



BITCOINS AND BANKRUPTCY

BY SRIKANT MIKKILINENI

BY BIANCA RUCKER

INTRODUCTION:

- What is a cryptocurrency?
 - A decentralized digital cash system.
 - Bitcoin is the most famous cryptocurrency (or infamous depending on who you ask).
 - Litecoin, Ethereum, Ripple, etc. are just a few other cryptocurrencies.
 - Many attempts prior to Bitcoin to create a digital cash product.
 - Digicash in the '90s
 - However, as the recording and movie industry can tell you, digital products are very easy to copy and distribute widely.
 - So how do you keep people from freely copying a Bitcoin and devaluing it?
 - Blockchain technology

INTRODUCTION:



- If you give someone an apple in the real world, they physically take possession of that apple.
- You no longer have control of the apple.
- Assuming you don't have any more apples, you no longer have an apple to give to anyone else.

- However, with a digital apple, things are different...
- It's possible a bad actor can copy the digital apple a hundred times, to make it look like he has a hundred apples instead of only one.

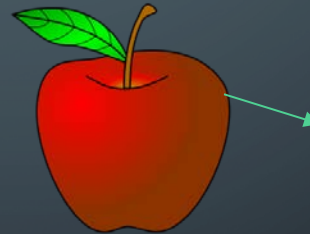


Image from:
<https://www.flickr.com/photos/flamephoenix1991/8375195501>



INTRODUCTION:

- However, everyone knows when you photocopy something, it loses some of its resolution.
- Similarly, every time you copy something digitally, the file changes subtly – the file hash is modified to account for the additional bits tracking the data changes.

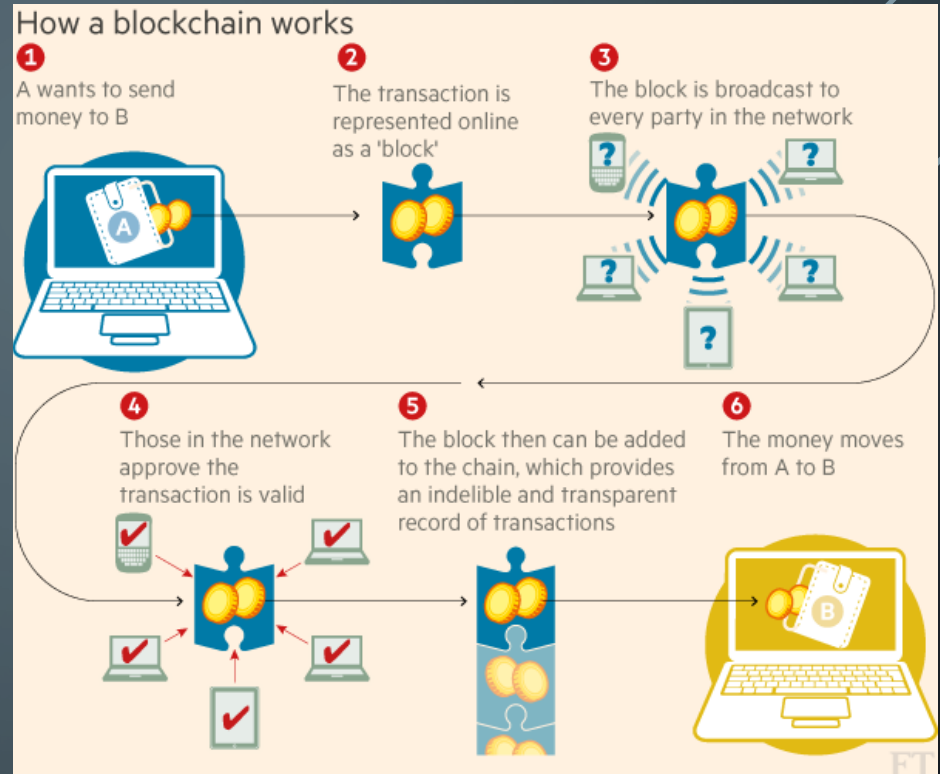


Image from: Financial Times, <https://www.weforum.org/agenda/2016/06/blockchain-explained-simply/>

