Not your keys, not your coins

How safe are customers' crypto assets in the insolvency of their crypto custodian?

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The bankruptcy of the crypto exchange *FTX* is a dramatic turn of events for the blockchain world and has further damaged confidence in the crypto market. Not only institutional investors have been affected. Many casual investors have also lost their savings on the collapsing exchange. The FTX bankruptcy is not an isolated case. For example, the Australian crypto exchange *My Crypto Wallet* collapsed in 2021. The crypto bank *Celisius* and the crypto custodian *Nuri* (formerly *Bitwala*) have been insolvent since 2022. The financial woes of *BlockFi* (a crypto bank) as well as *Genesis* (a crypto broker) are an open secret in the crypto community.

The importance of crypto exchanges for the financial markets is evident by taking a look at the comparison site *coinmarketcap*. More than 500 international crypto exchanges are listed there. The most important Austrian-based exchange is *bitpanda*. In the absence of specific regulations in Austria, domestic crypto investors face legal uncertainties with respect to the insolvency of their crypto custodian. Special provisions, such as for the custody of securities under the Austrian Securities Account Act (*Depotgesetz*), are not directly applicable. For crypto investors, the question therefore arises: *what is the best way to avoid a total loss of my crypto assets?*

Not your keys, not your coins

According to the crypto aphorism "not your keys not your coins", the answer seems quite simple at first glance: if you use your *own desktop or hardware wallet*, which is independent of any crypto exchange, to store your coins, you have nothing further to do with the insolvency of the crypto exchange. In practice, however, crypto investors often lack the know-how and interest to set up their own provider-independent wallet. Instead, they leave their crypto assets on the exchange. For them, it is important to take a closer look at the contractual provisions of their account, especially whether ownership of the crypto assets has been acquired at all and how they are held in custody.

Right to segregation of crypto assets

According to Austrian insolvency law, (only) the entire assets of the debtor (insolvency estate) serve to satisfy its creditors. Assets which are not owned by the debtor shall, in principle, not form part of the insolvency estate. Rather, assets that do not belong to the insolvency estate must be handed over to the actual owners or other beneficiaries. The latter have a *right of segregation* and can withdraw their assets from the insolvency proceedings, e.g. from their insolvent custodian, by means of an action for segregation.

Whether crypto investors also benefit from a right to segregation in the domestic insolvency of their crypto custodian is not yet clearly answered in legal literature; and there is no established case law. However, there are good arguments in favour of this.

The object of the segregation is property not belonging to the insolvency estate within the meaning of § 285 ABGB. The fact that crypto-assets fall under the broad concept of property of the ABGB corresponds to the unanimous opinion in the legal literature. A further prerequisite for the existence of a right to segregation is that the crypto-assets can be assigned to a person other than the insolvent crypto-custodian, namely the respective crypto-investor, in a sufficiently determined manner. This will regularly be the case if the crypto-investor is the owner of the coins and can also clearly prove this.

To assess the acquisition of ownership, it is worth taking a look at the contract with the crypto custodian. In practice, structures are often found according to which crypto investors do not acquire ownership (or similar rights), but only a claim to value under the law of obligations against the crypto custodian. The custodian itself remains entitled to dispose of the crypto assets. In such cases, crypto investors will typically not be entitled to a right to separate satisfaction, but merely to an insolvency claim to be satisfied on a pro rata basis.

Private key - key to the crypto treasure

If the crypto-investor is the owner of the crypto-assets, the *private key* serves as evidence. While the *public key* is a public address for the allocation of the crypto-values in the blockchain to specific wallets, the *private key* conveys the actual power of disposal over them. Anyone who knows, holds and is allowed to use the secret *private key* has *de facto* access to the crypto-values, can exclude other users from disposing of them and can ultimately be regarded as the rightful owner of the crypto-values.

Even if a crypto investor does not know the *private key*, for example because his/her crypto custodian only provides a user interface for managing the crypto assets that can be operated by means of login data, he/she can still be entitled to segregation. As long as it is clear that the assets are kept in a separate wallet from the crypto assets of other investors or the crypto custodian, the crypto investor's right to segregation can be determined without further difficulty.

Caution with omnibus accounts

Investors should be cautious when the crypto assets of a crypto custodian's clients (including its own) are pooled via one or more blockchain addresses in an *omnibus wallet*. In such a constellation, the assets do not belong to the crypto investors but are rather only allocated to the crypto custodian. Whether the lack of asset segregation stands in the way of a right to segregation is a question of the design of the respective *omnibus wallet*. In the worst case, the crypto assets would be lost, and the crypto investors would have to settle for an insolvency claim.

Conclusion

Having one's own wallet for crypto assets grants the greatest protection, as one is independent of the crypto custodian and its insolvency risk. Since the protection of crypto investors in the insolvency of a crypto custodian depends to a large extent on the specific disposal and custody structure, it is advisable in all cases to study the provisions of the contract with the crypto custodian carefully and also to read the fine print. This applies all the more in the case of *omnibus wallets*.

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