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Digital Assets Alert

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What happens in the event of the insolvency of a cryptocurrency business conducted through a "bank"?

By Lawrence D. Fruchtman

The growth of organizations involved in digital currencies raises the question of what happens when a business holding cryptocurrency for its customers becomes insolvent if it is structured as a banking organization.

What's the Impact?

- The answer is not clear, as bankruptcy law usually does not govern bank insolvency
- Insolvent banks are wound down differently than corporations, governed by different regulators and processes
- This difference is likely to lead to conflict between the bank regulators, in their capacity as receivers, and the bankruptcy courts, which play out in litigation

The phenomenal growth of institutions involved in crypto and virtual currencies raises the question of what happens when a business that holds cryptocurrency on behalf of its customers becomes insolvent. A number of these businesses have availed themselves of trust company and special purpose depository institutions charters under both state and federal law. These entities

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are structured to be regulated and supervised, from cradle to death, by the relevant state or federal banking authority, but typically do not take deposits and, in any case, are not insured by the FDIC. While "banks" are not eligible to become debtors under Chapters 7 and 11 of the Bankruptcy Code, and are generally thought not to be subject to the Bankruptcy Code, the Bankruptcy Code has been applied by courts in a variety of situations to override state bank insolvency regimes. Accordingly, it remains uncertain whether bank insolvency regimes will be honored by the courts in the event of a conflicting bankruptcy proceeding. This may be significant to customers of these entities that place cryptocurrencies with these entities in the expectation of their prompt return in the event of the custodian's insolvency, as well as creditors dealing with the entity that expect to participate in the liquidation of the firm's assets under nonbankruptcy rules. While we have not experienced an insolvency of a cryptobank thus far, the Terra (LUNA) collapse suggests that thought should be given to this question.

Conflict between the Bankruptcy Code and bank insolvency regimes

The U.S. Bankruptcy Code provides that a "bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, ... credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act" cannot be a "debtor" under Chapter 7 (Liquidations) or Chapter 11 (Restructurings).[i]

Historically, bank insolvencies were the province of the state banking authority that chartered the bank or the Office of the Comptroller of the Currency (OCC) with respect to national banks. With the advent of deposit insurance, the Federal Deposit Insurance Corporation (FDIC) was charged with acting as the receiver for insolvent insured depository institutions and was provided over time with significant "super" powers to resolve insolvent insured banks. For the most part, the FDIC, as the receiver, would seek to arrange the purchase and assumption by a stronger bank of an insolvent bank's good assets and all of its deposit liabilities so as to minimize harm to bank customers and the cost to the insurance fund. The Federal Deposit Insurance Act (FDIA) also provides depositors a preference in insolvency so that if the FDIC liquidated the bank and paid the depositors the amount of their insured deposits, the FDIC would be subrogated to the claims of depositors and thereby become the largest preferred creditor of the estate.[ii] The FDIC, as receiver, is also granted statutory powers that are substantially the same or more powerful than a bankruptcy trustee.[iii]

In response to the financial crisis of 2007–2009, the Dodd-Frank Act, P.L. 11-203, July 21, 2010, added provisions to address the failure of systematically important financial institutions, including nonbank financial institutions designated as such and provided new means of resolving such institutions. These included the requirement under Title I that such institutions prepare "living wills" and Title II, which created an "Orderly Liquidation Authority" for the FDIC to resolve such institutions. For this purpose, crypto businesses may well constitute "nonbank financial institutions" that could be subject to these provisions should they be deemed systemically important.

When the insolvent entity is a nondeposit trust company or a special purpose depository institution that is not FDIC insured, it is not clear that such an entity is excluded from the Bankruptcy Code. As set forth above, the language of the Code does not include "trust company" among the specified excluded entities. And while the term "bank" is used, the courts appear to place significant weight on whether the institution takes deposits.[iv] It has been observed that "the Senate Report accompanying the Bankruptcy Reform Act of 1978 provided the following rationale for the exclusion, namely, that "[b]anking institutions and insurance companies engaged in business in this country are excluded from liquidation under the bankruptcy laws because they are bodies for which alternate provision is made for their liquidation under various State or Federal regulatory laws."[v]

As discussed below, this is certainly the case with the nondeposit trust companies and special purpose banks discussed herein. The Senate Report also advised that the banking institution exemption was "expanded in light of changes in various banking laws" to add a number of additional categories of depository institutions. However, the statute failed to incorporate definitions of the excluded entities, and as noted, did not include trust companies.

