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Blockchain Bites: Celsius creditors feeling the heat over preference claims, A bridge too far? Cross-chain bridges under MiCA, US State Legislatures bizarrely seek to "ban" Central Bank Digital Currencies, Coinbase and SEC in legal stoush over Securities Law but agree Tokens aren't themselves securities

Michael Bacina, Steven Pettigrove, Tim Masters, Jake Huang, Luke Higgins, Luke Misthos and Kelly Kim of the Piper Alderman Blockchain Group bring you the latest legal, regulatory and project updates in Blockchain and Digital Law.

Celsius creditors feeling the heat over preference claims

Celsius, the crypto exchange and lending platform that went bankrupt 18 months ago, circulated a batch of notices to former customers late last week offering to resolve potential preference claims in the firm's bankruptcy. The move follows Celsius creditors' and the US Bankruptcy Court's approving Celsius' Reorganization Plan late last year.

Celsius has sent notices to customers who made net withdrawals from Celsius greater than USD$100,000 in the 90 days prior to the petition date – that is 13 July 2022 (i.e. creditors with Withdrawal Preference Exposure under the Reorganization Plan).

The notice gives customers three options:

1. either pay back 27.5% of their net withdrawals to settle any preference claims or avoidance actions (**clawbacks**), which Celsius may bring against them; or
2. obtain a court order ruling that the customer has no preference liability to Celsius; or
3. otherwise resolve their Withdrawal Preference Exposure with the Litigation Administrator after the Effective Date before receiving any distributions under the Plan.

Where a customer refuses to accept Celsius' offer, they may face clawback actions and other claims by Celsius and will not receive any initial distributions under the Reorg Plan. The bankruptcy administrators have also cautioned that:

> if the Debtors do not receive your WPE Settlement Payment by January 31, 2024, there is no guarantee that you will be able to settle your Withdrawal Preference Exposure and participate in the Account Holder Avoidance Action Settlement.

The deadline is fast approaching – if a customer chooses to make the settlement payment, they must file an electronic form through an online portal by **25 January 2024**, and then make the settlement payment by **31 January 2024**, the latter being the anticipated effective date of the Reorg Plan.

For those who accept the offer, the Celsius' bankruptcy advisors has previously projected recoveries of **67 cents** on the dollar depending the claim type.

Customer who reject the offer may need to rely on one of the various clawback defences under the US bankruptcy code,

which may be available depending on their individual circumstances.

As part of Celsius' Reorganization Plan, the US Bankruptcy Court has approved the firm's transition into a new bitcoin mining entity led by a creditor consortium. The plan also reportedly involves the distribution of USD$2 billion worth of Bitcoin and ETH to customers, along with shares in the newly established company.

Due to the fast-approaching offer deadline, customers and other creditors who have Withdrawal Preference Exposure must rapidly consider their options ensure they have monitored their emails used with their Celsius account, and seek urgent legal advice on the offer and the prospects of defending potential clawback actions by Celsius' Litigation Administrator.

Piper Alderman is presently advising a number of Australian Celsius customers on their options.

Written by J Huang, S Pettigrove and M Bacina

A bridge too far? Cross-chain bridges under MiCA

The EU's Markets in Crypto-assets Regulation (**MiCA** or **MiCAR**), one of the first comprehensive regulatory framework for crypto-assets, will come into force in 2024 across the EU. Since MiCA was introduced in its draft form, there has been ongoing debate on how the regime would impact different corners of the crypto world, for example, crypto exchanges, ICOs, stablecoins and decentralised finance (**DeFi**). Recently, the battlefield has been extended to another vital component of the crypto ecosystem: cross-chain bridges.

What are cross-chain bridges?

In brief, cross-chain bridges are software applications that enable transactions to occur between various blockchains by enabling the transfer of assets and information between blockchain networks.

Transferring digital assets between different blockchains can be beneficial for many reasons. For example, someone might want to transfer their Bitcoin to the Ethereum blockchain to use it on DeFi platforms, where they can potentially earn interest on their Bitcoin (in that case, wrapped Bitcoin or wBTC).

These so-called "cross-chain" or "bridge" protocols typically create synthetic crypto-assets called "bridged" or "wrapped token". Bridges require a person to transfer an underlying crypto-asset to the address of a centralised third party or a smart contract on the blockchain supporting that crypto-asset, which in turn issues, through a smart contract, a crypto-asset representing the underlying crypto-asset on a different blockchain (the wrapped token).

