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What Happens If Crypto Exchanges Such as Celsius or Coinbase Goes Bankrupt?

Celsius Prepares for Potential Bankruptcy

“Banks are not your friends,” said Alex Mashinsky, founder and CEO of Celsius, one of the largest crypto lending platforms.

On June 12th, his company surprised customers when it unexpectedly announced it was pausing all withdrawals, swaps, and transfers between accounts due to extreme market conditions.

For reference, this year, Bitcoin has lost more than half of its value and another popular cryptocurrency Ether has fallen around 70%.

Celsius decision to freeze customer accounts has rippled across the cryptocurrency industry. Shortly after its announcement, another Asia-based crypto lender called Babel Finance announced that it is also suspending withdrawals.

What Will Happen If Crypto Exchanges Such as Celsius or Coinbase Goes Bankrupt?

Unlike banks, which are FDIC insured, crypto lenders like Celsius lack the legal protections that are built into the traditional financial system. And as the crypto market continues to tumble, many users of Celsius and the exchange Coinbase are beginning to wonder, "If these crypto platforms go bankrupt, what happens to my assets?"

Celsius is one of dozens of unregulated lenders and lending platforms that have emerged in recent years, cutting high returns to investors who are willing to lend their digital assets. Celsius promised customers annual percentage yields as high as 18.6%. That's a lot more than customers can get from regular bank accounts today.

How Does It work?

Customers deposit their cryptocurrency in the Celsius system in exchange for a yield. This is essentially an unsecured loan. And in order to earn a return, the company lends out assets to other users and puts customer deposits in often high yield, high risk decentralized finance investments.

When the system is working correctly, Celsius says that customers can expect approval for their withdrawals within 24 hours. But as cryptocurrency prices continued to fall, customers started to withdraw at a rate Celsius couldn't keep up with. Celsius does not have enough liquidity, meaning readily spendable cryptocurrency on hand to hand back to the customers.

The company has since hired restructuring lawyers to advise on possible solutions for its mounting financial problems. One of the financing options included a financial restructuring, meaning that the company could potentially file for bankruptcy. And if that happens, users could face big losses.

According to Celsius's terms of use, users that deposit assets in the earn service grant the company "all right and title to such eligible digital assets, including ownership rights." That document also calls out bankruptcy explicitly, saying, "In the event that Celsius becomes bankrupt, enters liquidation, or is otherwise unable to repay its obligations, any eligible digital assets used in the earn service or as collateral under the borrow service may not be recoverable." You will likely not see a line like this in a user agreement for a bank, since most banks are FDIC insured.

So what does that mean for users? Based on Celsius' terms of use, in the event of a bankruptcy, customer who deposited cryptocurrencies into Celsius accounts may not be able to get their money back because they would be considered essentially unsecured creditors and even if they were to file for lawsuits against Celsius, they might not have a great chance of winning that legal action.

Coinbase's Bankruptcy Disclosure And Layoff

Similarly, the exchange Coinbase addressed bankruptcy in its quarterly filings, adding a disclosure based on SEC accounting guidelines released in March.

Coinbase made the disclosure that in the event of a bankruptcy, the digital assets that Coinbase holds for its customers may not really belong to the customers. Coinbase noted that the new language in its financial report could lead customers to view its service as "more risky and less attractive." Coinbase CEO Brian Armstrong has come out and said that the likelihood of the company going bankrupt is extremely low and the company is in very good financial conditions, but he made the disclosure just for the purpose of transparency.

Nearly one month after the bankruptcy disclosure, on June 14th, Coinbase announced it was laying off around 18% of its workforce. Armstrong said the decision was made to ensure Coinbase's health during this economic downturn.

But if a crypto platform like Celsius or Coinbase were to go bankrupt, it wouldn't be the first to go under in that way.

In 2014, Mt. Gox, then the largest crypto asset platform worldwide, filed for bankruptcy before ultimately filing for liquidation later that year. The collapse of crypto exchange Mt. Gox back in 2014 also rippled across the industry. It caused the price of Bitcoin to plummet and brought about, so to speak, one of the first crypto winters in the industry. A rehabilitation plan for affected Mt. Gox's users was not confirmed until last fall.

Challenges Ahead

Cryptocurrency as an industry still lacks comparable regulation and protection to traditional financial institutions, but a recent bill looks to change that.

Senators Cynthia Lummis and Kirsten Gillibrand proposed a bipartisan crypto bill that the Responsible Financial Innovation Act, which aims to provide a comprehensive regulatory framework for the crypto industry. While the bill was released around the same time that Coinbase made its bankruptcy disclosure, it is not in direct response to the platform’s announcement. The bill is not expected to pass and other lawmakers have not signed on to it.

As for Celsius, the company is under investigation. The Texas State Securities Board said it has opened an investigation into Celsius over its decision to freeze customer accounts and is working in conjunction with New Jersey, Kentucky, Alabama, and Washington.