Accordingly, courts have continued to apply tests developed under the predecessor Code, namely a "state classification test," which emphasizes the categorization, status, and operations of an entity under nonbankruptcy law, and an "independent classification test," under which the courts classified an entity as excluded or not according to the courts' own definition of the excluding term. "In applying either of the established tests, the courts generally place considerable emphasis on whether the entity in question is authorized to accept deposits or, if so, whether the 'deposits' are of the kind typically accepted by banking institutions." Both tests appear to come down to whether the institution accepts deposits, which is regarded as "the essential function of a banking institution." Id.

Bank insolvency regimes for non-FDIC-insured institutions engaged in virtual currency businesses

New York

Starting in 2015, the New York State Department of Financial Services (NYDFS) began issuing nondeposit trust company charters to virtual currency businesses as an alternative to the BitLicense. The NYDFS advised that "[t]o conduct virtual currency business activity in New York State, entities can either apply for a BitLicense or for a charter under the New York Banking Law (for example, as a New York State limited purpose trust company or New York State bank) with approval to conduct virtual currency business. While these forms of authorization are similar, a New York State limited purpose trust company charter may provide some additional benefits. For example, a limited purpose trust company can exercise fiduciary powers, while a BitLicensee cannot. In addition, a limited purpose trust company can engage in money transmission in New York without obtaining a separate New York money transmitter license." There are now nine (9) New York nondeposit trust company charters outstanding, including BitGo New York Trust

Company LLC, Coinbase Custody Trust Company LLC, and Paxos Trust Company, LLC (f/k/a itBit Trust Company, LLC).

Each of these trust companies has elected to be formed pursuant to New York Banking Law (NYBL) §§102-a and 4001-b, which, among other things, requires that they "do not receive deposits from the general public" and have been exempted by the [banking board] from the requirement that they obtain FDIC insurance under NYBL §32.

Limited purpose trust companies can also be chartered under the general provisions governing the chartering of New York banks and trust companies but, in any case, would be subject to restrictions contained in its organization certificate that prohibit the limited purpose trust company from receiving deposits and making loans except as incidental to the exercise of fiduciary powers. The NYDFS has advised that recent chartering documents include this standard clause:

> "The corporation is to exercise the powers conferred by Section 100 of the Banking Law. The corporation shall neither accept deposits nor make loans except for deposits and loans arising directly from the exercise of the fiduciary powers specified in Section 100 of the Banking Law."

These limited purpose trust companies are subject to examination and supervision by the NYDFS in the same manner as New York full depository institutions, though required capital levels significantly differ from the usual leverage and risk-based capital levels required of insured depository institutions.

In the event of the failure of a NY limited purpose trust company organized as an LLC, the statute (NYBL §102-a) provides "[n]otwithstanding any other provision of this chapter, a limited liability trust company shall dissolve[,] and its affairs shall be wound up upon the occurrence of any event specified in section seven hundred one of the limited liability company law. Upon such a dissolution, the provisions of this chapter [i.e., the NYBL] shall govern the winding up of the affairs of the limited liability trust company and the distribution of its assets." With respect to any other limited purpose trust company[,] the insolvency provisions of the NYBL would also apply.[vi]

Other states chartering limited purpose trust companies

South Dakota also has chartered limited purpose trust companies that engage in virtual currency custody and related activities (e.g., BitGo Trust Company, Inc. and Anchorage Trust Company, which has since converted to a national charter). These entities are chartered under the Trust Company chapters of the South Dakota Banking Law, South Dakota Codified Law (SDCL) Chapter 51A-6A, which contains provisions authorizing the director of the Division of Banking to take possession of an insolvent trust company. Other states, including Washington State (e.g., Protego Trust Company, now in the process of converting to a national charter), have issued similar charters. In each case, the insolvency of such an institution is intended to be governed by the insolvency provisions of the states' statutes governing such insolvency.[vii]

