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Digital Assets Defined: Writing Digital Assets into the Bankruptcy Code

As discussed in [previous installments of this *White Paper* series](#), the Lummis-Gillibrand Responsible Financial Innovation Act (the “Bill”)¹ proposes a comprehensive statutory and regulatory framework in an effort to bring stability to the digital asset market. One area of proposed change relates to how digital assets and digital asset exchanges would be treated in bankruptcy. If enacted, the Bill would significantly alter the status quo from a bankruptcy perspective.

OVERVIEW OF DIGITAL ASSETS IN BANKRUPTCY

There is little reported jurisprudence in the United States specifically relating to insolvency proceedings involving digital assets (e.g., cryptocurrencies). In fact, how these assets are treated in bankruptcy in certain aspects is currently developing, as several significant players in the cryptocurrency arena have commenced bankruptcy and insolvency proceedings in the United States and abroad (e.g., Voyager Digital Holdings, Celsius Network, Three Arrows Capital). The only other analogue was in 2014, when the high-profile cryptocurrency exchange, Mt. Gox, commenced a bankruptcy proceeding in Japan after halting bitcoin trading due to major security breaches and bitcoin theft. After years of legal proceedings, the Japanese trustee announced in October 2021 that a civil rehabilitation plan was accepted by a majority of creditors, yet it remains uncertain when distributions to creditors will occur and the effect market volatility will have on such distributions.²

In light of the lack of U.S. precedent and overall volatility in the cryptocurrency market, if passed, the Bill could provide much-needed certainty relating to the treatment of digital assets in a U.S. bankruptcy proceeding. To do so, the Bill largely proposes to integrate digital assets into existing statutory and regulatory frameworks relating to the treatment of commodities and the relief available to commodity brokers in bankruptcy.

The primary objective of the existing provisions of the Bankruptcy Code³ relating to commodities is to minimize the ripple effect and disruption that the bankruptcy of a major commodities player could have on the markets. The statutory framework relating to the liquidation of a commodity broker has been tested very little.⁴ Moreover, the U.S. Commodity Futures Trading Commission (“CFTC”) has enacted a complicated web of rules—the Part 190 Rules⁵—which apply in conjunction with, and sometimes supersede, the Bankruptcy Code in a commodity broker liquidation.

The Bill proposes to amend, among other things, the definition of “commodity broker” to include “digital asset exchange,” which the Bill in turn defines as “a centralized or decentralized platform which facilitates the transfer of digital assets”⁶ and “a trading facility that lists for trading at least one digital asset.”⁷ This, among other proposed changes, would enact significant changes to both the relief available to a digital asset exchange

should it file for bankruptcy and the treatment and protections offered to customers and non-debtor parties to digital asset contracts in a bankruptcy proceeding. For example, should a digital asset exchange seek bankruptcy relief, the Bill proposes to require such exchange to liquidate under the chapter 7 bankruptcy scheme relating to commodity brokers (the “Commodity Broker Liquidation Subchapter”).⁸ Conversely, in instances where a digital asset exchange is not the bankrupt entity but is party to a digital asset contract with a debtor, section 556 of the Bankruptcy Code would generally protect the digital asset exchange from certain key provisions of the Bankruptcy Code, which, if permitted to apply, could potentially cause a domino effect in the markets.⁹

BANKRUPTCY RELIEF AVAILABLE TO DIGITAL ASSET EXCHANGES

As proposed by the Bill, the only bankruptcy relief available to a digital asset exchange would be chapter 7 liquidation under the Commodity Broker Liquidation Subchapter. A digital asset exchange would not qualify for chapter 11 relief.¹⁰ By limiting bankruptcy relief to the Commodity Broker Liquidation Subchapter, the Bill would, among other things, put digital asset exchanges into an established framework that specifically governs the treatment of customer property vs. non-customer property, customer rights, and the portability of customer positions in digital assets.

