

Crypto Volatility and The Pine Gate Problem

--Anthony Casey, Brook Gotberg, and Joshua Macey

When a crypto intermediary such as FTX or Celsius files for bankruptcy, crypto assets may – depending on the terms of the underlying customer agreements – be treated as property of the estate and not as property of the individual or business that deposited coins with the intermediary.¹ When that happens, the intermediary's customers will likely be required to bring claims as creditors and not as owners of crypto coins. Scholars and bankruptcy practitioners have discussed this issue in some detail and expressed concern about the fact that people who use crypto intermediaries – especially those involved in crypto lending services – will be unable to access their coins during the bankruptcy and may end up being paid pennies on the dollar.² Scholars have focused on the financial stability and consumer protection concerns.³

In our opinion, there is an additional reason to treat crypto depositors as owners, not as creditors, of crypto assets, and to exempt holders of crypto assets from ordinary bankruptcy procedures such as the automatic stay. The first reason has to do with characteristics of crypto assets. With some exceptions such as stablecoins,⁴ crypto assets are highly volatile. Claims against a crypto intermediary, including those of customers, are valued at the filing date.⁵ The failure of a crypto intermediary is likely to occur when the crypto asset's value has declined significantly. The fact that claims are valued at the filing date could lead to strategic bankruptcy petitions that redistribute value away from junior claimants. And even if crypto intermediaries do not file with this purpose in mind, bankruptcy, by creating an artificial moment of reckoning, is likely to redistribute value from customers of a crypto intermediary to its other creditors or managers.

1. Customers are Creditors, Not Owners

In the *Celsius* case, Judge Glenn recently found that crypto assets deposited with a lender who can then invest those assets elsewhere belong to the estate.

¹ In re Celsius Network LLC, Memorandum Opinion and Order Regarding Ownership of Earn Account Assets, Case No. 22-10964 (Jan. 4, 2023). Notably, in cases involving merely custodial relationships (such as those involving only exchange or wallet services), customers retain ownership when that was consistent with the underlying agreement. The FTX case included the additional complication of allegations that the terms of the customer agreements were not followed.

² Dan Awrey, *Bad Money*, 106 Cornell L. Rev. 1 (2020); Paul Zumbro and David Portilla, *Viewpoint: How Crypto Can Minimize the Cryptopocalypse*, Wall St. J. Bankruptcy Pro (Jul. 21, 2022).

³ We are not sure financial stability concerns will always be present. Nor do we think FTX's bankruptcy presents risks to the safety and soundness of the financial system.

⁴ Even stablecoins may be volatile if stablecoins are not backed one-to-one.

⁵ 11 U.S.C. § 502.

In such a case, when a debtor intermediary takes ownership of an asset, then bankruptcy treats the assets not as a bailment but as though a sale was executed that creates a customer claim (and not a property right) in bankruptcy. That means that if a crypto intermediary can mingle customers' coins and lend them out or direct their deployment according to its own strategies, then the coins deposited with the intermediary become property of the estate. Moreover, many of the contracts – particularly in the case of lending services – that governed the relationships in the recent crypto bankruptcies disclaimed the customer's ownership and ability to exercise property rights over the crypto assets. Because crypto assets going to be deemed property of the estate in such cases, they will be subject to all the usual rules that attach when a debtor files for bankruptcy. Unless an exception to the automatic stay applies, the automatic stay prevents those customers who deposited crypto assets with the intermediary from redeeming their coins. And, unless the intermediary's terms of service specifically afford customers ownership or special protections such as margin or provide that the intermediary will retain a one-to-one accounting guaranteeing that it holds the full number of coins for all customer coins, then the customers will be treated as unsecured claimants for market the value of their crypto assets. As we show below, there are policy reasons to doubt that this treatment is appropriate in these cases, and to worry that bankruptcy will cause value to be redistributed from the intermediary's customers and given to its other claimants.

2. Volatility and Valuation

Crypto volatility can lead to the strategic use of the bankruptcy system by savvy debtors and creditors. Bankruptcy values claims at the filing date. It has long been recognized that the timing of bankruptcy valuation can create distortions in how parties behave, but that is especially true when it comes to volatile assets. Because crypto is highly volatile, the value of coins deposited with an intermediary can change significantly over the course of the bankruptcy and in the months and years after the intermediary emerges from bankruptcy. The result is that the claims of customers of an insolvent crypto intermediary are likely to receive a low valuation that favors other stakeholders.