Wyoming

In 2020, the State of Wyoming began approving digital banks under its Special Purpose Depository Institution Bank Charter (SPDI)[viii] and has approved four such charters thus far: Kraken Financial (an indirect subsidiary of Payward Limited, a company registered in the United Kingdom), Custodia Bank (f/k/a Avanti Financial Group), Commercium Financial, Inc., and Wyoming Deposit & Transfer.

The SPDI charter allows approved "banks" to custody digital currencies and to take U.S. dollar deposits from corporate (not individual) depositors in an amount not less than $5,000. The statute requires that the SPDI hold reserves of liquid assets backing all of its deposit liabilities and does not require such banks to obtain FDIC insurance. Wyoming statutes further provide that: "[d]igital assets held in custody under this section are not depository liabilities or assets of the bank. .... A customer shall elect, pursuant to a written agreement with the bank, one (1) of the following relationships for each digital asset held in custody: (i) Custody under a bailment as a nonfungible or fungible asset. Assets held under this paragraph shall be strictly segregated from other assets or (ii) Custody pursuant to subsection (e) of this section. (e) If a customer makes an election under paragraph (d)(ii) of this section, the bank may based only on customer instructions undertake transactions with the digital asset. A bank is deemed to maintain possession or control pursuant to subsection (d) of this section by entering into an agreement with the counterparty to a transaction [that] contains a time for return of the asset and other customary terms in securities or commodities transactions. The bank shall not be liable for any loss suffered with respect to a transaction under this subsection, except for liability consistent with fiduciary and trust powers."[ix]

In the event of an insolvency of an SPDI, the statute directs the banking commissioner to conduct a liquidation or appoint a conservator as provided by the Wyoming Banking Law.[x]

Federal approach

At the federal level, the OCC, in addition to allowing national banks to engage in certain crypto businesses, including custody of crypto assets, has now issued national nondeposit trust company charters to companies engaged in virtual currency custody and related business: Anchorage Digital Bank, National Association, which converted from a South Dakota trust company, and Protego Trust Bank, National Association, which is in the process of formation, but originally held a Washington state trust company charter. It has also issued a preliminary approval to form Paxos National Trust, New York, New York. The OCC has issued two relatively recent Interpretive Letters addressing the types of cryptocurrency activities in which a national bank may engage and discussing its authority to charter a national bank limited to engaging activities of a trust company and activities related thereto.[xi] In all cases, the charters are national bank charters granted under the National Bank Act; specifically, 12 U.S.C. 27(a), and such institutions remain subject to all of the provisions of that statute, including the provisions relating to the appointment of a receiver for a national bank, 12 USC §§191 to 200, or a conservator, 12 U.S.C. §§201-212. If the national bank is FDIC insured, the OCC is required to appoint the FDIC as receiver and may appoint the FDIC as conservator.

In the case of insolvent nondeposit national trust companies, the OCC will appoint the receiver or conservator, who will conduct the resolution of the institution under the provisions of the National Bank Act and, in the case of a receivership, pursuant to the OCC's regulation at 12 C.F.R. Part 51. Significantly, that regulation reaffirms that: "[a]ssets held by an uninsured bank in a fiduciary or custodial capacity, as designated on the bank's books and records, will not be considered as part of the bank's general assets and liabilities held in connection with its other business, and will not be considered a source for payment of unrelated claims of creditors and other claimants." This is consistent with the common law view that assets held in custody by a bank are a "special deposit" (i.e., a bailment) and do not give rise to a debtor-creditor relationship that characterizes deposits of fiat currency.