As noted previously, the overall purpose of the Commodity Broker Liquidation Subchapter is to minimize the ripple effect and disruption that the insolvency of a commodity broker could have on the markets. This is accomplished by a host of mechanisms, many of which equip customers with strong protections and powers that non-debtor parties ordinarily do not have in traditional chapter 7 or chapter 11 bankruptcies. The Commodity Broker Liquidation Subchapter provides a skeletal framework by which commodity brokers (as defined by the Bankruptcy Code)¹¹ are liquidated, which would include the appointment of a bankruptcy trustee. The Bankruptcy Code provisions are supplemented by and, at times, superseded by the Commodity Exchange Act¹² and the Part 190 Rules, which contain the bulk of regulations defining the trustee’s powers and responsibilities in a commodity broker liquidation.

One hallmark function of the Commodity Broker Liquidation Subchapter and the Part 190 Rules is to protect “customer property” (typically funds held by the debtor on account of a commodities customer¹³). The Bill proposes, among other things, to include “digital asset” in the definition of “customer property.”¹⁴ In a commodity broker liquidation, customer funds must be segregated and treated as property of the customer, not property of the bankrupt commodity broker. The Commodity Broker Liquidation Subchapter and the Part 190 Rules also give customers the highest priority claims over customer property, subject to payment of certain expenses for administering the bankruptcy case. Another significant customer protection is that a bankrupt commodity broker must undergo best efforts to promptly transfer all customer accounts to another non-bankrupt commodity broker.¹⁵ In contrast, the restructuring regime under chapter 11 of the Bankruptcy Code does not specifically enumerate these customer protections, which would likely result in the parties constantly litigating to determine or seek to enforce such rights.¹⁶ Accordingly, the conglomerate of statutes and rules governing a commodity broker liquidation seeks to provide more certainty, reduce litigation, and minimize the “domino” effect on the markets that could ensue by a commodity broker bankruptcy.¹⁷

Another aspect of the Bankruptcy Code designed to preserve the market is that sections 546(e) and 764(b) of the Bankruptcy Code effectively insulate from avoidance all payments made pre-bankruptcy or within seven days after the bankruptcy filing from a commodity broker to its customers.¹⁸ These provisions also facilitate the trustee’s directive to make best efforts to transfer all customer accounts to another commodity broker as soon as possible after the bankruptcy filing.

The Commodity Broker Liquidation Subchapter and the Part 190 Rules also require the trustee to provide notice to customers of the bankruptcy filing requesting that the customer instruct the trustee as to the disposition of such customer’s specifically identifiable property and file a proof of claim.¹⁹ The trustee must comply with, to the extent practicable, the customer’s instructions relating to the disposition of customer property. The primary objective of these provisions is to facilitate a prompt transfer of all customer accounts to another commodity broker, ensure that customers receive their pro rata share of customer property, and mitigate the ripple effect a commodity broker bankruptcy could have on the market.

SECTION 556 COMMODITY BROKER AND COMMODITY CONTRACT PROTECTIONS

The Bill also proposes to provide a digital asset exchange with certain protections in instances where such exchange is not the bankrupt entity but is party to a digital asset contract with a debtor. Specifically, the Bill seeks to expand section 556 of the Bankruptcy Code to enable a digital asset exchange to exercise its contract rights notwithstanding certain provisions of the Bankruptcy Code.²⁰

First, upon a bankruptcy filing, the “automatic stay” immediately halts all litigation and actions against the debtor or its property, including a non-debtor’s efforts to enforce its contract rights against the debtor.²¹ Section 556 permits non-defaulting “protected parties”—e.g., commodity brokers—to commodity contracts with a debtor to exercise their contractual rights notwithstanding the automatic stay. These rights can include, for example, the right to liquidate, terminate, cancel, or set off mutual debts and claims relating to commodity contracts. Were this not so, a commodity contract could be in a state of limbo for the entire pendency of the bankruptcy—possibly years—which could wreak havoc on the markets.

Second, in ordinary bankruptcy circumstances, section 365 of the Bankruptcy Code empowers a debtor to assume or reject executory contracts (i.e., contracts where both counterparties have material unperformed obligations).²² In a chapter 11 reorganization case, the debtor may assume or reject an executory contract at any time before confirmation of a plan, possibly years after commencement of the case.²³ In the context of commodities and derivatives contracts, the debtor would be, at minimum, incentivized to delay assuming or rejecting the contract until after the date on which the debtor was required to perform to see if the market price of the commodity fluctuated to the debtor’s benefit. To mitigate this problem, section 556 allows a protected party at any time to exercise its contractual rights.