- This modification can be, and is, tracked to verify whether the digital apple is authentic.
 - Your cryptocurrency is tracked and held in your “wallet”.
 - Wallets can store cryptocurrency online, on a local computer, external hard drive, or even on a piece of paper (the wallet is a string of characters that is your unique cryptographic hash).
- This is done by a decentralized, peer-to-peer network of public computers – the blockchain. People who dedicate their computers to the network are called miners and are rewarded or reimbursed for their efforts.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- IRS Notice 2014-21 provides guidance stating that although virtual currency can be used to pay for goods and services, it is not recognized as a currency by the IRS. Instead, the IRS has classified virtual currencies as property.
- Other IRS guidance takeaways include:
 - Employers paying in Bitcoin must file W-2 and withhold federal taxes;
 - Payments made to contractors must be disclosed and self-employment taxes shall apply;
 - Transactions with Bitcoins must be reported; and
 - Gains and losses in Bitcoin sales/exchanges is characterized by whether or not it is a capital asset in the hands of the taxpayer.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- FinCEN has additional guidance for virtual currency administrators and exchanges and classifies them as money transmitters which makes these operations subject to the bank secrecy act as well as money services business regulations from FinCEN.
 - Users and payment processors are expressly excluded from the FinCEN guidance from 2013.
 - See FinCEN, FIN-2013-G001

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- 40 states have enacted regulation, introduced regulations, formed task forces, and/or provided guidance with respect to cryptocurrency activities within their state. Provided below is a summary of the regulatory status of states in the 8th Circuit.
 - Arkansas:
 - Arkansas has no blockchain or cryptocurrency related guidance or regulations enacted or pending.
 - Iowa:
 - Iowa has no blockchain or cryptocurrency related guidance or regulations enacted or pending.
 - Minnesota:
 - Minnesota has no blockchain or cryptocurrency related guidance or regulations enacted or pending.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- Missouri:
 - Missouri's Office of the Secretary of State issued a cease and desist letter in June 2016 that makes it clear the selling of stock in Bitcoin is considered the selling of securities in Missouri. See Order to Cease and Desist and Show Cause Why Restitution, Civil Penalties, and Costs Should Not be Imposed, Office of Secretary of State, State of Missouri, available at <https://www.sos.mo.gov/cmsimages/securities/orders/AP-14-09.pdf> (2016).
 - Missouri's Department of Revenue ruled in 2015 that Bitcoin purchased through a Bitcoin ATM is not subject to Missouri sales tax since Bitcoin is an intangible property and only tangible property is subject to sales tax in the state. See Private Letter Ruling No. LR 7411, Missouri Dep't of Rev. (Sept. 2, 2014).
- Nebraska:
 - Introduced a series of bills in 2018, however, they have all been "indefinitely postponed." See LB691, 105th Leg. (Neb. 2018); LB694, 105th Leg. (Neb. 2018); LB695, 105th Leg. (Neb. 2018); LB987, 105th Leg. (Neb. 2018).
- North Dakota:
 - Legislative action was introduced in 2017, but failed to pass. See N.D. Senate Bill 2100, N.D. State Leg. 65th Leg. Assemb. (N.D. 2017-2018).
- South Dakota:
 - South Dakota has no blockchain or cryptocurrency related guidance or regulations enacted or pending.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- Uniform Law Commission:
 - ULC's model regulation, Uniform Regulation of Virtual Currency Business Act, was approved at last year's National Conference. Accordingly, it is likely we will start seeing states adopt same in the near future.
 - Model Regulation available at:
http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/2017AM_URVCBA_AsApproved.pdf

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- Uniform Law Commission:

- The model regulation identifies activities that require protection, namely, the storage, transfer, and exchange of virtual currency on behalf of others.
- The model regulation does not apply where other regulation is deemed adequate – e.g. Electronic Funds Transfer Act.
- Banks and companies that merely provide software, computing power, or other services that enable virtual currency business are exempt from the model regulation.
- Individual, academic, and *de minimus* use are also exempt.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- Uniform Law Commission:
 - The focus of the model regulation requires covered entities:
 - Maintain enough virtual currency to satisfy the entitlements of its users;
 - Ensure that the property interests of customers are pro rata in the event of a shortfall; and
 - Provide that the virtual currency of customers is not the property of the virtual currency business or reachable by its creditors.

