Bitcoin and bankruptcy: Why creditors and bankruptcy practitioners need to understand cryptocurrencies

By Erin Jane Illman, Esq., and Robert A. Cox Jr., Esq., *Bradley Arant Boult Cummings LLP*

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Over the past several years, bitcoin, which initially had a reputation as currency associated with underground or illegal goods, has emerged as a legitimate and frequently used form of cryptocurrency.

Many businesses have begun to accept bitcoin as a form of payment for goods and services. As of October 2017, companies such as Subway, Expedia, Dish Network, Etsy, Gap, J.C. Penney and Whole Foods accepted bitcoin as a form of payment, either directly or through gift cards purchased with bitcoin.

Bitcoin has become a defensive device and an investment tool for many companies, particularly in the event of a cybersecurity attack. In fact, a recent NBC news report determined that in 2016, nearly one-third of United Kingdom companies stockpiled large quantities of digital currencies to ensure they could regain access to critical data in the event of a ransomware attack.

Following the same strategy, thousands of U.S. companies have also set up digital currency wallets to quickly resolve ransomware attacks.

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As the mainstream use of bitcoin and other cryptocurrencies increases and the value of bitcoin rises, so does the likelihood that bitcoin, in large or small quantities, will begin to show up as an "asset" of the debtor in a bankruptcy case.

This may especially be the case for companies that are investing in and stockpiling bitcoin. If a company with a large amount of bitcoin files for bankruptcy, the value and use of such bitcoin may play an important role in the debtor's bankruptcy case.

Given the growing use of bitcoin and the likelihood of seeing it as an asset in future bankruptcy cases, it is important to understand the nature of this cryptocurrency and how a bankruptcy court may treat it in a bankruptcy filing.

WHAT IS BITCOIN?

A CNN Money article defined bitcoin as "a new currency that was created in 2009 by an unknown person using the alias Satoshi Nakamoto."

Bitcoins can be used to buy merchandise anonymously and are not tied to any country or subject to regulation. They are typically stored in a "digital wallet" on the user's computer or mobile device. The wallet acts like a virtual bank account and allows the user to send or receive bitcoins.

The IRS recently defined bitcoin as an "intangible asset" for investors, making it subject to capital gains and loss treatment using the realization method.

While bitcoin lingers between a currency and an asset, more than 100,000 bitcoin transactions are taking place every day. Bitcoin has become synonymous with cryptocurrencies, although there are more than 900 different cryptocurrencies in circulation.

Bitcoin and other cryptocurrencies are digital assets designed to be used as a unit of exchange or currency. The holding and transfer of these "currencies" use cryptography to secure transactions and to control the creation of additional units.

BITCOIN IN BANKRUPTCY

While bitcoin continues to work through its identity crisis outside of bankruptcy, the question for a company that files for bankruptcy protection and has a large supply of it is how the bitcoin will be treated for bankruptcy purposes.

Section 541 of the bankruptcy code broadly defines "property of the estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case." Given that expansive definition, there is no question that bitcoin will be considered property of the bankruptcy estate in the event of a bankruptcy filing. Nonetheless, how bitcoin will be treated in bankruptcy cases remains an open issue.

The mainstream use of bitcoin is a fairly new occurrence, so there is little case law that sheds light on how it will be treated in bankruptcy.

While there are no published decisions, the U.S. Bankruptcy Court for the Northern District of California was faced with the question of whether bitcoin constitutes a currency or a commodity in the case of *HashFast Technologies LLC v. Lowe (In re HashFast Technologies LLC)*.[1]

In that case, the bankruptcy trustee sought to avoid the transfer of bitcoin by the debtor to a third party as a preference and/or fraudulent conveyance. The trustee contended that the bitcoin was a commodity, such that the bankruptcy estate would be entitled to recover any increase in its value as of the date of recovery. The value of the bitcoin at stake in the case had increased substantially since the transfer, from $363,000 to $1.3 million.

The defendant-transferee contended that bitcoin was currency, not a commodity, such that the value of transferred bitcoin recovered by the trustee should be determined at the time of transfer.

Ultimately, the Bankruptcy Court did not reach a determination of whether bitcoin was a currency or commodity.

"The court does not need to decide whether bitcoin are currency or commodities for the purposes of fraudulent-transfer provisions of the Bankruptcy Code. Rather, it is sufficient to determine that, despite defendant's arguments to the contrary, bitcoin are not United States dollars," the court said. "If and when the liquidating trustee prevails and avoids the subject transfer of bitcoin to defendant, the court will decide whether, under 11 U.S.C.A. §550(a), he may recover the bitcoin (property) transferred or their value, and if the latter, valued as of what date."

