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Valuing crypto in the bankruptcy multiverse

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The recent bankruptcy filings by several major crypto platforms have given rise to unexpected realities for customers and investors. The sudden change in rights, legal exposure in bankruptcy litigation and varying outcomes in the several different proceedings can be reminiscent of a Hollywood multiverse where infinite realities are possible.

Perhaps the area in which an alternate reality is most accessible is the valuation of digital assets. The Bankruptcy Code does not specifically address how, and as of what date, digital assets are to be valued, and although certain bankruptcy courts have provided guidance, the outcomes appear highly dependent on context.

Valuing digital asset claims: different realities for different customers

Generally, in every bankruptcy, a claims administration process governs the filing and processing of claims, and creditors typically receive some percentage recovery pursuant to a confirmed chapter 11 plan or chapter 7 liquidation.

The Bankruptcy Code does not specifically address how, and as of what date, digital assets are to be valued, and although certain bankruptcy courts have provided guidance, the outcomes appear highly dependent on context.

In 2022 and 2023, Celsius, FTX and other crypto platforms went bankrupt, and many of their customers were relegated to the status of "general unsecured creditors," holding claims based on the digital assets they maintained on these platforms. Yet, many, even bankruptcy lawyers, questioned how, and as of what date, these claims should be valued.

Section 502(b) of the Bankruptcy Code provides that courts "shall determine the amount of [a] claim in lawful currency of the United States as of the date of the filing of the [bankruptcy] petition." While this is the general rule, at least two approaches for crypto-based claims have emerged: the petition-date approach and the distribution-date approach.

The petition-date approach is the most straightforward application of Section 502(b). This approach was taken in the Celsius, FTX and BlockFi bankruptcies, where, under each chapter 11 plan, claims for digital assets were based on the value of those assets as of the bankruptcy filing. Unfortunately for claimants, because these bankruptcies were filed during the "crypto winter" — when the crypto market experienced unprecedented losses — claim amounts do not reflect the recent rebound of the crypto market.

Although a court may adopt a particular valuation approach for valuing claims, it may nevertheless adopt a different valuation approach for other purposes.

In contrast to the petition-date approach, the distribution-date approach values claims as of the date distributions are made to creditors. This approach was proposed in the Genesis bankruptcy, with the stated goal of maximizing in-kind distributions to creditors. Although the approach was met with fierce opposition by certain equity holders who argued it resulted in creditors receiving over 100% on their claims, the bankruptcy court ultimately confirmed the plan over their objections.

Setting-off crypto claims sets up additional considerations

Although a court may adopt a particular valuation approach for valuing claims, it may nevertheless adopt a different valuation approach for other purposes. This dichotomy was on display in the Genesis bankruptcy.

Under section 553 of the Bankruptcy Code, creditors are permitted, in certain circumstances, to offset their debts to the estate against their claims against the estate. Prior to the Genesis bankruptcy, some customers received loans of digital assets from Genesis, giving rise to claims in favor of Genesis for repayment. As collateral for these loans, borrowers posted digital assets with Genesis, giving rise to claims in favor of borrowers for the return of collateral upon repayment.

To the extent section 553 is applicable, offsetting these competing obligations necessarily requires a valuation of the digital assets borrowed versus a valuation of the digital assets posted as

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collateral. For purposes of conducting those valuations, the Genesis plan relies on the petition date value, notwithstanding that it relies on the distribution date value for purposes of distributions.

Crypto preference claims create even further value issues

Section 547 of the Bankruptcy Code permits debtors to avoid (reverse) "preferential transfers" that, *inter alia*, were made to creditors within 90 days of a bankruptcy petition. Digital asset transfers made within 90 days of a bankruptcy raise a host of value questions that courts have yet to fully address.

The threshold question is, assuming the transfer is avoided, what is the value of that transfer for purposes of determining the amount that can be recovered from the transferee?

There are at least four possible answers to this question. In the first instance, the debtor may be entitled to recover the digital assets themselves — *i.e.*, the actual number of digital coins transferred — irrespective of value. Alternatively, the debtor may be entitled to recover the cash value of the transferred digital assets as of (a) the transfer date, (b) the petition date or (c) the recovery date.

The answer as to which of these options applies may depend on the classification of the digital asset in question. If the asset is classified as a commodity, the debtor may be entitled to recover the asset itself; however, if it is deemed currency, the debtor may be entitled to the value of the asset at the time of transfer.

The answer is even less clear if the asset is classified as a security. Notably, in December 2023, Judge Jed Rakoff ruled in *SEC v. Terraform* (S.D.N.Y.) that certain digital assets were "securities" under U.S. law.

Additional valuation issues exist in the preference context, yet remain unanswered. For example, section 547 requires a showing that the at-issue transfer enabled the transferee to receive more than it would have in a hypothetical chapter 7 liquidation, absent the transfer. This element necessarily requires valuing a creditor's hypothetical claim for the digital assets that are the subject of the preference claim, as well as a valuation of the alleged preferential transfer. Depending on how these two questions are answered, and given the volatility of digital assets, this element could be met on some days of the week but not others.

A further valuation issue is implicated by the "new value" defense under section 547(c)(4) of the Bankruptcy Code. Pursuant to that defense, a creditor's preference exposure may be reduced to the extent it provided "new value" to the debtor after receiving an alleged preferential transfer. If the creditor provided value in the form of digital assets, the court must determine how to value those assets for purposes of applying the defense.

Conclusion

Valuing digital assets in bankruptcy can raise more questions than answers, which is of no surprise given that Congress created the Bankruptcy Code more than 30 years before there was a gleam in Satoshi's eye. In the coming months and years, as the recent wave of crypto bankruptcies and attendant litigation progresses, answers to many of these questions will likely come into focus, providing much needed clarity for the market. For now, many questions remain open and subject to a multiverse of possibilities.

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