Feature

By Alan Rosenberg

The Cryptocurrency Craze
How to Treat Bitcoins in Fraudulent-Transfer Litigation

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Bitcoins: Are they the next big thing, or a modern-day repeat of "tulip mania"?[1] While cash remains king of the bankruptcy realm, the rapid increase in the use and consumption of bitcoins is undeniable. Given the volatility of the bitcoin market, it is entirely possible that a large fluctuation in the value of bitcoins could cause a surge in bitcoin-related bankruptcy filings. These "bitcoin bankruptcies" will require bankruptcy trustees to scrutinize an array of bitcoin transactions.

Inevitably, this heightened scrutiny will increase bitcoin-related fraudulent-transfer litigation. However, given their relative novelty, most bankruptcy courts have not had an opportunity to hear fraudulent-transfer cases involving bitcoins. So how does one treat bitcoins in fraudulent-transfer cases?

A Bit About Bitcoin

Bitcoin[2] "is the first decentralized peer-to-peer payment network that is powered by its users with no central authority or middlemen."[3] Users of the Bitcoin network use "bitcoins," a type of digital currency, or "cryptocurrency."[4] In contrast to traditional forms of currency, "bitcoins are not issued by a government or central banking authority,"[5] but instead "are created by 'mining,' a process where 'miners' receive transaction fees and newly minted bitcoins in return for verifying and recording payments in a public ledger."[6] More specifically:

Bitcoin miners are incentivized to process payment transactions by allowing miners to create new Bitcoins for themselves based on the number of "blocks" discovered. Blocks are files containing data regarding Bitcoin transactions that have yet to be recorded in the public ledger, and are discovered by calculating a SHA256 hash, an algorithm that is very difficult to solve, over and over again until the miner finds an input that matches an expected output.[7]

Bitcoin utilizes a public ledger called the "block chain,"[8] which "keeps track of every bitcoin created and who owns it."[9] Using a mobile application or computer program, each user's bitcoins are stored in their own "digital wallet," where they can only be accessed by entering a 64-character alphanumeric "private key," which is somewhat like a banking password.[10] However, unlike a banking password, a user who misplaces this private key will lose access to his/her bitcoins forever because there is no method for recovering a lost private key.[11] Losing a private key is analogous to removing money from circulation.[12]

Bitcoins and Avoidance Claims

Subject to certain exceptions, property of a bankruptcy estate includes all legal or equitable interests of a debtor.[13] Thus, bitcoins are considered property of a debtor's bankruptcy estate if owned on the petition date. A debtor's pre-petition transfer

1 Andrew Beattie, "Market Crashes: The Tulip and Bulb Craze (1630's)," *Investopedia, available at* investopedia.com/features/crashes/crashes2.asp (describing financial phenomena in Holland in the 1630s where the "prices [of tulip bulbs] were rising so fast and high that people were trading their land, life savings, and anything else they could liquidate to get more tulip bulbs") (unless otherwise specified, all links in this article were last visited on Nov. 16, 2017).
2 In this article, "Bitcoin" refers to the entire Bitcoin payment network, while "bitcoin" refers to the payment units utilized on the Bitcoin network.
3 "What Is Bitcoin?," Bitcoin, *available at* bitcoin.org/en/faq#what-is-bitcoin.
4 "Who Created Bitcoin?," Bitcoin, *available at* bitcoin.org/en/faq#who-created-bitcoin. *See also Alexander v. BF Labs Inc.*, CV 14-2159-KHV, 2016 WL 5243412, at *1 (D. Kan. Sept. 22, 2016).
5 *Alexander v. BF Labs Inc.*, 2016 WL 5243412, at *1.
6 *Id.*

7 *Id.* at n.3.
8 "How Does Bitcoin Work?," Bitcoin, available at bitcoin.org/en/faq#how-does-bitcoin-work.
9 Chelsea Deppert, "Bitcoin and Bankruptcy: Putting the Bits Together," 32 *Emory Bankr. Dev. J.* 123, 127 (2015) (internal citations omitted).
10 *Id.*
11 *Id.*
12 "What Happens When Bitcoins Are Lost?," Bitcoin, *available at* bitcoin.org/en/faq#what-happens-when-bitcoins-are-lost ("When a user loses his wallet, it has the effect of removing money out of circulation. Lost bitcoins still remain in the block chain just like any other bitcoins. However, lost bitcoins remain dormant forever because there is no way for anybody to find the private key(s) that would allow them to be spent again.").
13 11 U.S.C. § 541(a)(1).

of bitcoins has the potential to fall within the purview of the federal fraudulent-transfer statute.[14] The potential for conflict, however, arises in the interpretation of 11 U.S.C. § 550.

