



Crypto Winter Series: Bankruptcy, Insolvency, and Liquidation Principles for Crypto Investors | Part 2 of 3

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In bankruptcy parlance, the lookback period does not look good for the crypto industry. In the last 90 days, the cryptocurrency markets have suffered huge losses, and in the last 14 days, two major players have sought bankruptcy protection. During the prior 365 days, nearly three trillion dollars of value has been stripped from the digital wallets of cryptocurrency investors, and the industry has been forced to eliminate thousands of jobs. Against this backdrop, our blockchain team is publishing a series of articles to provide you with information to understand the legalities behind “crypto winter” developments. While many established players will brave the storm, which will also give rise to new opportunities, there is a lot of blood in the water.

Part 1 of our Crypto Winter series, which is [available here](#), looks at the lessons learned from the latest bankruptcies to hit the crypto space, including the debate surrounding the Three Arrows Capital (3AC) and Voyager filings. Or skip ahead to [Part 3](#) of our Crypto Winter series, which focuses on the classification of cryptocurrency.

Market Forces Are Creating Legal Uncertainty

Within 10 years, cryptocurrency went from being an obscure “peer-to-peer” cash system discussed in online chatrooms to being a Main Street investment class that until recently many financial advisors were touting as a worthwhile asset to diversify a 401k Plan. That optimism is being called into question by some analysts who are predicting a total market collapse for cryptocurrency. While a total collapse is unlikely, the questions now are, first, how far-reaching will the market collapse go and, second, will the short-lived Wall Street perception of asset value in cryptocurrency become a major thorn in the side of traditional financial players?

Those of us in the restructuring world are about to get a front-row seat for how the unique characteristics of cryptocurrency and the blockchain will impact the success or failure of companies forced to seek bankruptcy protection due to their investment in cryptocurrency and the related impact on customers and investors. On July 1, 2022, Three Arrows Capital, Ltd (3AC) [filed a Chapter 15 bankruptcy petition](#) in the United States Bankruptcy Court for the Southern District of New York as a domestic counterpart to liquidation proceedings that began on June 24 in the British Virgin Islands (BVI). The 3AC liquidation/bankruptcy was a major trigger point that caused Voyager Digital Holdings, Inc. (Voyager) and its related entities to file Chapter 11 bankruptcy petitions in New York on July 7, 2022. Both companies cited massive losses in the value of cryptocurrency as a reason for filing bankruptcy.

These bankruptcy proceedings are likely to become a roadmap for investors and begin to answer many legal questions regarding the valuation methodology and classification of cryptocurrency. Historically, bankruptcy courts faced with the challenges of administering cryptocurrency as an asset for the benefit of creditors have avoided these questions. But we predict the 3AC and Voyager cases will bring the issues of crypto valuation and classification to the forefront as investors clamor to recover their cryptocurrency or the cash value thereof. Currently, we are evaluating what strategies and tools of the bankruptcy and restructuring world can be used to address these cutting-edge questions about the legal nature of cryptocurrency.

Of equal importance will be the arguments of cryptocurrency investors who believed that their cryptocurrency on deposit with platforms remained their own as opposed to being commingled and potentially lost forever. The terms and conditions of various cryptocurrency investment platforms will be scrutinized, with exposed investors arguing they were materially misled when they deposited their cryptocurrency on any specific platform.

Bankruptcy Insights for Crypto Investors

Bankruptcy may be an unfamiliar concept to many cryptocurrency investors. As such, a high-level primer may be helpful to some

readers. When a company files a bankruptcy petition, an “estate” is created that is comprised of all of the debtor’s assets wherever located, including cryptocurrency. A debtor can file a petition under various chapters of the U.S. Bankruptcy Code and can pursue the liquidation of assets to satisfy debts or undertake a reorganization of their debts and related affairs. Importantly, the automatic stay is triggered the moment that a debtor files its petition, thereby protecting the debtor’s assets from continued attack by creditors. A bankruptcy estate can be controlled by a trustee or by the debtor itself as a debtor in possession. An additional layer of complexity in bankruptcy exists regarding cryptocurrency—the entities involved are all over the world. Hence, as we’ve seen in the 3AC developments, many foreign insolvency proceedings will result in filings domestically to recognize the foreign proceeding.

Further complicating the analysis is the question of whether a decentralized autonomous organization or DAO—a popular concept in cryptocurrency and blockchain—can legally be qualified as a debtor under the bankruptcy code. Finally, those who are stakeholders of the debtor, as investors, customers, or coin/token holders, will all want to know how they will be classified within the creditor priority scheme under the U.S. Bankruptcy Code. Creditor status largely dictates the likelihood of recovery for claims in bankruptcy, and higher priority claims are afforded greater protections.

In addition to asset classification, we see at least one other issue that requires consideration. Familiarity with the value of crypto assets as well as strategies to preserve value are vital keys for a liquidator or trustee—as well as any other advisor in a crypto bankruptcy. To protect themselves, creditors must also seek the guidance of counsel well versed in crypto assets. Crypto assets range from Bitcoin (which is well known to mainstream, traditional players) to securities tokens that may signify a stake in a startup venture. The specific characteristics of a cryptocurrency held by a debtor must be understood by the liquidator or trustee—and counsel for creditors—to avoid lost value.

In most cases, trustees or liquidators will likely be authorized to convert crypto assets to U.S. dollars. That approach may not be the

best strategy for the estate. Experience with crypto agreements is vital to preserve the value of crypto assets. For this reason, stakeholders navigating a crypto bankruptcy will need to seek out and rely upon advisors who are intimately familiar with both the nuances of bankruptcy law and the digital assets marketplace in order to preserve and enhance the value of the estate and, ultimately, the recovery to creditors.

[Part 3](#) in our Crypto Winter series focuses on the classification of cryptocurrency—specifically, what are the classifications and what do they mean to investors and others impacted in bankruptcy proceedings. Our [Blockchain & Cryptocurrency](#) team will continue to produce articles to offer insight into managing through the crypto winter. If you have specific questions, please reach out to the authors of this article.

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