Howey* test, based on the Supreme Court case *SEC v. W.J. Howey Co.*, which states that an "investment contract" (and therefore a security) "exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others."<sup>10</sup> In a recent SEC complaint alleging insider trading in crypto assets by an employee at Coinbase, the SEC asserted that it considered at least nine crypto-assets to be securities based on a fairly broad interpretation of the factors in *Howey*.<sup>11</sup> Coinbase has publicly disagreed with the SEC's interpretation.<sup>12</sup>

Relatedly, the Code defines the term "commodity broker" as a "futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer . . . with respect to which there is a customer."<sup>13</sup> In its *Digital Assets Primer*, the Commodity Futures Trading Commission (the "CFTC") explains that it uses a highly fact-specific approach in determining whether a crypto asset is a commodity, stating that, "[d]epending on its design, function, and use, a digital asset may be characterized differently, including a commodity."<sup>14</sup>

Determining whether or not certain crypto assets, especially cryptocurrencies and tokens, are securities or commodities appears to be the subject of continuing dialogue between the SEC and CFTC.<sup>15</sup> SEC Chair Gary Gensler recently mentioned the SEC and CFTC were considering entering into a "memorandum of understanding" regarding what types of crypto assets are securities or commodities.<sup>16</sup> However, as indicated above, there currently remains a lack of regulatory clarity or applicable court rulings regarding whether certain crypto assets constitute securities or commodities. In the absence of settled law on this point, it is possible that courts may classify certain crypto intermediaries as either banks, stockbrokers or commodity brokers depending on their activities and the types of tokens involved, even if the entities do not classify themselves as such in court filings. It is also worth noting that the Code's definition of "security" differs from

the definition under federal securities laws and may not fully square with the definition used by the SEC.<sup>17</sup> Thus, while it is likely that a bankruptcy court would consider the SEC's conclusions regarding what types of crypto assets are securities or commodities, it is possible a bankruptcy court could reach a different conclusion under the Code.

As noted above, if a crypto debtor qualifies as a stockbroker or commodity broker, it is excluded from filing under chapter 11 for bankruptcy; instead, the debtor must file under chapter 7.<sup>18</sup> A chapter 7 bankruptcy is a liquidation with a court appointed trustee to oversee the wind-down.<sup>19</sup> Critically, unlike chapter 11, the debtor does not continue to operate and there is no opportunity to restructure the debtor's operations. Therefore, a crypto debtor classified as a stockbroker or commodity broker would be required to liquidate. While a liquidation is generally not in the best interest of a debtor and its creditors, chapter 7 of the Code provides certain special protections for customer property in a stockbroker liquidation that could be beneficial for owners of crypto assets.<sup>20</sup> For example, customers of brokers have priority rights to "customer property" held by the debtor in a stockbroker liquidation that may put them ahead of general creditors.

Thus, while it appears that more crypto entities are likely to commence bankruptcy proceedings in light of the current market volatility and crypto winter, the rules under which they might do so are subject to complex legal determinations. Interested parties would be well served to consider the likely outcomes in assessing potential credit risks and protections based on the classification of the specific crypto entity.

## Footnotes

1 Voyager Digital LLC (a crypto execution, lending and custody platform), and Celsius Network (a crypto lending platform) have recently filed bankruptcy under chapter 11. See Olga Kharif & Joanna Ossinger, *Crypto Lender Celsius Files for Bankruptcy After Cash Crunch* (July 13, 2022, 8:19 PM) <https://www.bloomberg.com/news/articles/2022-07-14/crypto-lender-celsius-files-for-bankruptcy-in-cash-crunch>.

2 The Bankruptcy Code is codified in Title 11 of the U.S. Code.

< small>3 11 U.S.C. § 109(b).

4 It is worth noting that crypto exchanges in the United States fall under the regulatory scope of the Bank Secrecy Act (BSA) and must register with the Financial Crimes Enforcement Network (FinCEN), which could support an argument that such exchanges do qualify as a bank despite lacking many of the other characteristics.

5 US Courts, <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics> (noting that "stock and commodity brokers are prohibited from filing under chapter 11 and are restricted to chapter 7.") (last visited July 21, 2022).

6 In principle, a crypto stockbroker could also be a registered broker-dealer that is a member of SIPC and thus subject to resolution under the Securities and Investor Protection Act of 1970 ("SIPA") which is conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of the Code to the extent not inconsistent with SIPA.

