Crypto as Kryptonite: The Great Meltdown of 2022

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"It's like déjà vu all over again."
— Yogi Berra

I'm a creature of habit, to be sure. It wouldn't be the holidays without talking about a classic holiday movie: Frank Capra's 1946 classic *It's a Wonderful Life.* It's the story of George Bailey, who inherits the Bailey Building & Loan Association founded by his father in the 1940s, and who forgoes his dreams of traveling the world to instead help the multicultural residents of fictional Bedford Falls, N.Y., realize the dream of home ownership.

What does any of this have to do with the recent, dizzying crash of many crypto exchanges and the resulting staggering loss of value of this phantom currency? If there's any maxim that stands the test of time for me in 40 years of law practice, it is that history will repeat itself; the vignettes that flash across the economic landscape will just take different forms.

Let's Get Back to George Bailey and the Savings and Loan Industry

Savings and Loan Associations (S&Ls) started in 1831 as a way to help people buy their own homes when credit from traditional banks was unavailable.[1] Before 1980, S&Ls had been regulated financial institutions that had one primary purpose: financing home mortgages using depositor money. In this regard, S&Ls were like "special-purpose banks**"** (a.k.a. "thrifts") with a simple, quaint business model: Take in deposits, pay low interest rates to depositors, and lend out the deposited money at somewhat higher interest rates secured by residences, all for purposes of making a profit for the S&L.

This business model is nicely summarized by a great scene in *It's a Wonderful Life*. Jimmy Stewart, as only he can, in trying to dissuade panicked depositors from demanding their deposits back and trigger a "run on the bank," eloquently sets out the premise behind S&Ls:

> [B]ut you ... you ... you're thinking of this place all wrong. As if I had [your] money back in a safe. The, the money's not here. Well, your money's in Joe's house ... that's right next to yours … and in the Kennedy House, and Mrs. Macklin's house, and, and a hundred others. Why, *you're* lending them the money to build, and then they're going to pay it back to you as best they can. [2]

[1] As stated by George Bailey in admonishing Mr. Potter (the town's rich, greedy banker) and pointing out the differences between a traditional bank and an S&L. Mr. Potter says, "Now, you take this loan here to Ernie Bishop ... you know, that fellow that sits around all day on his brains in his taxi, you know. I happen to know the bank turned down this loan, but he comes here, and we're building him a house worth five thousand dollars." To which George Bailey replies, "Just remember this, Mr. Potter, that this rabble you're talking about ... they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath? Anyway, my father didn't think so.... He didn't save enough money to send Harry to school, let alone me. But he did help a few people get out of your slums, Mr. Potter." *It's a Wonderful Life* (1946).

[2] *It's a Wonderful Life* (1946). The monologue's next line has George Bailey asking what the depositors would have him do — foreclose on the home loans? The answer today would likely be a resounding "yes." Neighbors or not, time is money!

Enter Deregulation!

Prior to 1980, there were many regulations of the S&L industry that effectively limited what they could invest depositor money in. S&Ls were under FSLIC oversight. Overall, the business model was pretty rock-solid: home loans secured by real estate. What could go wrong? In the late 1970s, rampant inflation led to "asset/liability mismatches" — *i.e.,* S&Ls had long-term, fixed-rate home mortgage assets when inflation was eating up what small profits there were in these loans. Politicians then came to the rescue.

In March 1980, Congress deregulated S&Ls and allowed them to expand their portfolios.[3] This resulted in a number of major changes. S&Ls were now allowed to invest in non-home-based mortgage types of assets, with fewer FSLIC restrictions than traditional banks dealt with. Not surprisingly, S&Ls started investing in anything and everything to increase profits to remedy the asset/liability mismatches on their balance sheets. Of course, to generate higher returns (and outpace inflation, which continued into the 1980s), higher investment risks were undertaken.

In the pursuit of profits (and strong balance sheets), S&Ls turned to all sorts of interesting investments such as brokered deposits, but they didn't leave their foundation of real estate lending. S&Ls just got very aggressive in what they lent against. For example, S&Ls would lend 120% of the purchase price of real estate assets (at high interest rates). The interest reserve was put into escrow from the loan and used to pay interest current until the property could be sold (at a huge increase in value brought on by inflation, of course). Credit-checks just got easier, for sure! Everyone's happy! After all, real estate will always appreciate in value, so what could go wrong?[4]

I Never Saw This One Coming!