Section 550 of the Bankruptcy Code states that "the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property."[15] In cases where *currency* is transferred, the values are typically the same, but in the case of *property*, values can appreciate or depreciate drastically over time. For example, bitcoins have appreciated more than 1,000 percent in the last 18 months.[16] Accordingly, whether a trustee is entitled to recover the value of the bitcoins transferred (*i.e.*, the currency approach) versus the actual bitcoins (*i.e.*, the property approach) is of paramount importance. Unfortunately, most bankruptcy courts have not had the opportunity to classify bitcoins. Therefore, bankruptcy practitioners must look to other areas of the law for guidance.

Property or Currency? The Great Debate

For federal income tax purposes, the Internal Revenue Service (IRS) treats bitcoins as *property* and advises taxpayers that "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency."[17] In the criminal sector, however, courts treat bitcoins in a manner more akin to *currency*.

For example, in *United States v. Ulbricht*,[18] the defendant — the designer and facilitator of the infamous "Silk Road" website[19] — was indicted for, among other things, a money laundering conspiracy pursuant to 18 U.S.C. § 1956. A necessary component of such a claim is the existence of a financial transaction.[20] The *Ulbricht* court adopted broad interpretations of the terms "financial transaction" and "monetary instrument," and held that "[o]ne can money launder using Bitcoin."[21] Moreover, the court stated:

> Bitcoins can be either used directly to pay for certain things or can act as a medium of exchange and be converted into a currency which can pay for things. Indeed, the only value for Bitcoin lies in its ability to pay for things — it is digital and has no earthly form; it cannot be put on a shelf and looked at or collected in a nice display case. Its form is digital — bits and bytes that together constitute something of value. And they may be bought and sold using legal tender. Sellers using Silk Road are not alleged to have given their narcotics and malicious software away for free — they are alleged to have sold them. The money laundering statute is broad enough to encompass use of Bitcoins in financial transactions. Any other reading would — in light of Bitcoins' *sole raison d'etre* — be nonsensical.[22]

In addition, in *United States v. Murgio*,[23] the defendants were charged with, among other things, the operation of an unlicensed bitcoin exchange in violation of 18 U.S.C. § 1960, which criminalizes the operation of unlicensed money transferring businesses.[24] The statute defines "money transferring" as including the transfer of "*funds* on behalf of the public by any and all means."[25] Of critical importance to the application of the statute is the scope and interpretation of the term "funds." In *Murgio*, the court turned to the legislative history of the statute and concluded that bitcoins are funds. Moreover, the court stated:

> The legislative history of § 1960 supports the conclusion that bitcoins fall within the statute's purview. Section 1960 was enacted to address the fact that money launderers with illicit profits had found new avenues of entry into the financial system. From its inception, then, § 1960 sought to prevent innovative ways of transmitting money illicitly. It appears that Congress designed the statute to keep pace with evolving threats, and this Court must accordingly give effect to the broad language Congress employed — namely, that § 1960 applies to any business involved in transferring funds ... by any and all means. Dictionaries, courts, and the statute's legislative history all point to the same conclusion: bitcoins are funds.[26]

On the opposite end of the spectrum, at least one state court has held that bitcoins do not constitute "currency" or "monetary instruments." In *State of Florida v. Michell Abner Espinoza*,[27] a defendant was charged with unlawfully engaging in a "money services business" and two counts of money laundering. Before ultimately dismissing the state of Florida's information in its entirety, the court noted that bitcoins lack the most important characterizations of money. More specifically, the court stated:

> Bitcoin may have some attributes in common with what we commonly refer to as money, but differ in many important aspects. While Bitcoin can be exchanged for items of value, they are not a commonly used means of exchange. They are accepted by some but not by all merchants or service providers. The value of Bitcoin fluctuates wildly and has been estimated to be eighteen times greater than the U.S. dollar. Their high volatility is explained by scholars as due to their insufficient liquidity, the uncertainty of future value, and the lack of a stabilization mechanism. With such volatility they have a limited ability to act as a store of value, another important attribute of money. Bitcoin is a decentralized system. It does not have any central authority, such as a central reserve, and Bitcoins are not backed by anything. They are certainly not tangible wealth and cannot be hidden under a mattress like cash and gold bars. This Court is not an expert in economics, however, it is very clear, even to someone with limited knowledge

14 *Id.* ("The trustee may avoid any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within [two] years before the date of the filing of the petition.").

15 11 U.S.C. § 550.

16 *See* Rob Curran, "Why Bitcoin's Bubble Matters," *Wall Street Journal* (Oct. 8, 2017), *available at* wsj.com/articles/why-bitcoins-bubble-matters-1507515361.

17 *See* IRS Notice 2014-21, *available at* irs.gov/pub/irs-drop/n-14-21.pdf.

18 *United States v. Ulbricht*, 31 F. Supp. 3d 540 (S.D.N.Y. 2014).

