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Clawback to the future: avoidance actions in crypto bankruptcies

By Joseph Cioffi, Esq., Massimo Giugliano, Esq., and Adam Levy, Esq., Davis+Gilbert LLP

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When the history books are written, it may be said that the biggest event to shake the crypto world was not the crypto bankruptcies of 2022, but rather, the clawback of billions of dollars in crypto value in those bankruptcies.

Since summer 2022, five major crypto companies have filed bankruptcy: a hedge fund (Three Arrows Capital), two lenders (Celsius and BlockFi), a broker (Voyager), and an exchange (FTX). Next up, it is reasonable to expect a wave of lawsuits seeking to clawback crypto transfers made to customers and investors prior to the bankruptcies. When that happens, courts will need to synthesize existing law with modern finance, likely creating new law in the process.

Familiar tools for an unfamiliar future

In bankruptcy cases, debtors-in-possession (or trustees) can file avoidance, or "clawback," actions, which seek to invalidate or "avoid" certain pre-bankruptcy transactions and to recover their value for the benefit of the debtor's estate. As described further below, these claims are typically styled as preferential transfer and/or fraudulent transfer claims. In a voluntary bankruptcy case, such claims must generally be brought within the later of two years after the bankruptcy filing and one year after the appointment of a trustee (provided such appointment occurred within two years of the bankruptcy).

Section 547 of the Bankruptcy Code permits debtors to avoid so-called "preferential transfers." A transfer of a debtor's assets is deemed preferential if the transfer was made (i) to a creditor, (ii) on account of an existing debt, (iii) within 90 days of the bankruptcy, (iv) while the debtor was insolvent. In addition, such transfer must have enabled the creditor to receive more than it would have in a chapter 7 liquidation absent the transfer.

Separately, Section 548 permits debtors to avoid and recover actual and constructive "fraudulent transfers" made by a debtor within two years of its bankruptcy filing. Actual fraudulent transfers are transfers made by a debtor with actual intent to defraud. Constructive fraudulent transfers are transfers made by a debtor (i) for less than reasonably equivalent value and (ii) when the debtor was insolvent (or debtor became insolvent upon the transfer).

Section 544 also authorizes debtors to utilize applicable state fraudulent transfer laws to avoid pre-bankruptcy transfers, which may result in longer look-back periods.

Crypto clawback actions will soon swarm courts

In *In re: FTX Trading Ltd., et al.*, No. 22-11068 (JTD) (Bankr. D. Del.), customers reportedly withdrew $5 billion on the eve of the bankruptcy filing. We can expect that some portion of these transfers will be the subject of clawback claims. FTX also stated in a December 2022 press release it will seek to clawback tens of millions of dollars in political donations by Sam Bankman-Fried and others.

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In the Voyager bankruptcy, *In re: Voyager Digital Holdings, Inc., et al.*, No. 22-10943 (MEW) (Bankr. S.D.N.Y.), Celsius recently filed a motion seeking permission to pursue $7.7 million in crypto preference claims against Voyager. Celsius has also stated in its own bankruptcy filings that it continues to evaluate whether it has colorable crypto preference claims. *In re: Celsius Network LLC, et al.*, No. 22-10964 (MG) (Bankr. S.D.N.Y.).

Challenges with *prima facie* crypto clawback claims

The date of transfer

In 1992, the U.S. Supreme Court in *Barnhill v. Johnson* ruled that a payment by check is deemed made, for purposes of a preference claim, when the check is honored by the bank, or "cleared" (and not when the check was delivered). Courts have not yet ruled on when a crypto transaction is deemed made for purposes of whether a transfer occurred within the 90-day preference period or the applicable look-back period for fraudulent transfer claims.

Litigants may argue that crypto transactions occur the date they are "cleared." It is unclear whether that date would be, for example, the date the transaction is recorded on the blockchain or, if on a different date, when the crypto is actually received by the transferee.

Commingling of digital assets

Only transfers of a debtor's assets are subject to clawback claims.

Pre-bankruptcy crypto transactions may not involve the transfer of a debtor's property if the assets transferred belonged to customers and were merely held in trust by the debtor for the benefit of such customers. That determination may hinge on whether customer assets were commingled with non-customer assets. Bankruptcy Judge Martin Glenn presiding over the Celsius bankruptcy is likely to issue a ruling soon that will determine ownership of crypto assets held in accounts maintained by crypto debtors.

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Interestingly, per FTX's terms of service, FTX expressly agreed that none of the digital assets in customer accounts were the property of FTX and that it would not treat customers' property as its own. Notwithstanding such terms, the way in which such assets were maintained by FTX may ultimately determine whether they constituted property of the debtor for clawback purposes.

Affirmative defenses

For preference claims, common defenses include, among others, the ordinary course of business (OCB) and new value defenses (Sections 547(c)(2) and (c)(4)). The OCB defense applies when a transfer was made in the ordinary course of a debtor's and creditor's business or financial affairs (*i.e.*, subjective test), or made according to ordinary business terms (*i.e.*, objective test).

Separately, the new value defense applies when a creditor provides value to a debtor after receiving an alleged preferential transfer, which value can offset a creditor's preference liability.

Courts have not addressed these highly fact-intensive defenses in the crypto context. As such, it is unclear what factors a court would apply in determining whether a debtor made an OCB crypto transaction. Likewise, it is unclear what constitutes new value in this context.

Another open question is whether transferees can assert any "safe harbors" defenses. Section 546(e) prohibits the avoidance of certain transfers made in connection with a "securities contract," "commodity contract" or "forward contract." Section 546(g) separately prohibits the avoidance of certain transfers made in connection with a currency or commodity swap.

The applicability of the safe harbors will turn, in part, on the categorization of the particular crypto involved, including as a commodity or security. Future regulations promulgated partly in response to the recent bankruptcies may influence such categorization.

When values change

Even if a debtor prevails in avoiding a crypto transaction, another open question is the date as of which the crypto or digital asset should be valued, which is of particular importance given how rapidly such assets can fluctuate in value. There are at least three possible dates: (i) the transfer date; (ii) the judgment date; or (iii) the petition date. Debtors will advocate for a date with the highest value, whereas transferees will advocate for a date with the lowest value.

Similar to the applicability of safe harbors, the answer to the value question may depend on whether the court deems the particular crypto asset a currency, a commodity, or a security. If the asset is a currency, the debtor's recovery will likely be limited to the value as of the transfer date. The answer is less clear if the asset in question is a commodity or security.

Conclusion

Soon, the breaking news of crypto bankruptcies precipitated by the so-called "crypto winter" will give way to a wave of avoidance actions. One can already see the many legal uncertainties concerning basic questions, such as how a debtor may make a *prime facie* clawback claim and how a defendant would assert statutory defenses. Courts, and perhaps even Congress, will be tasked with drawing upon the jurisprudence of the past to resolve the clawback claims of the future.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

About the authors



Joseph Cioffi (L) is a partner at **Davis+Gilbert LLP** in New York City, where he is chair of the insolvency and finance practice. He has transactional, insolvency and litigation experience in sectors marked by significant credit and legal risks, such as, subprime lending and emerging industries. He can be reached at jcioffi@dglaw.com. **Massimo Giugliano** (C) is a partner in the insolvency and finance group at the firm. He advises financial institutions and service sector businesses in connection with a range of insolvency related matters and credit transactions. He can be reached at mgiugliano@dglaw.com. **Adam Levy** (R) is an associate in the insolvency and finance group at the firm. He helps creditors resolve their most significant commercial disputes, including fraudulent and preferential transfer actions and financial products litigation. He can be reached at alevy@dglaw.com.

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