

LEGAL UPDATES

PUBLISHED: DECEMBER 21, 2022

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Celsius Bankruptcy Update: Who Owns the Crypto?

On June 12, 2022, one of the largest crypto lenders in the nation, New Jersey-based Celsius Networks, froze all withdrawals and transfers between its various customer accounts, citing “extreme market conditions,” which in crypto-speak is usually a precursor to insolvency. Shortly thereafter, on July 13, 2022, Celsius filed for Chapter 11 bankruptcy in the Southern District of New York—the case is styled *Celsius Network LLC, et al.*, Case Number: 22-10964—seemingly marking the beginning of an era of bankruptcy among cryptocurrency exchanges.

Presiding U.S. bankruptcy judge Martin Glenn is tasked with resolving several issues of first impression. One of these issues is whether digital assets deposited on a centralized exchange are property of the debtors or of the depositors. A secondary issue related to the issue of ownership is whether these deposits are subject to a preference claim by the trustee or setoff. His ruling has the potential to reshape how agreements between cryptocurrency exchanges and their customers are crafted in the future.

Background of Celsius’ programs

Prior to the bankruptcy filing, Celsius’ main product was called the Earn Program. Earned Accounts within the Earn Program paid interest to customers and allowed them to make loans, but regulatory investigations resulted in a finding that Earned Accounts constituted unregistered securities offerings. As a result of the investigation, Celsius replaced the Earn Program with the Custody Account Program and the Withholding Account Program.

If a customer with an Earn Account lived in a state where the Custody Account was legal, the customer’s Earn Account was transferred to a Custody Account. Custody Accounts allowed users in the United States to store, access, borrow, spend, and grow crypto within Celsius’ products. If a customer with an Earn

Account lived in a state where the Custody Account was not legal, the customer's Earn Account was transferred to a Withhold Account. Withhold Accounts contained coins that did not earn interest, and could not be used to repay loans, to post as collateral, or buy or swap for other coins. And importantly for the issue of ownership before the bankruptcy court, unlike other accounts at Celsius, Withhold Accounts had no contractual term of service. The third category of accounts—"Pure" Accounts—refers to accounts owned by customers of either Custody or Withhold Accounts who never had an Earned Account.

Property of the estate issues

The two issues before the bankruptcy court are (1) whether customer deposits in the Custody, Withhold, and Pure Accounts, which have been frozen since June 12, 2022, are property of Celsius or the depositors; and (2) if the deposits are property of the customers, whether they are subject to a preference action by the trustee or setoff against loan obligations. While Celsius has acknowledged that at least some of the accounts are customers' property, it has argued that the return of all customer deposits is not proper because the replacement of the Earn Program occurred within 90 days of the petition date, subjecting the transfers from the Earn Accounts to the Custody and Withhold Accounts to claims of preference or setoff, two causes of action that are commonly used in bankruptcy to maximize the value of a debtor's estate to repay creditors in a manner that is equitable. Preference actions allow a trustee or debtor-in-possession to recover payments received by a creditor within 90 days of the bankruptcy filing to the extent that such payments provided the creditor with an advantage in the bankruptcy case vis-à-vis other creditors. Setoff is an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction. Specifically, as of the filing date, at least \$180 million in the Custody Accounts and \$15 million in the Withhold Accounts may be subject to a preference claim by the trustee. Additionally, approximately 58,300 users held assets worth \$210 million in loan programs, which may be subject to setoff. Customers with Pure Accounts who never used the Earned Accounts would not be subject to a preference action because no transfers between accounts were made within 90 days of the filing date. Celsius, however, sought to keep all funds until the court determined which accounts would be subject to preference or setoff so that it does not have to pursue recovering the funds after releasing them.