CRYPTOCURRENCY AND BLOCKCHAIN REGULATIONS:

- Uniform Law Commission:
 - The model regulation also requires businesses to register with their designated state authority and provide evidence of adequate capital on a regular basis.
 - There is an “on-ramp” process within the model regulation that successively increases the regulatory compliance required.
 - This is meant to ease the burden on virtual currency business start-ups.

BITCOIN ETFS AND FUTURES TRADING:

- The CME Group and Cboe Global Markets, Inc. listed Bitcoin futures in December of 2017, leading many to speculate approval for a Bitcoin ETF was around the corner.
- However, the SEC has repeatedly delayed deciding on the fate of Bitcoin ETFs
 - Notwithstanding the above, the Bitcoin ETF backed by the Winklevoss twins, BZX, was recently denied based on the SEC's finding that the request did not meet the requirement of the Exchange Act.
 - See Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to List and Trade Shares of the Winklevoss Bitcoin Trust, SECURITIES AND EXCHANGE COMMISSION (July 26, 2018), available at <https://www.sec.gov/rules/other/2018/34-83723.pdf>.

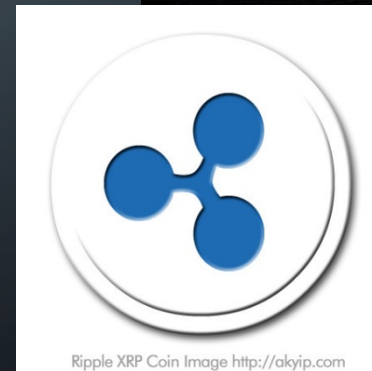
BITCOIN ETFS AND FUTURES TRADING:

- Most recently, the SEC has announced it will delay deciding the fate of two other proposed Bitcoin ETFs until September.
 - See 83 Fed. Reg. 142 (July 24, 2018), available at <https://www.gpo.gov/fdsys/pkg/FR-2018-07-24/html/2018-15768.htm>.
 - See Self-Regulatory Organizations; Cboe Bzx Exch., Inc.; Notice of Designation of A Longer Period for Comm'n Action on A Proposed Rule Change to List & Trade Shares of Solidx Bitcoin Shares Issued by the Van Eck Solidx Bitcoin Tr., Release No. 83792 (Aug. 7, 2018), available at <https://www.sec.gov/rules/sro/cboebzx/2018/34-83792.pdf>.
- On August 3, 2018, the owners of the NYSE, Intercontinental Exchange, announced the formation of BAKKT which will offer a federally regulated market for Bitcoin starting in November.
 - Intercontinental Exchange has partnered with Microsoft, Boston Consulting Group, Starbucks, and others for the endeavor.
 - Some industry experts have speculated this negates the need for a Bitcoin ETF.
 - BAKKT's goals are lofty – to create a stable, trusted global currency that will lead to wider adoption even allowing 401(k)s to invest and eventually rolling out credit card products based on Bitcoin.

OTHER CRYPTOCURRENCIES AND ICOS:

- Other Cryptocurrencies:
 - Ethereum;
 - Litecoin;
 - Ripple; and
 - 1,000s more out there.

- More coming via ICOs



OTHER CRYPTOCURRENCIES AND ICOS:

- Initial Coin Offering (“ICO”) in the U.S.:
 - The SEC’s position is that most ICOs are considered securities transactions and, as such, they must comply with existing SEC securities regulations.
 - However, if the ICO can pass the “Howey Test” they do not need to comply with the aforementioned regulations.
 - The Howey Test, in the context of blockchain tokens, requires three independent elements be met:
 - 1. An investment of money;
 - 2. In a common enterprise; and
 - 3. With an expectation of profits predominantly from the efforts of others.
 - See Sec. & Exch. Comm’n v. Howey Co., 328 U.S. 293 (1946).