The deregulation of S&Ls resulted in the collapse of S&Ls nationwide between 1986 and 1991. The collapse was precipitated by many things, but certainly key was continued inflation, and a real estate crisis that was fueled (perhaps ironically) in some respects by the contrived valuations of real estate by the S&Ls' lending practices.

By 1990, the feds had bailed out more than a third of the nation's S&Ls for a total price tag of about $160 billion, of which about $132 billion came from taxpayers.[5] Of course, the U.S. government reversed all the deregulation of 1980 in response, and in 1989 it passed the Financial Institution Reform Recovery and Enforcement Act of 1989 (FIRREA). FIRREA abolished the FSLIC (and other agencies) and created the Resolution Trust Company, which would go on to sue former S&L officers and directors, lawyers and accountants for numerous years after the collapse.

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[3] *See* Depository Institution Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutional Act of 1982.

[4] My personal favorite was "trading sick cats for sick dogs." This was a four-step dance that went something like this: (1) The S&L would lend 120% against a property to allow for its acquisition; (2) when the loan came due (interest would be current because of interest reserve), default loomed, as the owner didn't have the money to pay it off; (3) the S&L would facilitate the property's acquisition by a new buyer at 140%, thereby paying themselves off and creating a new interest reserve (and having the S&L book the loan on its balance sheet as a new, higher loan); and (4) repeat as needed. Not surprisingly, this led to artificial appreciation in real estate values, as these "sales" would show that the property was appreciating in value based on the new sale.

[5] *See* Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements, U.S. General Accounting Office, at pp. 8, 13 (July 1996). In total, of the existing 3,200 S&Ls in the U.S., more than 1,300 were ultimately closed, with depositors making claims.

What Exactly Is Cryptocurrency?

Let's get back to cryptocurrency. Bitcoin started the whole cryptocurrency (crypto) craze in 2009, and as of March 2022 there were more than 9,000 cryptocurrencies in the marketplace. (The author just launched "TommyCoins"™, so watch for those.) Any 12-year-old can give a better explanation than the author as to the "mining" process used to create these units of currency, but it takes a lot of Red Bull and computing power, and quite a bit of energy, to go through this process.[6]

What Is the Total Market Value of Crypto?

This is, of course, a hard number to pin down, as cryptocurrencies are highly volatile. Billions in value can (and has been lost) lost in a week's time. As the popularity of crypto increased, holders of crypto wanted/needed exchanges to facilitate transfers between holders (buying, selling, etc.), so large exchanges were created (where there's a need, there's a new industry).

What Exactly Is Crypto?

Of course, this depends on whom you ask. It is either "the future," or the equivalent of "pet rocks."[7] Technically, it is classified as both a currency and a commodities security. As a currency, it is premised on three defining characteristics:

1. **It exists only in digital form** (electronic debits and credits in highly encrypted digital wallets that can only be accessed by the holder). Actual shiny Bitcoins are just for show. If you forget your passcode to access your digital wallet, you are out of luck!
2. **The system is completely decentralized.** There is no FDIC, Federal Reserve or other government oversight. Of course, there is no government guarantee of accounts, either.[8]
3. **Given the digital wallet concept, it is intended to be secret** (known to the holder only). How much is in your digital wallet is known only by the holder and his/her God.[9]

So — Let's Talk About the Crypto Bankruptcy Craze

Everyone is aware of the spectacular crashes of FTX and BlockFi within one week of each other. Regarding FTX, it looks like there will be approximately $45 billion in claims at issue (based on what account-holders once thought they had). FTX is perhaps the most spectacular, given the 30-somethings living in penthouses in the Bahamas doing press conferences in sweatpants and Birkenstocks, but it isn't the first meltdown. Mt. Gox was also a crypto exchange, and it went belly-up in 2014. It didn't get the same press, however, because crypto wasn't as widespread back then, and Mt. Gox was based in Japan.[10] The folks running

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[6] The mining process requires expensive (and power-consuming) computer arrays (called "mining rigs"), many of which are financed. With the crypto crash, many of these miners are simply returning the "rigs" to the lenders. *See* "Cryptominers Unable to Repay Millions in Loans Are Handing Over Their Mining Rigs Instead," *Techspot* (Dec. 7, 2022) (reporting that the computer arrays have lost 85% of their value since last November). Just what the lenders need: used computer equipment.