Over 50 objections were filed to Celsius' request to keep customers' deposits until further determination by the court. After several days of oral arguments in early December, the Court ordered Celsius to release funds to customers with less than \$7,575 in holdings, which is the statutory cap for preference actions under Section 547(c)(9) of the Bankruptcy Code. The Court also permitted distribution to customers with Pure Custody Accounts, which affected 15,680 customers holding approximately \$44 million in Pure Custody Accounts.

Customers with Custody Accounts, Withhold Accounts, and Pure Withhold Accounts in amounts greater than \$7,575 in investments, however, continue to have their funds frozen for further determination by the Court. The Court has not indicated when it plans to rule on the release of those funds.

Moving forward

Section 541 of the Bankruptcy Code provides that all property in which a debtor has a legal or equitable interest, including any interest in property that the debtor acquires post-petition, becomes property of the estate. Determining whether a debtor has a legal or equitable interest in property or whether the property is property of the bankruptcy estate requires courts to parse state law and the debtor's contractual rights. Cryptocurrency is an asset that has not been frequently litigated in bankruptcy courts or regularly evaluated under property or contract law. When there is no legal or regulatory framework, parties rely upon written agreements. Whether or not the crypto assets are property of the estate will likely be determined by the language of the agreements between Celsius and its customers under the relevant state law.

Although Celsius is based in New Jersey, the relevant "Terms of Use" applicable to the Custody Accounts are governed by the laws of the state of New York. The latest version of those terms became effective on April 14, 2022, just two months prior to Celsius' halting of withdrawals. Notably, the Custody Accounts' Terms of Use include the following provision:

Title to any of your Eligible Digital Assets in a Custody Wallet shall at all times remain with you and not transfer to Celsius. Celsius will not transfer, sell, loan or otherwise rehypothecate Eligible Digital Assets held in a Custody Wallet unless specifically instructed by you, except as required by valid court order, competent regulatory agency, government agency or applicable law. As title owner of assets, you bear all risk of loss.

This provision specifically states that the customer is the owner of the deposits, indicating that the funds in the accounts are not property of Celsius' estate. Another provision in the Terms of Use also indicates an intent to not pass ownership to Celsius:

When you use the Custody [Program], you understand and agree that Celsius may act as the custodian or we may use a Third Party Custodian to provide the Custody [Program] By using the Custody [Program], you understand and agree to appoint Celsius or a Third Party Custodian selected by Celsius as your agent to store and secure Eligible Digital Assets in a Custody Wallet, and perform other duties customarily performed by a custodian By using the Custody [Program], you authorize Celsius to transfer your Eligible Digital Assets to a Third Party Custodian or Custodians as may be selected by Celsius, and to instruct and cause any such Third Party Custodian to transfer your Eligible Digital Assets to another Third Party Custodian

or Custodians as may be selected by Celsius, or to Celsius, in each case without the need for any further notice to or consent from you, and consistent with providing the Custody [Programs] as set forth herein.

Reading both provisions together suggests that Celsius did not intend to have ownership of the digital assets in the Custody Accounts, but rather keep the individual account holders as the owners. Interestingly, the Withhold Accounts do not have any terms of use governing the ownership of the deposits in these accounts. This means that the Court would need to decide who owns the funds in the Withhold Accounts without having contractual terms, possibly leading to an analysis under an implied contract theory.

On December 19, 2022, the Court issued a briefing schedule to determine Celsius' liability to account holders under the Terms of Use. The final evidentiary hearing is scheduled for February 6, 2023.

What this means to you

Ultimately, Judge Martin Glenn will need to rule on the ownership status of all classes of accounts and whether the funds can continue to be held by Celsius while pursuing preference and setoff litigation. His decision in the matter could have far-reaching implications for the way crypto exchanges and their customers transact in the future.

Contact us

Husch Blackwell's team of blockchain attorneys will continue to monitor industry developments and keep its crypto clients apprised. Should you have a bankruptcy, blockchain, or cryptocurrency-related questions, please contact Iana Vladimirova, Amber Fly or your Husch Blackwell attorney.