

The Coming Storm: DeFi and Bankruptcy Courts

BLOCKCHAIN AND DIGITAL CURRENCY | CRYPTO INSOLVENCY AND FIDUCIARY PRACTICE |
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DeFi or “decentralized finance” is an emerging branch of the cryptocurrency and blockchain movement that attempts to use smart contracts and blockchains to provide financial services typically only available from centralized regulated businesses. The most popular DeFi platforms provide a variety of financial services and products including lending, interest rate arbitrages, or access to products and services involving cryptocurrencies. Instead of traditional third-party intermediaries, users of these DeFi systems interact with smart contracts to obtain services and products.

Users of these systems generally do not enter into binding legally enforceable agreements with any service provider. Instead, DeFi systems rely on the operation of smart contracts governed by hard-coded rules that transform, escrow, or enable access to new assets. Smart contracts are mechanisms encoded in hardware and software systems that bind parties to, and automatically enforce the terms of, an agreement. DeFi systems place technology in the position of the typical counterparty and decentralize the power to control and modify those technology systems. Thus, it may be unclear who, if anyone, is providing the services or products to the user.

This decentralized governance approach has been problematic in situations in which the code has executed in ways not anticipated or where governance mechanisms controlling that code were not able to quickly and effectively address unexpected smart contract conduct. However, some DeFi systems have achieved sufficiently high levels of functionality that they are now widely used. Indeed, DeFi systems now control almost \$1 billion worth of assets.

The lack of a documented legal relationship between users of DeFi technology and a counterparty may pose a challenge if that user seeks protection from creditors by filing a petition for relief under the U.S. Bankruptcy Code. A bankruptcy court may question whether transactions of assets into DeFi systems are bona fide transactions for value. The lack of a legal agreement may be problematic. Although DeFi systems may be structured to mimic familiar legal relationships, like lender or escrow agent, most of these platforms will fail to adhere to the formalities necessary to legally establish that a given DeFi system has created an enforceable loan or is holding an asset as legal collateral to secure a promise. This may complicate a court’s consideration of users who have transferred the control of assets to DeFi systems, and claims related to them.

When confronted with a transfer of an asset of value into a DeFi system, a court may take one of a few different positions.

First, a court may imply a contract based on conduct. This would require the court to identify a counterparty who is liable for a DeFi system’s operation. A court may also view a DeFi transaction as an improper transfer for no consideration and potentially allow a trustee or debtor in possession to attempt to claw back any assets transferred. This again would require the court to identify a counterparty against which to act. Finally, a court may view these relationships to be unenforceable because they fail to adhere to the formalities necessary to be enforceable under relevant state law, such as the writing requirement that may be imposed by the state statute of frauds, or requirements that documents be witnessed or recorded to be enforceable.

Regardless of whether participation in a DeFi scheme created a legal contract, court orders generally cannot act directly against smart contract code. Thus, any court order would need to identify and act against a legally cognizable party. In many cases, courts may seek to hold accountable the creators of the DeFi smart contracts, operators of those smart contracts, and the parties who benefit from their operation. In at least one case, regulators have identified code deployers and parties with

power to control the function of smart contract code as responsible for its conduct. In another analogous case involving different facts, in this case the decentralized file-sharing system Grokster, a court found that it was difficult, if not impossible, to hold a broadly distributed group of individuals liable, and instead held the central coordinating entity liable.

To date, no bankruptcy court has opined on any DeFi system. If you are concerned about the legal implications of your participation in a DeFi system, or are concerned about claims that you may have against someone using DeFi systems, contact Carlton Fields' Crypto Insolvency and Fiduciary Practice.

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