OTHER CRYPTOCURRENCIES AND ICOS:

- ICOs Around the World:
 - China and South Korea have banned ICOs.
 - The EU has stated there is no recourse in cases of dispute with ICOs.
 - Canada and Russia are creating regulatory sandboxes to allow ICO firms to experiment for a certain time without being subject to securities laws.
 - Many governments have cautioned against investment in ICOs.
 - U.S.
 - UK
 - Germany

OTHER CRYPTOCURRENCIES AND ICOS:

- **Celebrity Warnings and Endorsements:**
 - Jordan Belfort, a.k.a. the Wolf of Wall Street, called ICOs “the biggest scam ever” in October of 2017.
 - However, other “celebrities” have endorsed ICOs as a way to garner additional attention for the ICO in an attempt to drive up the price of the ICO.
 - Floyd Mayweather – Stox Coin
 - Paris Hilton - LyndianCoin
- The SEC has recently warned that celebrity endorsements of ICOs may be “potentially unlawful.”
- Additionally, the DOJ, SEC, FTC, CFTC, and CFPB have formed the Task Force on Market Integrity and Consumer Fraud to investigate and prosecute, among others, fraudulent and criminal ICO offerings.

BLOCKCHAIN TECHNOLOGY:

- As mentioned before, blockchain technology is a peer-to-peer, publicly accessible validation technology that came about with the Bitcoin digital currency.
 - Traditional validation methods require banks to send transactions to a central authority or clearinghouse for validation.
 - Blockchain technology utilizes a distributed network of computers to each verify/validate a transaction thereby exponentially increasing the number of computers a criminal must compromise to effectively initiate and validate a fraudulent transaction.

BLOCKCHAIN TECHNOLOGY:

- Blockchain technology is a data structure that allows for the creation of a publicly accessible digital ledger of transactions that is shared among multiple computers on a distributed network, i.e., computers that are not located together.
- A common mechanism of encrypted communication allows the distributed network of computers to each manipulate the ledger securely.

BLOCKCHAIN TECHNOLOGY:

- When data representing a transaction is recorded to the blockchain ledger it is extremely difficult to change or remove because each of the participants in the network receives a copy of the existing blockchain and they run algorithms to evaluate and verify the proposed transaction.
- If a majority of the computers agree that the transaction is valid, the new transaction is approved and a new “block” is added to the blockchain.

BLOCKCHAIN TECHNOLOGY:

- At its core, blockchain technology requires a network of computers, a network protocol that the computers can communicate through, and a consensus mechanism, i.e., the rules used to verify each transaction and agree on the state of the blockchain.
 - Accordingly, blockchain technology can be used in other applications outside of cryptocurrencies.

BLOCKCHAIN TECHNOLOGY:

- Startups and industry associations have come about to apply blockchain technology to other markets or more traditional payment methods such as real time payment systems.
 - R3CEV, consortium of financial institutions working to adopt a distributed ledger system (not publicly accessible).
 - IBM is attempting to adopt blockchain technology for supply chain validation.
 - Mastercard has applied for at least four blockchain patents.
 - Smart contracts have been a growing implementation of blockchain technology recently.

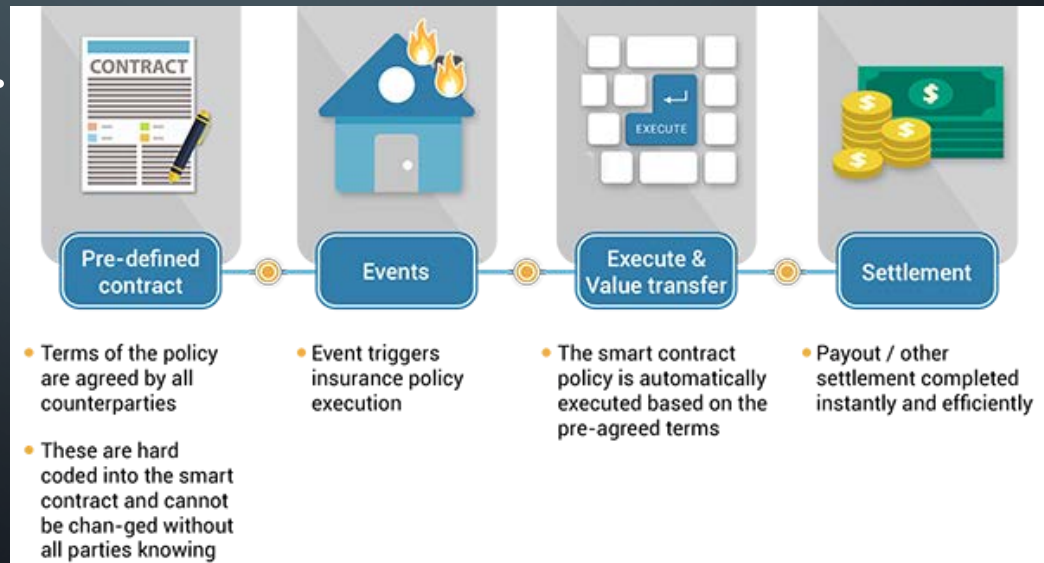
BLOCKCHAIN TECHNOLOGY:

- Blockchain technology is in the process of or has already been applied to:
 - Food safety networks;
 - Medical and insurance record verification;
 - Identification verification;
 - Inventory tracking and supply chain metrics;
 - Case history processing; and
 - Real estate records (Chicago).

BLOCKCHAIN TECHNOLOGY:

- Smart Contracts – Public and Private/Custom Blockchain or Distributed Ledger Implementations

- Smart Contract name is a bit of a misnomer.
- More accurate to call them self-executing digital contracts.
- Already recognized in Arizona and Ohio and more state recognition likely.



BLOCKCHAIN TECHNOLOGY:

- Smart Contracts – Public and Private/Custom Blockchain or Distributed Ledger Implementations
 - These contracts verify the execution of obligations by both parties to a contract before executing an end result – very similar to an escrow agent (which is often an attorney).
 - Can also act as identity verification before executing the terms of a contract – similar to a notary.

BLOCKCHAIN TECHNOLOGY:

- Smart Contracts – Public and Private/Custom Blockchain or Distributed Ledger Implementations
 - For example, you want to rent a house – typically, you make a deposit, which the landlord holds in escrow, perhaps with their attorney, and then provides you with the access key on a particular date defined within the contract as the start of the term of the rental.
 - With a self-executing contract, you would provide your payment via the blockchain or distributed ledger, the landlord would receive notification of the verified funds and would provide the digital access key and the system would allow the tenant access to the key on the agreed-upon date.
 - If the landlord does not provide the key by the specified date, your verified funds are returned to you. If the landlord provides the key early, both your funds and the key are held until the start date – no escrow or escrow agent required.

BANKRUPTCY LAW

1. Property of the Estate under 11 U.S.C. § 541
2. Disclosure on Schedules
3. Exemptions Under 11 U.S.C. § 522
4. Turnover Under 11 U.S.C. § 542
5. Use/Sale/Lease Under 11 U.S.C. § 363
6. Avoiding Fraudulent Transfers/Preferences and Recovering Against Transferees Under 11 U.S.C. §§ 546, 547, 548, & 550
7. Valuation
8. Treatment in Chapter 13/11 Plans
9. Tax Issues
10. Co-owners

PROPERTY OF THE ESTATE AND DISCLOSURE ON SCHEDULE A/B

- Bankruptcy schedules include multiple questions where Cryptocurrency (“CC”) might be listed, but none specifically ask about CC:
 - Cash (Sched. A/B, No. 16);
 - A deposit of money (Sched. A/B, No. 17)
 - Any financial asset not already listed (Sched. A/B, No. 35)
 - Any other property of any kind not already listed (Sched. A/B, No. 53)
 - Potential other categories on Sched. A/B
- Transfers may appear on Statement of Financial Affairs

PROPERTY OF THE ESTATE AND DISCLOSURE ON SCHEDULE A/B (P. 2)

- **Property:** In March 2014, the IRS issued Notice 2014-21: virtual currencies that can be converted into traditional currencies are property (not currency) for purposes of reporting income to the IRS, and a taxpayer can have a gain/loss on the sale or exchange.
- **Commodity:** In 2015, the Commodity Futures Trading Commission (CFTC) classified virtual currencies as commodities. See *In the Matter of: Coinflip, Inc.*, CFTC Docket No. 15-29 (stating that “Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.”).
- **Security:** The Securities and Exchange Commission’s Report of Investigation issued on July 25, 2017 stating that tokens offered and sold by a "virtual" organization known as "The DAO" were securities and therefore subject to the federal securities laws.

