Crypto Volatility and The Pine Gate Problem

--Anthony Casey, Brook Gotberg, and Joshua Macey

When a crypto exchange such as FTX files for bankruptcy, crypto assets will often be treated as property of the estate and not as property of the individual or business that deposited coins with the exchange.[1] As a result, the exchange'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 exchanges 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 exchange, including claims submitted by customers who traded crypto assets on the exchange, are valued at the filing date.[5] The failure of a crypto exchange 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 exchanges 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 exchange to the exchange's other creditors or managers.

1. Customers are Creditors, Not Owners

Adam Levitin has provided an excellent explanation of why crypto assets will generally be considered property of the estate.[6] Judge Glenn recently reached the same conclusion in the Celsius bankruptcy, so we will only briefly explain why customers of a crypto exchange are likely to be treated as creditors of the exchange and not as owners of the coin.

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[1] In re Celsius Network LLC, Memorandum Opinion and Order Regarding Ownership of Earn Account Assets, Case No. 22-10964 (Jan. 4, 2023).

[2] Dan Awrey, Bad Money, 106 Cornell L. Rev. 1 (2020); Adam Levitin, What Happens if a Crypto Exchange Files for Bankruptcy, Credit Slips, https://www.creditslips.org/creditslips/2022/02/what-happens-if-a-cryptocurrency-exchange-files-for-bankruptcy.html (Feb. 4, 2022); 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.

[6] Adam Levitin, What Happens if a Crypto Exchange Files for Bankruptcy, Credit Slips, https://www.creditslips.org/creditslips/2022/02/what-happens-if-a-cryptocurrency-exchange-files-for-bankruptcy.html (Feb. 4, 2022).

When someone does not have a right to a specific, tangible good, then bankruptcy treats the assets not as a bailment but as though a sale was executed that creates a claim in bankruptcy. That means that if a crypto exchange can mingle customers' coins and does not owe customers any specific identifiable coin, then the coins traded on the exchange become property of the estate. Moreover, many of the contracts 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 are usually going to be deemed property of the estate, they will be subject to all the usual protections that attach when a debtor files for bankruptcy. Unless an exception to the automatic stay applies, the automatic stay prevents customers who traded crypto assets on the exchange from redeeming their coins. And, unless the exchange's terms of service afford customers special protections such as margin or the coins were not commingled with other assets, 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 exchange'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 traded on the exchange can change significantly over the course of the bankruptcy and in the months and years after the exchange emerges from bankruptcy. The result is that the claims of customers of an insolvent crypto exchange 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 little 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

[7] 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 exchanges may face risks that are correlated with the value of the crypto market. If the value of crypto declines, an exchange may therefore face distress. Similarly, the collapse of a large crypto exchange such as FTX may cause the entire crypto market to experience distress. Either way, the crypto assets held on the exchange are likely to have a relatively low value on the filing date but could increase in value in the future. If the exchange holds onto the crypto assets and pays claimants based on the market value of their claims at filing, then the exchange 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 exchanges do not file strategically, the reality is that customers of the crypto exchange will have a claim based on a low valuation that, in FTX's case, was partly caused by the exchange'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 exchanges 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, exchange'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 exchange'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 exchange to relinquish their option value. If crypto assets are firm specific 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. Even 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.

[8] 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 Morrision and Franklin Edwards have made in the context of financial derivatives assets, and we think it may also apply to crypto assets.[9]

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