Third, a debtor is equipped with certain powers to claw back fraudulent or preferential pre-bankruptcy transfers or transactions.²⁴ Section 556 operates in conjunction with section 546(e) of the Bankruptcy Code to exempt from clawback a transfer “made by or to (or for the benefit of) a [protected party]” that is “in connection with a ... commodity contract.”²⁵

These protections limit the trustee's ability to avoid a host of transfers that are germane to the commodity and derivatives markets—in particular, for example, maintenance margin and mark-to-market payments.²⁶ Section 546(e) does not, however, disarm the debtor's powers to avoid transfers made with the actual intent to hinder, delay, or defraud creditors.

CONCLUSION AND OUTLOOK

While it is unlikely the Bill will pass in its current form, it proposes a framework that could establish much-needed certainty regarding how digital assets are treated in bankruptcy.

The pending bankruptcy and insolvency cases involving digital assets may highlight additional issues unique to the treatment of digital assets in bankruptcy and prompt Congress to propose further changes to the Bankruptcy Code. At present, while subject to some debate, a digital asset exchange could seek to reorganize or liquidate under chapter 11 of the Bankruptcy Code, which means far less certainty for customers than if the digital asset exchange were subject to the Commodity Broker Liquidation Subchapter and Part 190 Rules.

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ENDNOTES

- 1 Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong., § 101(a) (2022) (proposed 31 U.S.C. § 9801(2)).
- 2 “Mt. Gox Creditors to Get Billions in Bitcoin After Plan Approved,” Bloomberg.com, October 20, 2021.
- 3 11 U.S.C. §§ 101 *et seq.*
- 4 See, e.g., *In re Peregrine Financial Group, Inc.*, Case No. 12-27488 (Bankr. N.D. Ill. July 10, 2012).
- 5 17 C.F.R. § 190.00 *et seq.*
- 6 S. 4356, § 203(a) (proposed 26 U.S.C. § 864(b)(C)).
- 7 *Id.* § 401 (amending 7 U.S.C. § 1a).
- 8 11 U.S.C. §§ 761-767.
- 9 *Id.* § 556.
- 10 See *id.* § 109(d) (providing that “[o]nly ... a person that may be a debtor under chapter 7 of this title (except a stockbroker or a commodity broker) ... may be a debtor under chapter 11 of this title”); §§ 761-767 (liquidation regime for commodity brokers).
- 11 *Id.* § 101(6).
- 12 7 U.S.C. § 1 *et seq.*
- 13 11 U.S.C. § 761(10) (defining “customer property” as “cash, a security, or other property, or proceeds of such cash, security, or property, received, acquired, or held by or for the account of the debtor, from or for the account of a customer...”). Not all cash, securities, or property subject to a commodity contract fall within the “customer property” protections.
- 14 S. 4356, § 407(e)(2) (amending 11 U.S.C. § 761(10)).
- 15 See 11 U.S.C. § 766(c).
- 16 While the Commodity Broker Liquidation Subchapter definitively establishes customer protections, whether a party or property is entitled to such protections could be subject to litigation.
- 17 Commodity Fut. Trad. Comm’n, Bankruptcy—Proposed Rules, 46 Fed. Reg. 57,535 *et seq.* (Nov. 24, 1981).
- 18 11 U.S.C. §§ 546(e); 764(b). Specifically, section 764(b) and the Part 190 Rules protect, in most instances, any transfer or liquidation of a commodity contract from avoidance if such transfer or liquidation is approved by the CFTC by rule or order.
- 19 *Id.* § 765.
- 20 S. 4356, § 407(c) (amending 11 U.S.C. § 556).
- 21 11 U.S.C. § 362(a).
- 22 *Id.* § 365.
- 23 See *id.* § 365(d)(2).
- 24 See *id.* §§ 544, 547, and 548.
- 25 *Id.* § 546(e).
- 26 Courts hold that the safe harbor provisions of section 546(e) do not automatically bar avoidance claims, but are an affirmative defense that is waived if not timely raised. See, e.g., *Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239, 338–40 (Bankr. S.D.N.Y. 2013).

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