



# The Cramdown

The Newsletter of the Tampa Bay Bankruptcy Bar Association

*Editor-in-Chief, Suzy Tate, Suzy Tate, P.A.*

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## PRESIDENT'S MESSAGE

*by Stephenie Biernacki  
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### A Reflection in Time

Now that my term as President of the Tampa Bay Bankruptcy Bar Association has come to an end, I find myself reflecting on my career to date as a bankruptcy practitioner, beginning with my position as a Law Clerk for the Honorable Alexander L. Paskay, Chief Judge Emeritus, in May 1997. Following my two year clerkship with Judge Paskay, I began my career in private practice with my partner, and now husband, John A. Anthony. If you had asked me 17 years ago where I thought I would be today, I am sure I would not have predicted that I would have had the privilege of serving this Association and its members as the 2013 - 2014 Tampa Bay Bankruptcy Bar Association President.

For the privilege of serving this Association, I would like to thank the Judges and lawyers that make up our membership for their confidence in my ability to lead the Association, the other 2013 - 2014 Officers and Directors of the Tampa Bay Bankruptcy Bar Association for their hard work and dedication to the Association, my mentor, Judge Paskay, who took me under his wing and helped make me the bankruptcy practitioner I am today, the past Presidents of the Association for their

wisdom and guidance, my family for loving and believing in me, and, last but not least, my wonderful friends and partners at Anthony & Partners who have supported me throughout this past year by attending and participating in the monthly CLE luncheons, by volunteering in our Pro Bono Clinic, and by submitting articles for our publication, The CramDown.

In closing, it is my hope that after another 17 years go by, the 2013 – 2014 Board is remembered for its contribution of hundreds of volunteer hours in connection with the startup and staffing of the Tampa Bay Bankruptcy Bar Association's Pro Bono Clinic, during its kickoff year, and for the financial contributions raised at the Tampa Bay Bankruptcy Bar Association's Annual Installation Dinner for the benefit of the Bankruptcy Law Educational Series Foundation, Inc., otherwise known as BLES, a not for profit organization formed to promote bankruptcy legal education and to fund pro bono and other public service projects relating to the practice of bankruptcy in the Middle District of Florida.

Congratulations on another successful year as an Association, and good luck Edward Peterson! Hail to the Chief!

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# **Regulatory and Commercial Law Concerns Relating to Bitcoin and Internet Payment Systems<sup>©</sup>**

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## **I. Introduction**

Recently there has been wide spread interest in the propagation of virtual currency based payment systems, including most notably, Bitcoin. Advocates of Bitcoin suffered a significant setback in February 2014 when Mt. Gox, formerly the most active Bitcoin exchange in the world, filed for bankruptcy in Japan after suffering losses of approximately \$473 million.<sup>1</sup> In the wake of the Mt. Gox collapse, the value of a bitcoin has fallen from a high of \$1000 to around \$500.<sup>2</sup> Even so, interest in Bitcoin remains surprisingly resilient.

This article will briefly explore the intersection between efforts to develop a new and improved digital medium of exchange and the existing regulatory and commercial law environment. As will be seen, existing law provides only partial answers as to the rights, remedies and obligations of parties using virtual currencies.

## **II. The Emergence of Bitcoin**

The term “Bitcoin” or “bitcoin” can be used in two ways: capitalized Bitcoin refers to the technology and network used to make and process Bitcoin transactions, while lowercase bitcoin refers to the unit of digital currency itself.<sup>3</sup> Bitcoin was initially proposed and created by Satoshi Nakamoto (an alias) in 2009 as a digital medium of exchange referred to as a “cryptocurrency.”<sup>4</sup> It was intended to be an electronic peer to peer payment system based upon cryptographic proof.<sup>5</sup> The system would supposedly eliminate the need for trusting a financial intermediary, like a bank or credit card company, to handle such payments.<sup>6</sup> The basic premise was that the

system would be non-reversible, less expensive than conventional bank and credit card transactions, and inflation free.<sup>7</sup>

## **III. How Bitcoin Works**

The Bitcoin system was designed to create an electronic trail for each bitcoin back to its point of origin. This type of trail would make double spending a bitcoin extremely difficult. While the digital history of each bitcoin is available in a public ledger called the “block chain,” each Bitcoin transaction is designed to be anonymous. The block chain maintains a record of every transaction ever processed, allowing Bitcoin users to authenticate each transaction.<sup>8</sup> The validity of each transaction is protected by digital signatures corresponding to the sending addresses, providing Bitcoin users full control over sending bitcoins from their own Bitcoin addresses.<sup>9</sup> Moreover, once consummated, the transaction cannot be reversed.<sup>10</sup>

Bitcoin can be acquired in various ways, including, accepting it as payment for goods and services, buying it from an exchange, trading traditional currency, or acquiring it by “mining.”