While the California Bankruptcy Court did not find that bitcoin was a commodity for purposes of bankruptcy, its comment that "bitcoin are not United States dollars" may signal that it believed bitcoin is more akin to a commodity than currency.

CURRENCY OR COMMODITY?

The determination of whether bitcoin is a currency or a commodity could have important ramifications in a bankruptcy case. If bitcoin is found to be a currency for bankruptcy purposes, then any exchange agreements of bitcoin for cash may be considered "swap agreements," as that term is defined under the Bankruptcy Code to include currency swaps.[2]

Transactions under swap agreements are granted greater protections in bankruptcy; they are exempt from the bankruptcy automatic stay provisions and from avoidance as a fraudulent transfer.[3]

If bitcoin is classified as a commodity, it may also qualify for similar protections against the applicability of the automatic stay and the right to avoid such transactions as fraudulent transfers.

However, to qualify for such protections as a commodity, any agreement related to the transfer of bitcoins would have to constitute a "forward contract" as that term is defined under the Bankruptcy Code.[4] Given the nature of bitcoins, it may be difficult for any transactions or agreements with the transfer of bitcoins to meet the definition of forward contract.

COLLATERAL ON SECURED LOAN?

Another area of uncertainty for bitcoin in bankruptcy is how it will be treated if it serves as collateral on a secured loan to the debtor. The determination that bitcoin is not currency could affect whether it would constitute "cash collateral" securing the debt owed to the secured creditor.

Under Section 363 of the Bankruptcy Code, "cash collateral" is defined as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest," including the cash collateral's "proceeds" and "products."[5]

For a debtor to use a secured creditor's cash collateral, either the secured creditor must consent or the court must authorize the debtor's use of cash collateral.[6]

To the extent that bitcoin does not constitute cash or a cash equivalent, it may not meet the definition of cash collateral under the Bankruptcy Code. If this is the case, the debtor may be authorized to use the bitcoin in the ordinary course of business without first seeking the consent of the secured creditor or authorization from the bankruptcy court.

ADEQUATE PROTECTION

However, under Section 363(e) of the Bankruptcy Code, the secured creditor could seek to prohibit or condition the debtor's use of bitcoin and require that the debtor provide adequate protection to the secured creditor for the debtor's use of it.[7]

Adequate protection is typically provided in the form of additional or replacement liens, periodic cash payments to the secured party, or some other form of protection to the secured creditor against the diminution of value of the collateral resulting from the debtor's use of it.[8]

The problem with providing adequate protection in relation to bitcoin is that its value fluctuates wildly and is difficult to project. While the secured creditor may be adequately protected based upon the value of the bitcoin at a certain point in the bankruptcy case, such protection could prove to be inadequate at a later point if the value drops during the bankruptcy case.

Accordingly, to the extent the debtor wants to use bitcoin that serves as collateral for a loan during the bankruptcy case, the debtor may be required to provide adequate protection in the form of an additional lien or periodic payments to the secured party.

ARE BITCOINS INEVITABLE?

Given that bitcoin and other cryptocurrencies are becoming more pervasive in the marketplace, it is inevitable that more of these assets will become part of debtor bankruptcy cases. Bankruptcy courts will increasingly be tasked with determining how such assets are to be treated.

With more than 900 cryptocurrencies in circulation and new ones being formed at a breakneck pace, creditors and creditors' rights and bankruptcy practitioners should carefully examine cryptocurrency assets in any underlying credit transactions. In addition, they should stay abreast of developments on how bankruptcy courts determine the treatment and valuation of these cryptocurrencies.

NOTES

[1] *HashFast Technologies v. Lowe (In re HashFast Technologies LLC)*, No. 14-30725-DM (Bankr. N.D. Cal. Feb. 22, 2016) (order on motion for partial summary judgment).

[2] 11 U.S.C.A. § 101(53B).

[3] 11 U.S.C.A. § 362(b)(17); 11 U.S.C.A. § 546(g).

[4] 11 U.S.C.A. § 101(25).

[5] 11 U.S.C.A. § 363(a).

[6] 11 U.S.C.A. § 363(c)(2).

[7] 11 U.S.C.A. § 363(e).

[8] 11 U.S.C.A. § 361.

ABOUT THE AUTHORS

Erin Illman (L) is an associate and **Robert Cox** (R) is a partner in the Charlotte, North Carolina, office of **Bradley Arant Boult Cummings LLP**.

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