Approach to governance

In summary, in a standalone bank insolvency pursuant to state law (and the National Bank Act, in the case of national nondeposit trust companies), unless the bank or trust company holds deposits that are FDIC insured, state law governing bank insolvency or the National Bank Act will govern the resolution of an insolvent bank or trust company. Any FDIC insured bank will be subject to the usual resolution procedures of the FDIC under the FDIA. In general, each of these regimes treats property, presumably including virtual currencies, as a "special deposit" as to which the bank is a bailee. This includes property held in commingled accounts (e.g., securities held by position or CUSIP number or cryptocurrencies). So long as the records of the trust company or SPDI are accurate as to ownership of the property, the owner will be entitled to recover the property from the receiver. In contrast, deposits of fiat currency (i.e., U.S. dollars) give rise to a debtor-creditor relationship between the bank and the customer. For this reason, customer funds ancillary to transactions effected by a custodian or simply held pending a purchase of cryptocurrency are typically held in an omnibus account for the benefit of the custodian's customers at an FDIC insured correspondent bank with the custodian maintaining the underlying records of its customers' accounts.

So, who "wins"—bankruptcy or bank insolvency?

The growth of nondeposit trust companies and other special purpose depository institutions has highlighted the failure of the Bankruptcy Code to accommodate such institutions, which are regulated and supervised by the state and federal banking authorities that are in the best position to address their failure, having had years of experience dealing with these types of institutions, as well as supervision over the specific institution from inception. However, it seems likely that upon the occurrence of an entity's insolvency or other event triggering a state banking or OCC receivership, interested parties may well seek protection under the Bankruptcy Code. Needless to say, this will trigger litigation over the appropriate venue and raise interesting questions of policy and law.

It is also worth noting that many of these entities are part of larger organizations, including foreign-based organizations, such as Payward, Inc. d/b/a Kraken, which is the U.S. arm of Payward Limited, a company registered in the United Kingdom. Kraken operates a cryptocurrency exchange in the U.S. and, as noted, was the first digital asset company to receive

a Wyoming SPDI charter. It is most likely that a failure of Kraken's SPDI would arise in the context of the bankruptcy in the U.S. and likely abroad of the larger organization, so that competing interests and statutes, including the U.S. Bankruptcy Code and foreign resolution regimes, will come into play. Since this is novel ground, at least in the context of custodial accounts of cryptocurrency, the outcome may not be simple.[xii]

Finally, to the extent that a cryptocurrency organization becomes systematically important, the Dodd-Frank provisions regarding such institutions could come into play and presumably trump both state insolvency provisions and the Bankruptcy Code. A determination of systemic importance would turn the resolution of such an entity over to the Federal Reserve and the FDIC.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Lawrence D. Fruchtman
212.940.3015
lfruchtman@nixonpeabody.com

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[i] See 11 U.S.C. § 109(b) and (d).

[ii] See 12 USC §1821(d)(11) and (g).

[iii] See, 12 USC § 1821(d) et seq. and 12 USC §1823(e) (the codification of the D'Oench Duhme doctrine against the enforceability of "secret contracts" against the receiver).

[iv] See, 87 A.L.R. Fed. 282.

[v] See **S Rep No. 95-989**, 95th Cong, 2d Sess 31.

[vi] See, NYBL §§606-634.

[vii] See, e.g., South Dakota Codified Law (SDCL) 51A-6A-41 et seq. and Revised Code of Washington (RCW) Chapter 30B.44B (State Trust Companies—Involuntary Dissolution And Liquidation).

[viii] See, Wyo. Stat. § 13-12-101et seq.

[ix] See, Wyoming Statutes §34-29-104(d) and (e), and Wyoming Administrative Rules Chapter 20, Section 6(p).

[x] See, Wyo. Stat. §13-4-301 et seq.

[xi] See OCC Interpretive Letters #1176 (January 11, 2021) and #1179 (November 18, 2021).

[xii] See, e.g., *In re Deposit Insurance Agency, as Bankruptcy Administrator of Jugobanka A.D. v. Superintendent of Banks of the State of New York*, 482 F.3d 612 (2d Cir. 2007).