

Deal carefully with bitcoins until legislation catches up

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Interest in cryptocurrencies is growing, even after Mt. Gox, formerly the largest international bitcoin exchange, filed for bankruptcy in Japan following \$473 million in losses. Bitcoin's resulting drop in value, from a \$1,000 high to around \$500, should be a reminder that cryptocurrencies are volatile payment systems under which the applicability of existing regulatory and commercial law is unclear. Because bitcoin is not backed by any government or central bank, banking and financial industry regulations may not apply to bitcoin transactions. For this reason, Federal Reserve chairwoman Janet Yellen testified before Senate that the Federal Reserve lacks regulatory authority over bitcoin. Similarly, the Federal Deposit Insurance Corp. indicated in at least one context that a money transmitter like PayPal is not a bank for federal banking law purposes. Consequently, bitcoin users cannot expect deposit or investment protection from the FDIC or customer protection from the Securities Investor Protection Corp. Given this uncertainty, the Federal Trade Commission, Consumer Financial Protection Bureau, Securities and Exchange Commission and Commodity Futures Trading Commission are studying the need for cryptocurrency regulation. Additionally, New York and California are racing to pass state regulations. Notwithstanding, it appears bitcoin exchanges may be subject to money-laundering rules under the Bank Secrecy Act. The U.S. Treasury Department's Financial Crimes Enforcement Network, or FinCEN, previously stated that exchanges must register with FinCEN as money services businesses and report large or suspicious transactions. This is not surprising given the anonymous and irreversible nature of bitcoin transactions, which make them susceptible to money laundering and other criminal activity. For these reasons, it is unclear how bitcoin exchanges can fully comply with reporting requirements.

Existing Law

It is equally uncertain how bitcoin transactions are treated under existing commercial laws not designed to address cryptocurrency concerns. Because bitcoin is intangible yet acts as a store of value and a financial medium for the exchange of goods and services, it is difficult to classify as a property type. Under nonbankruptcy law, bitcoins are likely a "general intangible" or "payment intangible" for purposes of Article 9 of the Uniform Commercial Code, as adopted in most jurisdictions. Consequently, a creditor taking bitcoin as collateral should obtain a security agreement from the debtor sufficiently identifying the collateral. Perfection of the security interest would require filing a UCC-1 financing statement in the state where the debtor is located. Failure to perfect

may render the creditor's security interest subject to avoidance by a subsequently appointed bankruptcy trustee. Interestingly, because secured lenders sometimes take blanket security interests in all of a debtor's property, including general intangibles, many banks and financial institutions may already hold security interests in a debtor's bitcoins without realizing it. At least one commentator has also indicated that, because bitcoin exchanges may not constitute banks, bitcoin held by an exchange would not qualify as a "deposit account" under the UCC but rather as a "payment intangible." Thus, perfection in a debtor's cryptocurrency held on an exchange cannot be accomplished by an account control agreement typically used to perfect against deposit accounts. As a result, when a debtor transacting business through a bitcoin exchange defaults, it may be harder for secured creditors to liquidate their collateral. Use As

Given bitcoin's inherent volatility and the difficulty secured creditors may face collecting against it, bitcoin's use as collateral in conventional lending transactions remains highly suspect. For these reasons, cautious lenders should consider including representations and covenants in lending agreements to prohibit or limit a borrower's use of bitcoin. In bankruptcy, a debtor's bitcoin at filing would likely qualify as property of the estate since the debtor would have a legal or equitable interest therein. Accordingly, a bankruptcy trustee should be able to assert control over a debtor's bitcoins (or their value) and liquidate them for the estate's benefit. A debtor's failure to schedule or adequately explain the absence of previously held bitcoins, or turn over existing bitcoins to the trustee, could provide grounds to object to the debtor's discharge. A debtor's pre-bankruptcy transfers of bitcoins may provide grounds for a trustee to pursue preference or fraudulent conveyance actions against bitcoin recipients. However, identifying the recipients may be complicated by the anonymity of bitcoin's users. Regardless, prudent trustees should inquire about a debtor's existing or past bitcoin investments or transactions. Increased awareness of bitcoin's potential security pitfalls highlights the uncertainties surrounding cryptocurrency's future. Going forward, legislation and case law will likely provide more clarity on existing commercial law and regulatory concerns. Until then, parties transacting business with or investing in bitcoin should exercise caution. Originally published by the Daily Business Review, Vol. 88, No. 217 (April 2014).

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