[7] *See* "'Why Do We Allow This Stuff?' Jamie Dimon Says Investing in Crypto Tokens Is Like Buying 'Pet Rocks,'" *Fortune* (Dec. 7, 2022).

[8] Of course, this feature is also what makes it the currency of choice for criminals, terrorists and money-launderers worldwide. *Id.*

[9] *Id.*

[10] Mt. Gox was a Bitcoin exchange launched in 2010, and it was handling about 70% of all Bitcoin exchanges in the world at the time. Allegations of malfeasance (loss/theft of millions in Bitcoin) surfaced, leading to the suspension of trading at Mt. Gox and its eventual liquidation proceedings in 2014.

these things today remind the author of the young and brash investment banker "masters of the universe" who ruled the junk bond craze days in the 1980s: smarter than everyone, and most definitely very wealthy.

What Are These Bankruptcies?

They are exchanges (for a fee, of course) for transfers of crypto, where at least the exchange knows who has how much in their digital wallets. But like the S&Ls of years gone by, with fees for transfers growing to astronomical amounts, the founders got bored and greedy.

Surely there was more to be made from this new world of currency. They had access to huge amounts of a type of currency, in an environment with little to no regulation, and the value of this currency was certain to simply continue to grow.

Surely there was more to be made here than merely collecting fees. As the value of crypto would always continue to grow, using some crypto deposits to invest in or lend to others (thereby reaping untold millions in additional returns) would be a good use of assets trusted to the exchanges.

Hence, a new generation of George Baileys was born! It was, in all respects, a perfect storm.

So Exchanges Diversified

FTX started in 2019 with over a million "customers." FTX was spawned by an investment and trading house called Alameda Research (the CEO of which is the former girlfriend of Sam Bankman-Fried, known now as "SBF"). Alameda is a trading firm and essentially started borrowing from FTX's accounts to make other investments, so FTX/Alameda were leveraging the digital wallets of FTX's customers' crypto deposits.[11] FTX was also making loans to other crypto exchanges (including BlockFi, whose chapter 11 was a direct result of the FTX filing).

A run on the digital bank started in September 2022, which was precipitated by a number of investigations that started popping up — including by the SEC (saying FTX was selling unregistered securities) and the FDIC (for misrepresentations that somehow FTX accounts were covered by depositor insurance-like bank accounts). The CFTC also started an investigation (because crypto is a type of commodities security). A couple of states also piled on.

Some planned acquisition and divestiture deals cratered, which caused a panic among FTX's customers and a demand for the return of their "deposits." The former CEO (SBF, the son of two Stanford professors) resigned and is most likely going to face criminal charges. He wisely just retained high-profile criminal counsel. He also is addicted to Twitter and keeps sending damning tweets every few minutes (all of which should be labeled Exhibit 1, Exhibit 2, etc.). Mr. Bankman-Fried also has been on a public apology speaking tour (much to the chagrin of his lawyers) explaining how in hindsight perhaps he should have followed these transfers more closely — essentially admitting, "My bad."

The Chapter 11 Came a Few Weeks Ago

[11] Alameda was investing in such things as SpaceX and a variety of crypto tokens such as HOLE (whose asset — no joke — is a product called "Super Black Hole"), Polygon and NEAR. Alameda also was investing in equity positions such as Bitcoin-mining firms (*e.g.,* Genesis Digital) and the now-bankrupt Voyager Digital. *See* Throuvalas, "Here's Alameda's Investment Portfolio: WSJ Report," *Cryptopotato* (Dec. 6, 2022).

There's a competing receivership in the Bahamas (the HQ of FTX). The CRO is John Ray — a lawyer who ultimately helped unwind and figure out the Enron debacle. Ray publicly stated that in his 40 years of being a bankruptcy lawyer, he has never seen a company handle so much in value with so few controls. It was like eighth-graders taking over a classroom.

Other than the "toys" that were the executive perks (lavish homes, cars, penthouses in the Bahamas, etc.), what assets are there to be liquidated to repay depositor claims? Therein lies the rub. There is simply no "there" there. Crypto only has value to the extent that other crypto holders agree that it does. While to an extent this is true of all fiat currency (such as the dollar), crypto does not have the full faith and credit of any government backing it up. There are no skid marks when this car hits the wall.