As the wrapped token purportedly is backed by the underlying crypto-asset on a 1:1 basis and can be redeemed for the underlying crypto-asset at any time, it is designed to be the economic equivalent of that asset.

In its Decentralised Finance Report, the International Organization of Securities Commissions (**IOSCO**) gave two prominent examples of how bridge protocols and wrapped tokens work:

- wBTC gives holders of BTC the ability to participate in DeFi protocols running on other blockchains, such as Ethereum, through a process that locks up their BTC holdings (for so long as the wBTC is outstanding) but does not require them to sell the tokens.
- Wrapped ether (**wETH**) is another token that is increasingly being used as, among other things, a bridge to Ethereum-compatible networks that enable faster and cheaper transaction execution (e.g., a Layer 2 network).

These bridged or wrapped tokens offer synthetic exposure to an underlying or reference crypto-asset, and are affected by events involving both the reference asset, including volatility, and the blockchain to which it is bridged.

Separately, there are tokens that are intended to offer same exposure to an underlying reference asset and are similar to traditional derivatives such as options, swaps, and more complex structured products.

What elements of cross-chain bridges may attract regulation under MiCA?

Around a dozen types of crypto-asset services are expressly regulated under MiCA. A typical cross-chain bridge may involve a number of them, for example, crypto-asset custody, issuance, and transfer.

Crypto custody

Crypto-asset custody is defined in MiCA as follows:

> Safekeeping or controlling, on behalf of third parties, crypto-assets or the means of access to such crypto-assets, where applicable in the form of private cryptographic keys.

Bridging protocols would appear to prima facie satisfy this definition where operated by a centralized intermediary.

Crypto issuance

As cross-chain protocols typically create synthetic crypto-assets (e.g. wBitcoin and wETH) on the destination chain, prima facie, they also involve crypto issuance.

However, the nature of any such issuance will need to be carefully considered. In general, the issuance of a crypto-asset is only regulated by MiCA where it is offered to the public or admitted to trading on a trading platform, except when the crypto-assets are of specific types, such as asset-referenced tokens (ARTs) and e-money tokens (EMTs). Issuers of ARTs and EMTs will be subject to certain reporting obligations.

Crypto transfer

MiCA defines crypto-asset transfer services as follow:

> Providing services of transfer, on behalf of a natural or legal person, of crypto-assets from one distributed ledger address or account to another

This broad definition is also a material consideration for cross-chain bridges that facilitate transfers between blockchains and, accordingly, from one distributed ledger address account to another.

However, the identity of the provider of the above-mentioned crypto-asset services is also important.

Possible exemption: full decentralisation?

MiCA's application to DeFi projects is currently uncertain and subject to ongoing consultation in the EU. Such uncertainties arise from Recital 22 of MiCA which indicates an intention not to regulate so-called "fully decentralised" projects. However, the notion of what it means to be "fully decentralised" does not have a fixed definition and is a matter of debate among industry experts.

Recital 22 of MiCA states:

> This Regulation should apply to natural and legal persons and certain other undertakings and to the crypto-asset services and activities performed, provided or controlled, directly or indirectly, by them, including when part of such activities or services is performed in a decentralised manner. Where crypto-asset services are provided in a **fully decentralised manner** without any intermediary, they should not fall within the scope of this Regulation.

(our emphasis)

Even if a cross chain protocol involves a crypto-asset service, MiCA's intention appears to be only to regulate that service if there is an identifiable crypto-asset service provider (**CASP**) which provides the relevant service – making a cross-chain protocol outside of MiCA's jurisdiction when it is fully decentralised and no CASP can be identified.

It is no easy task to rely on this exemption. Critics have pointed out that it is practically impossible for a project to be "fully decentralised" depending on how the term is defined, and also that decentralisation and disintermediation (which appear to be confused as the same thing in MiCA) are very different concepts.

In response, the European Security Markets Authority (**ESMA**) has released a consultation paper acknowledging the fact that DeFi can operate in a manner in which a person can access a blockchain or smart contract based application as a mere user of a tool or piece of technology, rather than through forming a contractual relationship as service provider and customer.

ESMA's approach seems somewhat at odds with recent IOSCO recommendations which asserted that DeFi is not sufficiently different to existing financial services and so should be addressed in broadly the same way.

The question of whether a particular suite of smart contracts is decentralised will remain subject to nuanced analysis. It is hoped that further clarity can be provided in the final MiCA regulations or guidance before MiCA comes into force in June 2024. We will watch this space closely.