This is an extreme version of a familiar problem, which is that bankruptcy, by forcing a moment of reckoning, causes claimants who have invested in volatile assets to lose the option value of those investments. Imagine a company that has an asset that could appreciate significantly in the future but currently holds little value. If the firm files for bankruptcy, creditor claims are based on the value of the asset at the time the firm files for bankruptcy. If there is reason to think that the asset's value will increase in the future, a bankruptcy filing allows the debtor to pay the relatively low value and then benefit when the asset's value goes up.

One classic form of this problem is lien stripping and can be described as the *Pine Gate* problem after the eponymous 1976 case.⁷ In *Pine Gate*, a creditor's collateral depreciated when real estate prices went down. The creditor had a non-recourse loan, meaning the creditor's recovery was limited to the value of the collateral. Because the real estate market had declined, the creditor was undersecured. The debtor crammed down a chapter 11 plan. By extinguishing the creditor's lien, the debtor paid the creditor the appraised value of the collateral, which was low because the real estate market had declined. The bankruptcy thus allowed the debtor to

⁶ In re Pine Gate Assocs., Ltd., Case No. B75-4345A, 1976 U.S. Dist. LEXIS 17366 (N.D. Ga. Oct. 14, 1976).

pay a depreciated value and ensure that it would be entitled to any future appreciation. Section 1111(b) of the Bankruptcy Code was passed to prevent this type of lien stripping.

Crypto bankruptcies can lead to similar issues. Crypto intermediaries may face risks that are correlated with the value of the crypto market. If the value of crypto declines, an intermediary may therefore face distress. Similarly, the collapse of a large crypto intermediary such as FTX may cause the entire crypto market to experience distress. Either way, the crypto assets held by the intermediary are likely to have a relatively low value on the filing date but could increase in value in the future. If the intermediary holds onto the crypto assets and pays claimants based on the market value of their claims at filing, then the intermediary could take advantage of a decline in the value of crypto assets to seize value for itself and its senior creditors. It is as if they are forcing the claimants to sell at the bottom of the market. Even if intermediaries do not file strategically, the reality is that customers of the crypto intermediary will have a claim based on a low valuation that, in FTX's case, was partly caused by the intermediary's misconduct. Crypto volatility can thus lead to strategic use of the bankruptcy system by savvy debtors and creditors.

A related issue is that crypto intermediaries may sell crypto to fund the bankruptcy proceeding. FTX may try to sell crypto assets to fund its bankruptcy or pay off creditors.⁸ They just need the money. Here, there is no *Pine Gate* issue. The debtor is not filing to capture the upside value of crypto assets. Still, the effect is the same: because the bankruptcy filing is likely to occur when the value is low, an intermediary's customers are forced into a bottom of market sale to provide liquidity for someone else! As a result, they receive a low valuation and lose their right to the possibility that the value will appreciate. Of course, crypto assets could continue to decline in value, but typically we allow investors to decide when to liquidate investments. Bankruptcy forces the intermediary's customers to cash out in what may well be the worst possible time. This problem can be expected to repeat itself.

Thus, regardless of whether the firm treats crypto assets as firm-specific or not, the bankruptcy forces customers of the intermediary to relinquish their option value. If crypto assets are firm specific assets that the company plans to hold onto after it reorganizes, then there is a *Pine Gate* problem because the firm could take advantage of the low valuation to seize future appreciation of crypto assets. Alternatively, the firm could treat the crypto assets non-firm-specific and sell them at the outset to finance the bankruptcy. Either way the customers lose, without any strong bankruptcy policy being served.

3. Do Crypto Assets Create Surplus Going Concern Value?

Another reason to think that holders of crypto assets should not be treated as mere creditors is that crypto assets, like financial derivatives contracts, may not be firm specific assets. As a result, retaining them may not preserve a firm's going concern value—the surplus value provided when assets are kept together rather than being sold in a piecemeal liquidation.

⁷ FTX has already sought permission to sell some assets, though these may not be crypto assets. See Max Koopsen, FTX Cleared To Sell LedgerX, Other Assets To Repay Creditors, Decrypt (Jan. 15, 2023), <https://decrypt.co/119267/ftx-cleared-to-sell-ledgerx-other-assets-to-repay-creditors>.

This is a point Ed Morrison and Franklin Edwards have made in the context of financial derivatives assets, and we think it may also apply to crypto assets.⁹

⁸ Edward Morrison and Franklin R. Edwards, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 Yale J. Reg. 91 (2005).