Logistically, transfers of bitcoins between people or companies may be accomplished using a virtual “wallet” stored on a personal computer, mobile app or the web. Bitcoin exchanges and money transmitters evolved in order to facilitate these transactions by offering Bitcoin users a platform for the purchase and sale of bitcoins using different currencies. Since Bitcoin’s inception, exchanges have become the most common means for acquiring bitcoin. At one time, Mt. Gox was the largest of these exchanges.

Mining, another means for acquiring bitcoin, is a process by which software is run through specialized hardware on a user’s computer, using its computing power to process and verify transactions, secure the Bitcoin

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<sup>1</sup> Verified Petition for Recognition and Chapter 15 Relief ¶ 9, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 9, 2014), ECF No. 2; see also Robert McMillan, The Inside Story of Mt. Gox, Bitcoin's \$460 Million Disaster, Wired Enterprise (March 3, 2014, 6:30 AM), <http://www.wired.com/wiredenterprise/2014/03/bitcoin-exchange/> (noting that it is believed that the millions in losses at Mt. Gox resulted from skimming by hackers over several years).

<sup>2</sup> Joshua Brustein, True Believers Cheer the Fall of Bitcoin Exchange Mt. Gox (Feb. 25, 2014), Bloomberg Businessweek, <http://www.businessweek.com/articles/2014-02-25/bitcoin-exchange-mt-dot-gox-falls-true-believers-cheer>

<sup>3</sup> Maria Bustillos, The Bitcoin Boom, The New Yorker (April 2, 2013), <http://www.newyorker.com/online/blogs/elements/2013/04/the-future-ofbitcoin.html>.

<sup>4</sup> Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System, <https://bitcoin.org/bitcoin.pdf> .

<sup>5</sup> Id.

<sup>6</sup> Id.

<sup>7</sup> Id.

<sup>8</sup> Frequently Asked Questions: How Does Bitcoin Work?, available at <https://bitcoin.org/en/faq>

<sup>9</sup> Id.

<sup>10</sup> Id.

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network, and keep all users in the system synchronized together.<sup>11</sup> In exchange, new bitcoins are created and issued to those users. The recipients of these newly minted bitcoins are known as miners.<sup>12</sup> Notwithstanding the creation of new bitcoins through mining, the system is engineered so that no more than 21 million bitcoins will ever exist.<sup>13</sup> Consequently, as more people sign up to become miners, the mining process will yield less and less new bitcoins. However, because bitcoin is not a physical currency, bitcoins can be divided infinitely.<sup>14</sup>

### IV. Regulation of Bitcoin

Since Bitcoin is not created by any government or central bank, laws which regulate banking and the financial industry may not be applicable to Bitcoin and Bitcoin transactions. For example, the FDIC has indicated, at least in one context, that a money transmitter such as PayPal is not acting as a bank for purposes of federal banking laws.<sup>15</sup> Similarly, Federal Reserve Chairwoman Janet Yellen provided testimony before the Senate in February 2014 that the Federal Reserve does not have regulatory authority over Bitcoin since it takes place outside the banking system.<sup>16</sup> As a result, parties dealing in bitcoin cannot expect any protection for deposits or investments from the Federal Deposit Insurance Corporation ("FDIC").<sup>17</sup> However, the Federal Trade Commission, the Consumer Financial Protection Bureau, the Securities and Exchange Commission and the Commodity Futures Trading Commission are all currently studying the potential need for virtual currency regulation.<sup>18</sup> Additionally, due to the slow pace at which

federal regulations may evolve, state governments in New York and California are rapidly exploring possible state regulations for virtual currency.<sup>19</sup>

Notwithstanding the current lack of government regulation, it is believed that Bitcoin and other virtual currencies, especially when traded through an exchange, are subject to moneylaundering rules under the Bank Secrecy Act.<sup>20</sup> In March 2013, the Financial Crimes Enforcement Network ("FinCEN") of the U.S. Treasury Department released a statement that virtual currency administrators and transmitters (i.e. exchanges) must register with FinCEN as a money services business ("MSB") and report large or suspicious transactions.<sup>21</sup> This is not surprising considering Bitcoin's anonymity and irreversibility, which make it susceptible to use in criminal transactions, including laundering money from illegal sales of drugs, firearms, weapons and stolen personal information. But for these same reasons, it is unclear how a Bitcoin exchange can fully comply with such reporting requirements since Bitcoin transfers are anonymous by design.