The *Celsius Network* crypto exchange chapter 11 pending in the SDNY is now deciding whether depositors even own their crypto deposits, or whether they are merely creditors of the exchange. If depositors don't own their deposits, can they be sold, with claimants getting *pro rata* shares of the proceeds after payment of the likely huge administrative expenses?

Regardless of actual ownership, trying to sell what crypto deposits remain to a market already skittish will lead undeniably to the freefall devaluation of this currency, adding insult to injury to those claimants of these failed crypto exchanges. The loss in value in this volatile market has been immediate. November 2022 saw a seven-day realized loss of more than $10 billion in Bitcoin investments as investors were forced to exit long-term positions. This was the fourth-largest loss on record.[12] In the words of one investment advisor, "This is not the winter season anymore; this is a bloodbath, because the FTX crisis was like a domino that toppled so many companies."[13]

So — Let's Bring This Full Circle from Where We Started

In closing, I submit two points:

1. **What does this have to do with the S&L meltdown of more than 20 years ago?** The crypto exchanges are like S&Ls on steroids: no regulation, and aggressive and brash entrepreneurs with access to tons of capital. This has been a bad witches' brew, and we are seeing the foreseeable consequences play out in real time. Like the S&L collapse, lawsuits against officers, directors, lawyers and accountants have already started and will be on the courts' dockets until the next meltdown of the latest tulip bulb craze.[14]
2. **The three defining characteristics that drew crypto holders to it will now be its downfall:**
    a. *Decentralization:* It is highly unlikely that crypto markets will remain decentralized. The bright light of truth has shone on them, and what has been revealed as the real consequences as far as lack of oversight can never be unseen. Expect a new federal alphabet agency to be born — the Crypto Oversight Financial Authority (COFA) or something like that, like a Federal Reserve or FDIC for cryptocurrency.

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[12] "Cryptoverse: Forget Crypto Winter; This Is a Bitcoin Bloodbath," *Reuters* (Dec. 6, 2022) ("Cryptoverse Article").

[13] Cryptoverse Article, quoting Linda Obi, a crypto investor for blockchain firm Zenith Chain. To be fair, losses in crypto are really nothing new (although the sheer magnitude of the current crisis dwarfs the losses in the past). A study from the Bank of International Settlements estimated that between 2015-2022, 73%-80% of retail investors lost money in crypto investments. *Id.*

[14] *See, e.g.,* "FTX's Auditors Face Class Action over Crypto Co.'s Collapse," *Law360* (Dec. 5, 2022).

b. *Lack of Regulation:* These meltdowns will most assuredly lead to stringent regulations in this industry.[15] Politicians simply can't ignore this, because these losses are affecting Main Street, not just Wall Street. In the words of Charley Cooper from blockchain technology firm R3, "Politicians have a lot harder time ignoring calls from constituents that lost their savings or grocery money than from high-flying crypto hedge funds."[16] There were already concerns about the lack of regulations as enabling end users to skirt around money-laundering and tax laws. Congressional hearings should start right after the last Constitutional existential fires have been tamped down. After the S&L meltdown, S&Ls as quaint business models were effectively regulated out of business. The same regulated future awaits the crypto industry.

c. *Secrecy:* Another of the reasons people flocked to crypto was its secrecy. Laundering currency had never been easier! For obvious reasons, crypto was the preferred currency of criminals and terrorists the world over. Despite what customers of these exchanges thought, in fact their identities and ultimate holdings are not secret at all. They are (or will be) all listed as creditors in the bankruptcy cases (surprise!). While some information will be redacted, they are known and ultimately will have to file claims to identify precisely what they held in their digital wallets.[17]

It's a brave new world, folks. Just listen to Matt Damon in the commercials.

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[15] *See, e.g.* "Cryptocurrency Regulations Around The World", *Investopedia* (November 30, 2022) ("The U.S. announced a new framework in 2022 that opened the door to further regulation. The new directive has handed power to existing market regulators such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)").

[16] "Cryptoverse: Forget Crypto Winter This Is A Bitcoin Bloodbath), *Reuters* (December 6, 2022).

[17] There are interesting potential tax issues for holders of crypto who have not reported what they thought were untraceable or secret gains in trading crypto. The information that will be made public in these bankruptcies will be a potential resource for the IRS to start connecting dots! Something for those thousands of new IRS agents to do!