PROPERTY OF THE ESTATE AND DISCLOSURE ON SCHEDULE A/B (P. 3)

- **Money:**

- United States v. Mansy, 2017 U.S. Dist. LEXIS 71786 (D. Me. 2017)(citing cases and stating that “the statute’s language, structure, and purpose all point towards Bitcoin falling within [money laundering statute’s] scope.”).
- Related: Financial Crimes Enforcement Network, by letter dated February 13, 2018 to U.S. Senator Ron Wyden, stating that “a developer that sells convertible virtual currency, including in the form of ICO coins or tokens, in exchange for another type of value that substitutes for currency is a money transmitter and must comply with AML/CFT requirements that apply to this type of [money services business]. An exchange that sells ICO coins or tokens, or exchanges them for other virtual currency, fiat currency, or other value that substitutes for currency, would typically also be a money transmitter.”

- **Not U.S. Dollars:** HashFast Technologies LLC and HashFast LLC v. Marc A. Lowe (In re HashFast Technologies LLC), Bankr. Case No. 14-30725DM, Adv. Pro. No. 15-3011DM (Bankr. N.D. Cal. Feb. 19, 2016).
- **Applicability of State Law:** “[P]roperty interests are created and defined by state law,” and “[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.” Stern v. Marshall, 564 U.S. 462, 495, 131 S. Ct. 2594, 2616 (2011)(quoting Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co., 549 U.S. 443, 451, 127 S. Ct. 1199, 167 L. Ed. 2d 178 (2007) (quoting Butner v. United States, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979)).

EXEMPTIONS UNDER 11 U.S.C. § 522

- Federal exemptions
 - Wildcard under 11 U.S.C. § 522(d)(5)
- State exemptions
 - Wildcard
 - Other potential arguments:
 - Cash
 - Deposit accounts
 - Earnings/wages
- Determining Non-Exempt Equity
 - Liens
 - Valuation Issues

TURNOVER UNDER 11 U.S.C. § 542

- In sum, property that the Trustee may use, sell or lease under section 363, or the value of such property, that is not of inconsequential value or benefit to the estate shall be delivered to the trustee.
- Turnover Issues:
 - Valuation/benefit determination with use value in mind:
 - *Senate Report No. 95-989 to § 542*: “The holder of property of the estate is excused from the turnover requirement of this subsection if the property held is of inconsequential value to the estate. However, this provision must be read in conjunction with the remainder of the subsection, so that if the property is of inconsequential monetary value, yet has a significant use value for the estate, the holder of the property would not be excused from turnover.”
 - The actual, physical turnover of CC to the trustee – how is the CC held?
 - Online exchange like Coinbase
 - Paper wallet (physical printout of the address and passkey)
 - Hardware wallet
 - What happens while litigation is pending?

USE/SALE/LEASE UNDER 11 U.S.C. § 363

- If held in an online exchange like Coinbase:
 - For instance, using the Coinbase app, transfer of Bitcoin to another Bitcoin wallet, or hit “sell” and cause a deposit to be made to a traditional bank account.
- If stored offline in a “paper wallet,” (a piece of paper that includes the secret key) this is harder. You must set up a separate wallet, then transfer it to an online exchange.
- If stored in a “hardware wallet” or “cold storage” (i.e., printed on paper, etched in metal, etc.), work to get your Bitcoin to a digital wallet designed to work with hardware wallets before transferring to Coinbase and exchanging it for cash.

AVOIDING FRAUDULENT TRANSFERS/PREFERENCES AND RECOVERING AGAINST TRANSFEREES UNDER 11 U.S.C. §§ 546, 547, 548, & 550

- Valuation:
 - § 550 allows the trustee to recover the property transferred or, if the court orders, the value of such property.
 - Trustee can recover property or the value of such property
 - If value, value as of what date?
 - Implicates currency vs. property analysis
- Other Avoidance Action issues:
 - If commodity, then swap agreement protection?

OTHER ISSUES

- Treatment in Chapter 13 and Chapter 11 Plans
 - Does it meet the definition of cash collateral?
 - Relief from Stay Motions
 - Providing adequate protection
 - value fluctuations
 - risk of loss of physical key
- Tax issues involved in selling CC
 - Internal Revenue Bulletin: 2014-16
 - Capital gains
- Co-owners: when multiple persons/entities hold the private key

QUESTIONS?

- Please feel free to email/call us with any additional questions or comments.

Thank you.

- **Srikant Mikkilineni**

srikant@brickgentrylaw.com

(515) 271-5907

- **Bianca Rucker**

ruckerlaw@outlook.com

(479) 445-6340