The recent charges brought by the U.S. Attorney in New York against underground Bitcoin user Robert M. Faiella a/k/a "BTCKing," and Charlie Shrem, the CEO and Compliance Officer for U.S. Bitcoin exchange BitInstant, highlight the potential complications involved in regulating Bitcoin and prosecuting illegal Bitcoin activity.<sup>22</sup> Faiella and Shrem were both charged with conspiracy to commit money laundering and operating an unlicensed money transmitting business in connection with an alleged scheme to sell over \$1 million in bitcoins

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11 Frequently Asked Questions: What is Bitcoin mining? and How does Bitcoin mining work?, available at <https://bitcoin.org/en/faq>

12 Id. see also Sam Biddle, What is Bitcoin?, Gizmodo Magazine (May 19, 2011), available at <http://gizmodo.com/5803124/what-is-bitcoin>.

13 Sunny Freeman, What is Bitcoin? 11 Things You Need to Know about the Digital Currency, The Huffington Post (Jan. 26, 2014, 11:21PM), [http://www.huffingtonpost.ca/2014/01/26/what-is-bitcoin\\_n\\_4661604.html](http://www.huffingtonpost.ca/2014/01/26/what-is-bitcoin_n_4661604.html).

14 Freeman, *supra*.

15 Pamela J. Martinson & Christopher P. Masterson, The Hazards of Lending to Bitcoin Users, American Banker (Jan. 2, 2014, 10:00 AM), <http://www.americanbanker.com/bankthink/the-hazards-of-lending-to-bitcoin-users-1064622-1.html> (citing Troy Wolverton, Feds: PayPal not a Bank, CNET (March 12, 2002), <http://news.cnet.com/2100-1017-858264.html>).

16 Steven Rusillo, Yellen on Bitcoin: Fed Doesn't Have Authority to Regulate It in Any Way, The Wall Street Journal, <http://blogs.wsj.com/moneybeat/2014/02/27/yellen-on-bitcoin-fed-doesnt-have-authority-to-regulate-it-in-any-way/> (Feb. 27, 2014, 12:43 PM).

17 It is also unlikely that parties engaging in Bitcoin transactions would be entitled to customer protection by the Securities Investor Protection Corporation ("SIPC").

18 Ryan Tracy & Stephanie Armour, Losses Mobilize the Bitcoin Police, The Wall Street Journal, March 3, 2012, also available at <http://online.wsj.com/news/articles/SB10001424052702304585004579415422696315770>.

19 Carter Dougherty, New York Vying With California to Write Bitcoin Rules, Bloomberg News (Jan. 27, 2014 8:18PM), <http://www.bloomberg.com/news/2014-01-27/new-york-duels-california-to-write-bitcoin-rules.html>; see also Carter Dougherty, New York to Accept Bitcoin-Exchange Proposals to Speed New Rules, Bloomberg News (Mar. 11, 2014 2:19 PM), <http://www.bloomberg.com/news/2014-03-11/new-york-to-accept-bitcoin-exchange-proposals-to-speed-new-rules.html>.

20 Tracy & Armour, *supra*.

21 U.S. Dept. of Treas., Guidance No. FIN-2013-G001, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013), available at [http://fincen.gov/statutes\\_regs/guidance/html/FIN-2013-G001.html](http://fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html); see also Tracy & Armour, *supra*.

22 U.S. Attorney's Office (S.D.N.Y) Press Release, Manhattan U.S. Attorney Announces Charges Against Bitcoin Exchangers, Including CEO of Bitcoin Exchange Company, For Scheme To Sell And Launder Over \$1 Million In Bitcoins Related To Silk Road Drug Trafficking (Jan. 27, 2014), available at <http://www.justice.gov/usao/nys/pressreleases/January14/SchremFaiellaChargesPR.php>; see also Mukund H. Sharma, United States: Bitcoins and Liability in the Wake of Recent Silk Road Arrests (Feb. 16, 2014), <http://www.mondaq.com/unitedstates/x/293076/IT+internet/Bitcoins+and+Liability+in+the+Wake+of+Recent+Silk+Road+Arrests>

23 Id.

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to users of “Silk Road,” a drug trafficking website.<sup>23</sup> In Faiella’s case, the issue of liability for accepting payment for illegal items with Bitcoin may not be all that different than conventional theories of prosecution for money laundering against sellers who knowingly accept proceeds of illegal activity.<sup>24</sup> Shrem’s case on the other hand, may have a more troubling impact on the Bitcoin system as whole, since it would potentially subject all virtual currency exchanges to prosecution for abuse and misuse by their users.<sup>25</sup> In this context, an exchange’s degree of knowledge of and involvement with suspicious activity will likely be the key factors determining criminal liability.

