Crypto Lender Celsius Network Bankruptcy: Want to get money out? Not much hope

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Bankruptcy of Celsius Network and Voyager raises questions about what happens to investors' money when a crypto exchange goes bankrupt.

Key Takeaways

- Crypto lenders Voyager Digital and Celsius Network filed for Chapter 11 bankruptcy proceedings after pausing account withdrawals.
- The collapse of these two companies raises questions about what happens to investors' moneywhen an exchange goes bankrupt.
- Traders expectingto recover their money from failed crypto exchanges anytime soon are very likely to end up disappointed, according to legal experts.

Crypto lenders Voyager Digital and Celsius filed for bankruptcy protection this month, leaving users' assets trapped inside their platforms. Both firms froze customer accounts after large withdrawals led to liquidity issues.

Celsius operated much like a bank, taking customer deposits and lending them out or making risky gambles on so-called decentralized finance products to generate high yields.

Voyager had a similar model. The company got caught up in the collapse of high-profile crypto hedge fund Three Arrows Capital, which itself went belly up after defaulting on a $661 million loan from Voyager.

Such interconnectedness has left the crypto market vulnerable to contagion, with major firms falling like dominoes as a plunge in token prices has unwound excessive leverage in the system.

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Behind Voyager Failure: How Crypto Broker Went Bankrupt Like a Bank?

Is my crypto secured?

Cryptocurrencies aren't regulated, meaning they don't offer people the same protections they would get with money held in a bank or shares in a brokerage firm.

For example, the U.S. Securities Investor Protection Corporation insures traders up to $500,000 in cash and securities if a member broker runs into financial difficulties.

The Federal Deposit Insurance Corporation, meanwhile, offers bank depositors protection of up to $250,000 if an insured lender fails.

There are similar schemes in place in the U.K. and European Union.

With no laws governing cryptoassets, there's no guarantee investors would be able to recoup their funds if an exchange were to freeze someone's account — or, worse yet, completely collapse.

"There isn't such a scheme like that at this point" for crypto, said Daniel Besikof, partner at Loeb & Loeb.

"It wouldn't surprise me if one happens down the line," he added. "This will ramp up calls for enhanced regulation."

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What happens if an exchange goes bankrupt?

For now, it's still not entirely clear. While there are examples of crypto firms filing for bankruptcy overseas — Mt. Gox in Japan, for example — such an event is unprecedented in the U.S.

Creditors of Mt. Gox, which went offline in 2014, are still waiting to get repaid billions of dollars' worth of the cryptocurrency.

The problem with centralized crypto platforms is they can mix different clients' funds together to make risky bets, according to Daniel Saval, a lawyer with Kobre & Kim. Such commingling may lead to a ruling that the assets are the property of the exchange, not users.

"Users may be surprised to learn that, in a bankruptcy scenario, the crypto and funds held in their accounts may not be considered their own property," Saval says.

"Exchanges will often pool different customers' crypto and funds together in the same storage wallet or account."

What happens to customers' funds in bankruptcy cases will depend a lot on the company's user agreement and how it used their assets, Besikof said.

Celsius' terms of use state that any funds deposited with the firm "may not be recoverable" in the event of bankruptcy. The firm filed for Chapter 11 protection last week, revealing a $1.2 billion hole in its balance sheet and owing users around $4.7 billion.

Celsius claims to have $167 million in cash on hand. But it's still not letting customers withdraw their funds, and hasn't offered clarity on when it will reopen withdrawals.

Voyager says its customers' dollars are kept in an FDIC-insured account at Metropolitan Commercial Bank in New York — however, this claim was contested by legal experts and the bank itself. The FDIC only offers protection of funds in the event of a bank's failure, not a crypto exchange.

For its part, Voyager says it's working through a "reconciliation and fraud prevention process" with its banking partner, after which users will be able to regain access to their cash.

Voyager also laid out a plan to reimburse users with crypto in their accounts, Voyager shares and the company's own token, as well as any debt recovered from Three Arrows Capital.

Both Celsius and Voyager hired Kirkland & Ellis, the prestigious law firm, to represent them in court.

"Investors holding crypto assets through Voyager Digital and now Celsius have been placed in a difficult position, with their accounts frozen, their lawsuits stayed and the value and timing of any recoveries unknown," Besikof said.

"There is a lot of work for them to do in bankruptcy court before these issues will be resolved."

Celsius and Voyager filed for what's known as Chapter 11, a form of bankruptcy protection that allows firms to restructure their debts. The aim is to ensure there's still a viable business by the end of the process.

There's a strong likelihood that Celsius and Voyager's users will be treated as "unsecured creditors," legal experts said, a categorization that puts them in the same bucket as a business' suppliers and contractors.

This means they would likely be at the back of a long queue of creditors lining up for a payout from the court proceedings — behind banks, employees and tax authorities.

In a May regulatory filing, Coinbase said its users would be treated as "general unsecured creditors" if it goes bankrupt.

“In general, most customers in cryptocurrency exchanges are unsecured creditors, so when an exchange collapses, secured creditors are paid back first, along with legal fees,” said Dustin Palmer, managing director at consulting firm Berkeley Research Group. “Customers will be paid last on a pro rata basis. In a typical bankruptcy, this is pennies on the dollar.”

“Customers will likely have to wait until the full bankruptcy process is complete before receiving remuneration, and bankruptcy usually lasts years,” Palmer added. “Lehman took years. Some Mt. Gox customers, for example, still haven’t received any remuneration.”

Saval added customer recoveries in bankruptcy proceedings “may be further diluted by other unsecured creditors such as vendors, lessors and litigation claimants.”

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How can I store and protect my crypto?

Investors can opt to move their crypto off an exchange into so-called “self-custody” wallets instead.

This is where someone is in charge of their private key, which is the secret password needed to access a crypto wallet.

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However, such a move comes with its own set of risks. If a cryptocurrency holder loses their private key, they may never be able to recover their funds.

There are countless examples of people who have lost hard drives or USB sticks containing millions of cryptocurrencies worth of money.

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