7 11 U.S.C. § 101(53)(A).

8 See e.g. Securities and Exchange Commission v. Ripple Labs Inc. et al., No. 1:20-cv-10832 (S.D.N.Y. 2021) (Thomson Reuters Westlaw); Lummis-Gillibrand Responsible Financial Innovation Act, S.4356, 117th Cong. (2022).

9 SEC, Framework for "Investment Contract" Analysis of Digital Assets (April 3, 2019), <https://www.sec.gov/files/dit-framework.pdf>.

10 *Id.* See also *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In recent enforcement actions, the SEC also applied the *Reves* test, based on *Reves v. Ernst & Young*, 494 U.S. 56 (1990), to determine whether certain instruments are "notes" (and therefore securities). See, e.g., SEC Order, BlockFi Lending LLC, File No. 3-20758, at 2 (SEC Feb. 14, 2022) (applying both the *Howey* and *Reves* tests in an enforcement action regarding unregistered crypto asset securities), <https://www.sec.gov/litigation/admin/2022/33-11029.pdf>.

11 The crypto-assets mentioned in the enforcement action are: AMP, RLY, DDX, XYO, RGT, LCX, POWR, DFX, and KRO. See SEC Complaint, *U.S. v. Wahi*, Case 2:22-cv-01009 (2022), <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-127.pdf>.

12 See The Coinbase Blog, *Coinbase does not list securities. End of story.* (July 21, 2022), <https://blog.coinbase.com/coinbase-does-not-list-securities-end-of-story-e58dc873be79>.

13 11 U.S.C. § 101(6).

14 CFTC, Digital Assets Primer, Release No. 8336-20 (December 17, 2020), <https://www.cftc.gov/media/5476/DigitalAssetsPrimer/download#:~:text=This%20Primer%20is%20a%20publication,industry%2C%20stakeholders%2C%20and%20policymakers>.

15 See Carter Burwell et al., *SEC Chair Gary Gensler's Top Crypto Market Priorities*, Debevoise & Plimpton Fintech blog (April 12, 2022), <https://www.debevoisefintechblog.com/2022/04/12/sec-chair-gary-genslers-top-crypto-market-priorities/>. See also, CFTC Public Statements & Remarks, Statement of Commissioner Caroline D. Pham on *SEC v. Wahi* (July 21, 2022), <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement072122> (decrying the SEC's Coinbase insider trading enforcement action and their classification of securities there).

16 Stefania Palma and Patrick Jenkins, *SEC chair urges 'one rule book' for crypto to avoid gaps in oversight*, Financial Times (June 24, 2022), <https://www.ft.com/content/b9466a10-a2a6-412d-acf4-086609283df2>.

17 See 11 U.S.C. § 101(49) defining "security" to include, among other things, "other claim or interest commonly known as a 'security'", but specifically excluding currencies.

18 11 U.S.C. § 109(d). It is worth noting that liquidations of registered broker-dealers are overseen by the Securities Investor Protection Corporation under the Securities Investor Protection Act. See Sid Levinson, et al., *Recent Disclosure Guidance Highlights Growing Concern Surrounding the Risks of User Assets Held by Various Crypto Custodians*, Debevoise & Plimpton Fintech blog (June 3, 2022), <https://www.debevoisefintechblog.com/2022/06/03/recent-disclosure-guidance-highlight-growing-concern-surrounding-the-risks-of-user-assets-held-by-various-crypto-custodians/>.

19 11 U.S.C. §§ 701-704.

20 See 11 U.S.C. § 741(4) defining "customer property" to include "cash, security, or other property, and proceeds of such cash, security, or property, received, acquired, or held by or for the account of the debtor, from or for the securities account of a customer."

*The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.*

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AUTHOR(S)



**Jeff Robins**  
Debevoise &  
Plimpton



**Alison M. Hashmall**  
Debevoise &  
Plimpton



**Elie J. Worenklein**  
Debevoise &  
Plimpton



**Michael C. Godbe**  
Debevoise &  
Plimpton



**Ezra Newman**  
Debevoise &  
Plimpton



**Lily D. Vo**  
Debevoise &  
Plimpton



**Justice H. Walters**  
Debevoise &  
Plimpton



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