At the present time, “bitcoin and other digital-payment systems are operating in a sort of regulatory vacuum, with exchanges and money transmitters free to start up and solicit U.S. customers without the same type of oversight or protections that apply to credit cards, banks or other financial service business.”<sup>26</sup> In this vacuum, the doctrine of caveat emptor cannot be overly emphasized.

### V. Treatment of Bitcoin under Existing Commercial Law

Just as in the regulatory sphere, there is uncertainty as to how Bitcoin and related transactions will be regarded under existing commercial laws which were not enacted or designed to specifically address virtual payment systems. A fundamental inquiry in this regard must ask what exactly is a bitcoin? It does not have a tangible or physical manifestation, yet it has the capacity to act as a store of value and as a financial medium for the exchange of goods and services. In a bankruptcy context, bitcoin held by a debtor upon filing, would likely qualify as property of a bankruptcy estate since the debtor would have a legal or equitable interest therein.<sup>27</sup> Accordingly, a bankruptcy trustee should be able to assert control over a debtor’s bitcoins (or the value thereof) and liquidate them for the benefit of the estate and creditors. Trustees would also be well advised to question debtors as to

existing or past Bitcoin investments or transactions. Failure of an individual debtor to schedule or adequately explain the absence of previously held bitcoins, or turnover existing bitcoins to the trustee, could provide grounds to object to the debtor’s discharge.<sup>28</sup> Pre-bankruptcy transfers of bitcoins by a debtor may also provide a basis for a trustee to pursue preference or fraudulent conveyance actions against the recipients of the bitcoins.<sup>29</sup> Again, such actions may be complicated by the anonymous nature of Bitcoin transfers and the inability to identify a recipient.

Under non-bankruptcy law, bitcoins are likely to be classified as a general intangible<sup>30</sup> or payment intangible<sup>31</sup> for purposes of Article 9 of the Uniform Commercial Code (“UCC”) in most jurisdictions. As such, a creditor seeking to take bitcoin as collateral would need a security agreement with the debtor sufficiently identifying the collateral. Perfection of the security interest will require the filing of a UCC-1 Financing Statement in the state where the debtor is located as prescribed under the UCC. Failure to perfect may render the creditor’s security interest subject to avoidance by a subsequently appointed bankruptcy trustee. Moreover, since it is not uncommon for a secured lender to take a blanket security interest in all property of a debtor, including general intangibles, many banks and financial institutions may already hold security interests in a debtor’s bitcoins without even realizing that their security interest may extend to cover such property.

At least one commentator has also pointed out that because money transmitters or exchanges may not constitute banks as it relates to Bitcoins transactions, bitcoin held by an exchange would not qualify as a “deposit account” under the UCC, but rather as a “payment intangible.” Thus perfection in virtual currency of a debtor held on such a platform cannot be accomplished through the usual method of perfection for deposit accounts by an account control agreement.<sup>32</sup> Consequently, the

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24 Sharma, *supra*.

25 *Id.*

26 Tracy & Armour, *supra*.

27 Under 11 U.S.C. § 541, property of the estate is broadly defined to include all legal and equitable interests of the debtor as of the commencement of the case, which includes all types of property, including tangible and intangible. See 5 Collier on Bankruptcy ¶ 541.03 (Lawrence P. King et al. eds., 15th ed. rev. 1997).

28 11 U.S.C. § 727(4)(A), (5) and (6)(A).

29 11 U.S.C. §§ 547, 548 and 550.

30 Section 9-102(a)(42) of Revised Article 9 of Uniform Commercial Code defines a “general intangible” as: “any personal property including things in action, other than accounts, chattel, paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.”

31 Section 9-102(a)(61) of Revised Article 9 of the Uniform Commercial Code defines a “payment intangible” as: “a general intangible under which the account debtor’s principal obligation is a monetary obligation.”

32 Martin & Masterson, *supra*.

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absence of an account control agreement may make it more difficult for a secured creditor to realize upon its collateral in the event of a default by a debtor who is performing Bitcoin transactions through an exchange.