Written by J Huang, S Pettigrove and M Bacina

US State Legislatures bizarrely seek to "ban" Central Bank Digital Currencies

State legislatures in the United States are oddly fighting back against the JUS Federal government's proposed introduction of a Central Bank Digital Currency (**CBDC**). Florida's Governor Ron DeSantis has recently sought to block the use of CBDCs in business money transactions by signing a bill to amend the state's Uniform Commercial Code (**UCC**).

The "ban", according to Mr DeSantis is to prevent government overreach and the transfer of power from individual consumers to a central authority. Mr DeSantis cited that a future government may be able to stop someone purchasing a gun or buying too much gasoline.

According to Carla Reyes, an assistant professor at Southern Methodist University's Dedman School of Law the "ban" seems to arise out of a misunderstanding of the UCC and how CBDCs operate.

They didn't ban anything…The law does exactly zero of the things that it says that it does.

In fact, the bill signed by Governor DeSantis does not provide any roadblock to CBDCs in Florida, as that is not within the power of the UCC.

According to legal scholar and teacher at University of Pennsylvania's Carey Law School Andrea Tosato, the UCC represents standards for basic transactions and give both parties in a transaction basic legal protections. The UCC, according to Ms Tosato, does not tell parties what they can or can't exchange, whether it is fiat or digital currency, and that this is the job of regulations or criminal codes.

Ms Tosato took issue with the Florida's definition of CBDC as something which is problematic, but also with the effect of the change.

> the rabbit hole and the craziness of what was done with this Florida bill…there is no light-bulb moment. It makes no sense.

At a press conference Governor DeSantis made his speech in front of a sign which read "Big Brother's Digital Dollar", indicating not only a distrust with the Federal Government's "control" over a CBDC, but also potential privacy implications.

This appears to be borne out of a fundamental understanding of CBDCs which are underpinned by a transparent and accessible blockchain. Further, other jurisdictions which have entered into the CBDC space, such as the United Kingdom with its 'Digital Pound', have emphasised the importance of baking in privacy and data protection.

According to legal scholars, Florida's amendment to the UCC has no power at law to ban CBDCs and if Congress eventually authorises a federal CBDC, this will override any state-based legislation.

Written by M Bacina and L Misthos

Coinbase and SEC in legal stoush over Securities Law…but agree Tokens aren't themselves securities

June 2023 saw the Securities and Exchange Commission (**SEC**) sue Coinbase , alleging breach of securities laws in 'operating its crypto asset trading platform as an unregistered national securities exchange, broker, and clearing agency'. The exchange was charged for unregistered sale and offering of its crypto asset staking program. Unsurprisingly, Coinbase filed a motion to dismiss the lawsuit in August.

In a 17 January 2024 hearing, US District Judge Katherine Polk Failla deliberated on these matters, focusing on the question of whether transactions in tokens traded on the platform involved an 'investment contract' and thus constituted securities. Despite diverging on this view, both parties agreed in court that the tokens themselves were not securities, echoing Judge Torres' famous ruling in the Ripple case, that XRP token is not in and of itself a "contract, transaction[,] or scheme".

On the question of whether an investment contract was established, the lawyers for the SEC submitted that when users purchase a token, they are 'investing into the network behind it' in hopes of sharing the gains of the ecosystem, as when the network's value rises, so does the token value. In making this point, they argued that the tokens are inseparable by nature from its ecosystem,

> The token is the key that gets you into the ecosystem. The token is worthless without the ecosystem.

However, Coinbase argued that there were only secondary-market transactions with no contracts involved and for an 'investment contract' to be established, there needs to be a statement conveying 'an enforceable promise'. They clarified that the purchasers were not signing contracts or entitled to the proceeds of a common enterprise in buying tokens over a secondary market such as Coinbase's platform.

During the hearing, Justice Failla acknowledged SEC's previous crypto cases, in particular SEC's loss against Ripple Labs and the regulator's win in the Terraform Labs case. However, she distinguished the present case from the Terraform's case, stating that the case involves 'quite different' facts, as Terraform did not concern tokens being listed on a secondary exchange.

Ultimately, after 14 pages of questions and over 4 hours of deliberation, Justice Failla opted not to make a decision from the bench, with an eventual decision anticipated in the coming weeks. While her position is unclear yet, Justice Failla reflected hesitance during the hearing that the SEC was asking her to effectively:

broaden the definition of what constitutes a security.

All eyes are on the outcome of this case, as it will be informative in clarifying the SEC's jurisdiction over the crypto sector.

Written by T Masters and K Kim