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September 7, 2022

Crypto Considerations in Bankruptcy Plans of Reorganization

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Lowenstein Sandler's previous article on crypto bankruptcies discussed some bankruptcy basics and the role of a creditors' committee in protecting the rights of customers. This article will delve deeper into the administration of a crypto bankruptcy case by discussing the negotiation of a crypto bankruptcy plan of reorganization.

A Chapter 11 bankruptcy typically results in two scenarios: a bankruptcy sale (commonly known as a "363 sale," a reference to the section of the Bankruptcy Code authorizing the sale of assets free and clear of liens and other interests) or confirmation of a plan of reorganization. A 363 sale frequently will involve the sale of all or substantially all of a debtor's assets, followed by confirmation of a plan of liquidation, conversion to Chapter 7, or dismissal of the Chapter 11 case. In many instances, a plan of liquidation creates a trust that is given the power to litigate and liquidate preserved causes of action for the benefit of general unsecured creditors.

Exclusivity

A Chapter 11 debtor is the only party that may file a plan during the "exclusive period." The exclusive period runs for the first 120 days of a Chapter 11 case, but can be reduced or extended (to a maximum of 18 months) for "cause." Cause to extend is generally found to exist in large and complex cases, or when the debtor demonstrates it is progressing toward a successful reorganization. Courts do not grant extensions where the debtor seeks to use the exclusive period as a delay tactic or as a way to pressure parties to accept a plan, and may reduce the exclusive period upon a finding of gross mismanagement or where the debtor's management has a conflict that interferes with the debtor's reorganization efforts.

Mandatory and Permissive Plan Provisions

The Bankruptcy Code requires that every plan must:

- Classify claims and interests, other than certain priority claims
- Specify any class that is not impaired under the plan
- Describe the treatment of any class that is impaired under the plan to allow such class members to make an informed decision about whether to accept or reject the plan
- Treat each claim or interest within a class identically
- Establish adequate ways to implement the plan, for example, through profits from operations, funding from a sponsor, or the sale of the debtor's assets

Although not required to, a plan may:

- Impair or leave unimpaired any class of claims or interests
- Provide for the assumption, rejection, or assignment of any executory contract or unexpired lease not previously rejected
- Provide for the settlement or adjustment of claims belonging to the debtor or the preservation or assignment of such claims
- Provide for the sale of all or substantially all of the property of the estate and the distribution of sale proceeds

Disclosure and Solicitation

Before a plan of reorganization can be circulated for voting among creditors, the debtor must seek court approval of a disclosure statement containing "adequate information." A typical disclosure statement describes the events that led the debtor to bankruptcy, the major events that occurred during the bankruptcy case, the

classification of claims, the expected return percentage for each class and whether each class is impaired or unimpaired, the means of implementing the plan, and certain risk factors and tax consequences.

Once a disclosure statement is approved, the debtor is authorized to solicit votes on the plan from holders of claims that are impaired and receiving a recovery (unimpaired creditors are deemed to accept the plan and cannot vote; impaired creditors who are receiving nothing are deemed to reject the plan and also cannot vote). Voting is done on a class-by-class basis. A class of claims accepts a plan if the plan is accepted by creditors holding at least two-thirds in dollar amount and more than half in number of the claims in that class that actually vote on the plan. A plan can be approved if all impaired classes vote in favor of the plan, or if at least one impaired class votes in favor of the plan and the plan does not discriminate unfairly against any impaired non-consenting class, and is fair and equitable (for general unsecured creditors, this means that equity interest holders do not receive a distribution unless general unsecured creditors are paid in full).

Additionally, the court must find that a plan is feasible and in the best interests of creditors. To satisfy this feasibility standard, the debtor must demonstrate that it is not likely to fail after it emerges from bankruptcy and that projected cash flow is sufficient to satisfy the obligations under a plan. For the best interests of creditors test, a plan must provide each claim holder with more than it would receive or retain in a Chapter 7 liquidation.

Crypto Considerations in a Plan of Reorganization

The recent bankruptcy filings of Voyager Digital Holdings Inc. and Celsius Network LLC have raised many novel questions that must be addressed prior to the confirmation of any plan in those cases.

Likely one of the most important questions is ownership of crypto assets by account type. The differences between being a secured creditor, a general unsecured creditor, or a beneficial owner of crypto assets held in custody or trust by a debtor may be among the most important distinctions when discussing treatment under a bankruptcy plan. If customers are found to be the beneficial owners of crypto assets that a debtor merely holds in trust, then the debtor cannot distribute or use such assets under a plan of reorganization, and such assets would likely need to be turned over to customers well in advance of confirmation of a plan. If a customer is determined to have a valid and perfected security interest in crypto assets held by a debtor, then the customer must receive, at a minimum, the "indubitable equivalent" of such collateral under a plan, meaning the return of the collateral, a distribution no less than the value of the collateral, or a lien on the sale proceeds of such collateral. Being classified as a general unsecured creditor, together with a finding that customers' crypto assets in a debtor's possession are property of the estate, provides the least protection, as any plan of reorganization must provide general unsecured creditors no less than what they would receive in a hypothetical Chapter 7 bankruptcy liquidation, which can be as little as zero.

If the debtor is able to pay back its customers all or some of their claims under a plan, questions exist as to whether customers can be paid back in cash without impairing their claims. Also, if a plan provides for distributions in cash, instead of in-kind, there is a question as to whether the debtor can value the claims as of the petition date, the effective date of the plan, or the date when distributions are made; these dates can potentially be years apart and result in wildly different distribution percentages to customers based on the condition of the crypto market. Likewise, if a bankruptcy court applies the best interests test as of the date of the confirmation hearing, should the debtor be allowed to benefit from the appreciation of crypto assets? Or, in the inverse situation, if the value of crypto assets depreciates after a confirmation hearing, must a debtor amend its plan to provide for reduced distributions, or can it wait for crypto assets to appreciate in value? A customer-friendly plan structure could provide creditors with the option to elect a present or a future distribution.

Finally, with respect to feasibility, how much weight should the court give to customer trust of current management and any pending and potential governmental or other regulatory enforcement actions? In the Celsius bankruptcy cases, customers are alleging that current management, including the CEO, engaged in massive fraud prior to freezing customer accounts and filing bankruptcy petitions. Whether that is true or not, the court must determine if a plan relying on reorganization of business operations is feasible where a "run on the bank" is likely to follow confirmation. Additionally, if government entities assert that the debtor is violating applicable laws and cannot continue to operate, will the bankruptcy courts be at the forefront of determining the legality of crypto offerings (such as their status as securities) in various jurisdictions?

Lowenstein continues to monitor crypto bankruptcy cases and the entire crypto market for new developments, and will be publishing additional articles providing more detail on the novel issues arising in crypto bankruptcies.

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