In light of the significant fluctuations in value of bitcoin and the difficulty secured creditors may experience in gaining control over and liquidating bitcoin, the use of bitcoin as collateral in conventional lending transactions remains highly suspect. Cautious lenders may also wish to consider including representations and covenants in lending agreements which prohibit or limit a borrower's acceptance or use of bitcoin in its operations.<sup>33</sup>

## **VI. The Mt. Gox Catastrophe**

Mt. Gox, formerly the largest Bitcoin exchange in the world, filed for bankruptcy in Tokyo in February 2014 after nearly half a billion dollars worth of cryptocurrency (at that time) disappeared from customer accounts.<sup>34</sup> In the same month, Mt. Gox was sued in federal court in Chicago by an Illinois resident alleging a class action lawsuit for misappropriation and fraud, among other claims.<sup>35</sup> Prior to the Illinois lawsuit, the company was sued by CoinLab, Inc. in Washington for an alleged \$75 million breach-of-contract claim under an exclusive licensing agreement for the U.S. and Canada.<sup>36</sup> As a result of this proceedings Mt. Gox filed for bankruptcy protection in Dallas, Texas on March 9, 2014, under Chapter 15 of the U.S. Bankruptcy Code, which allows debtors to shield U.S. assets while the main bankruptcy proceeding is resolved in another country.<sup>37</sup> The U.S. petition listed approximately \$37.7 million in assets and \$63.9 million in liabilities, noting that almost 750,000 customer bitcoins and 100,000 of its own, about 7 percent of all bitcoins in existence worldwide, were missing and probably stolen.<sup>38</sup> Mt. Gox's U.S. bankruptcy filing was

targeted at protecting its U.S. assets from creditors and halting the two U.S. lawsuits pending against the exchange.<sup>39</sup> That relief was temporarily granted by the Texas Bankruptcy Court on March 10, 2014.<sup>40</sup> Given the recent fall of Mt. Gox and increased awareness with respect to the possible security pitfalls of Bitcoin and other cryptocurrencies, it remains to be seen whether virtual currencies and the exchanges that trade them will survive and how they might evolve.

## **VII. Conclusion**

The above limited analysis demonstrates that parties currently conducting transactions using Bitcoin (or similar cryptocurrencies<sup>41</sup>) are subject to significant risk and uncertainty as to their rights, remedies and obligations under current statutes, regulations and commercial law. Future legislation and case law development will likely provide more clarity with respect to many issues. Until this occurs, however, parties should exercise a high degree of caution when contemplating virtual currency transactions.

<sup>33</sup> Id.

<sup>34</sup> Tom Hals, Mt. Gox files U.S. bankruptcy, opponents call it a ruse, Reuters (March 10, 2014), <http://www.reuters.com/article/2014/03/10/usbitcoin-mtgox-bankruptcy-idUSBREA290WU20140310>; see also Verified Petition for Recognition and Chapter 15 Relief ¶¶ 9, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 9, 2014), ECF No. 2.

<sup>35</sup> Hals, *supra*; see also Complaint, Greene v. Mt. Gox, Inc., et al., Case No. 1:14-cv-1437 (N.D. Ill. Feb. 27, 2014), ECF No. 1.

<sup>36</sup> Hals, *supra*; see also Complaint, LabCoin, Inc. v. Mt. Gox KK, et al., Case No. 2:13-cv-0777 (W.D. Wash. May 2, 2013), ECF No. 1.

<sup>37</sup> Chapter 15 Petition for Recognition of Foreign Proceeding, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 9, 2014), ECF No. 1.

<sup>38</sup> Verified Petition for Recognition and Chapter 15 Relief ¶¶ 6 & 9, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 9, 2014), ECF No. 2.

<sup>39</sup> Chapter 15 Petition for Recognition of Foreign Proceeding, and Declaration of Robert Marie Mark Karpeles, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 9, 2014), ECF Nos. 2 & 3; Hals, *supra*.

<sup>40</sup> Order Granting Application For Provisional Relief, Scheduling Recognition Hearing, and Specifying Form and Manner of Notice, In re: MtGox Co., Ltd., Case No. 3:14-bk-31229 (Bankr. N.D. Tex. Mar. 10, 2014), ECF No. 13.

<sup>41</sup> While there are numerous alternatives to Bitcoin, some of the more commonly known cryptocurrencies include Dogecoin, Litecoin, Namecoin, Freicoin, Quarkcoin and Peercoin. Ryan W. Neal, Bitcoin Competitors: What You Should Know About 6 Alternative Cryptocurrencies, International Business Times (Jan. 15, 2014 5:53 PM), <http://www.ibtimes.com/bitcoin-competitors-what-you-should-know-about-6-alternativecryptocurrencies-1540168>