19 The Silk Road was "an online marketplace for illicit goods and services." *Id.* at 547 (S.D.N.Y. 2014).

20 *See, e.g.*, 11 U.S.C. § 1956(a)(1) ("Whoever, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity.") (emphasis added).

21 *United States v. Ulbricht*, 31 F. Supp. 3d at 570.

22 *Id.*

23 *United States v. Murgio*, 209 F. Supp. 3d 698 (S.D.N.Y. 2016).

24 18 U.S.C. § 1960(a) applies to "[w]hoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business."

25 18 U.S.C. § 1960(b)(1)(C) (emphasis added).

26 *United States v. Murgio*, 209 F. Supp. 3d at 708 (internal citations omitted).

27 *State of Florida v. Michell Abner Espinoza*, Case No. F14-2923, in the Eleventh Judicial Circuit in Miami-Dade County, Fla.

28 *See* Order Granting Defendant's Motion to Dismiss the Information, *State of Florida v. Michell Abner Espinoza*, Case No. F14-2923, in the Eleventh Judicial Circuit in Miami-Dade County, Fla.

in the area, that Bitcoin has a long way to go before it is the equivalent of money. The Florida Legislature may choose to adopt statutes regulating virtual currency in the future. At this time, however, attempting to fit the sale of Bitcoin into a statutory scheme regulating money services businesses is like fitting a square peg in a round hole.[28]

Fraudulent Transfers of Bitcoins in Bankruptcy

While still a novel issue, at least one bankruptcy court has been presented with the issue of the fraudulent transfers of bitcoins. In *In re Hashfast Technologies LLC*, a trustee sought to avoid and recover an alleged fraudulent transfer of 3,000 bitcoins.[29] At the time of the transfer, the bitcoins were worth approximately $363,000. However, at the time of the lawsuit, the bitcoins were worth approximately $1.3 million. In his motion for partial summary judgment, the trustee argued that he was entitled to the bitcoins or their present value because bitcoins are a commodity, not a currency.[30] The trustee also argued that the anti-money laundering cases likening bitcoin to currency were inapplicable because they concern "shutting down criminal enterprises, and so define the terms 'funds' and 'money' as broadly as possible."[31] Although the court partially ruled in the trustee's favor, the court declined to find whether bitcoins should be treated as property or currency until the trustee prevailed and avoided the subject transfer.[32] Since the case was eventually settled, the court never issued a ruling in that regard.

How Should Bitcoins Be Treated in Fraudulent-Transfer Litigation?

In the context of fraudulent-transfer litigation, bitcoins should be treated in the same manner that one might treat a foreign currency. For example, assume that you are the trustee pursuing a fraudulent transfer of 100 euros. At the time of the transfer, the euros were worth $120, but at the time of the adversary proceeding, the euros were worth $150 (*i.e.*, the Euros appreciated by $30).

Under § 550, a trustee "has the ability to recover the property transferred, which would allow the estate to benefit from any appreciation."[33] So whether bitcoins are treated as currency or property, the Bankruptcy Code provides that the trustee in the above example may recover either $150 — the *appreciated* value of the euros —or the euros themselves. This approach is not only logical, but supported by the case law.[34] The fact that bitcoins are a form of cryptocurrency instead of a fiat currency does not demand a different result.

Conclusion

Whether you believe in the future of cryptocurrency or not, the Bitcoin bubble is too big to be ignored. In particular,

bankruptcy practitioners should be paying close attention, as fluctuations in the value of bitcoins could cause a wave of Bitcoin-related bankruptcies. Given the potential for accompanying fraudulent-transfer litigation, bankruptcy practitioners should be prepared to grapple with bitcoins in a bankruptcy setting. Regardless of one's feelings on the subject, bankruptcy practitioners should take heed and keep up with the cryptocurrency craze. **abi**

29 *Michael G. Kasolas v. Marc A. Lowe (In re Hashfast Techs. LLC)*, Case No. 15-03011 (Bankr. N.D. Cal.).
30 *Id.* at ECF No. 42, ¶ 4-5.
31 *Id.* at ECF No. 42, ¶ 7.
32 *Id.* at ECF No. 49, ¶ 1-2.
33 *In re Brun*, 360 B.R. 669, 675 (Bankr. C.D. Cal. 2007).
34 *See, e.g., In re Am. Way Serv. Corp.*, 229 B.R. 496, 531 (Bankr. S.D. Fla. 1999) (analyzing § 550 and noting that "when the property has appreciated, the trustee is entitled to recover the property itself, or the value of the property at the time of judgment"); *In re Blitstein*, 105 B.R. 133, 137 (Bankr. S.D. Fla. 1989) (stating that "the Trustee is entitled to at least a money judgment in the amount of the greater of the value at the time of the transfer; or the value at the time of recovery less the value of improvements made").