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The Trustee and the Bitcoin

Identifying and Recovering International Cryptocurrency Assets

Cryptocurrency has been all the rage recently in the financial and legal news. Everyone has or knows someone who owns bitcoin (the most common form of cryptocurrency), but what exactly is cryptocurrency? Specifically, is cryptocurrency an asset, capable of being recovered by a bankruptcy trustee? This article will explore what exactly cryptocurrency is (in its current form), whether it is an asset available to be recovered, and what worldwide strategies a trustee can employ to recover cryptocurrency as an asset of the bankruptcy estate.



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What Is Cryptocurrency?

At its most basic level, cryptocurrency is a string of computer-generated code, identified in a public decentralized ledger called a “blockchain.” This line of code is accessed by an owner’s unique passcode: a secret and private key giving access to the owner’s “virtual wallet” (an account where cryptocurrencies are held). The interface is functionally similar to traditional banking portals for customers. However, if a user loses his/her private key, the wallet would be forever inaccessible because it is impossible to recover a lost key. Ownership and use of cryptocurrency is, for the most part, anonymous.

Cryptocurrency takes many forms with many names such as Bitcoin (the most well known), Ethereum, Komodo and KodakCoin. There are more than 1,500 of these alternative currencies that operate outside the control of any central bank or sovereign treasury department. Exchange platforms such as BitConnect and Bitfinex maintain the virtual wallets and facilitate transfers, and the structures of these platforms vary.

For example, Bitfinex utilized multi-signature segregated wallets, where both the owner of the account, the exchange platform and a third-party vendor held separate keys — all of which were necessary in order to authorize fund transfers.¹ These exchanges often reside outside the U.S., making their reach by trustees difficult. Some exchanges maintain the identity and contact information of their customers, but this is not currently the norm. However, these exchanges could (and should) have traditional bank account information whenever their customers “cash in” or “cash out” of the cryptocurrencies.

How Does Cryptocurrency Work?

Any blockchain transfer occurs through the blockchain protocol. A transaction is initiated by the transferor (using his/her private key) to broadcast to other holders of the decentralized ledger that he/she is decreasing their virtual wallet and correspondingly increasing the virtual wallet of the transferee. The other members of the network verify and confirm the transaction, which is then recorded on the blockchain ledger.

While each transaction of each particular cryptocurrency unit is recorded on the blockchain, there is (typically) no online record that identifies the person associated with any particular address. An analogy of this in practice would be a wall of glass post office boxes, where each box is a virtual wallet. Anyone can see the cryptocurrencies inside and watch the transactions taking place among the boxes, but you cannot determine who owns any particular box and, unless you have the key, you cannot access the box.

How Is Cryptocurrency Defined as an Asset?

For purposes of recovery, including avoidance actions under Chapter 5 of the Code, it is necessary to define the asset to determine ownership rights and security interests.

Is It a Security?

The Securities and Exchange Commission (SEC) has not approved any exchange-traded products (such as ETFs) holding cryptocurrency-related assets for listing or trading. The SEC has also never registered an initial coin offering (ICO), but the court in *SEC v. Shavers* held that Ponzi scheme Bitcoin “investments” could be considered securities under federal securities laws because the Bitcoin itself was a “currency” — giving the SEC jurisdiction to prosecute claims.² Trustees could benefit from this classification as, under Article 8, if cryptocurrency is a “security,” it would not be perpetually encumbered by previous creditors’ security interests.

Is It a Commodity?

The Commodity Futures Trading Commission (CFTC) has designated Bitcoin as a commodity and announced that fraud and manipulation involv-

¹ See, e.g., L. Chambers, “The Keepers of the Keys: Remedies and Legal Obligations Following Misappropriations of Cryptocurrency,” 11 JIBFL 673A (Dec. 1, 2016).

² 2013 U.S. Dist. Lexis 110018 (E.D. Tex. Aug. 6, 2013).

ing Bitcoin traded in interstate commerce and the regulation of commodity futures fall directly under its authority. The CFTC permitted the CME and CBOE to launch Bitcoin futures. The CFTC also approved a platform for the trading and clearing of virtual currency derivatives.

If cryptocurrencies are deemed commodities, there are fewer protections extended under the Bankruptcy Code. The Code affords commodity transactions significant protection only if the transactions contract constitutes a “forward contract,” providing for the commodity’s delivery two days in advance of the contract’s maturity date.³

Is It a Currency?

On its face, virtual currencies do not meet the Uniform Commercial Code (UCC) definition of “money” under 1-201(b)(24), since they are not authorized or adopted by a government. However, courts have found that bitcoins are “funds” under 18 U.S.C. § 1960 for actions involving conspiracy with the operation of an unlicensed money-transmitting business. For example, the *United States v. Murgio* court reasoned that bitcoins are funds because they can be accepted “as payment for goods and services” or are bought “directly from an exchange with [a] bank account.”⁴ Therefore, they “function as ‘pecuniary resources’ and are ‘used as a medium of exchange’ and ‘a means of payment.’”⁵

If classified as currency, cryptocurrency transfers would receive beneficial protections under the Bankruptcy Code as swap agreements.⁶ Under §§ 362(b), 546(g) and 560, the Code protects swaps from avoidance as constructive fraudulent transfers and from the constraints of the automatic stay. Thus, under this interpretation, cryptocurrency traders would receive the same protections as though they were exchanging U.S. dollars and euros.

At least one bankruptcy judge has concluded that Bitcoin is not currency for the purposes of a trustee’s recovery of avoidable transfers. In *Hashfast Technologies LLC*, a trustee sought the return of the value of Bitcoin that a debtor paid to a promotor.⁷ The court concluded that Bitcoin was property for purposes of § 550(a) of the Bankruptcy Code, but were not U.S. dollars.

Is It a General Intangible Under Article 9?

Under yet another perspective, UCC § 9-102(a)(42), a general intangible is defined to include payment intangibles. If virtual currencies are general intangibles, the secured party is left to perfect its security interest by filing a UCC-1 financing statement. This leaves the secured party with a perfected security interest, but no fast mechanism to prevent a borrower from transferring its virtual currencies after a default or other triggering event.

Under the current system, a creditor who perfects by filing remains susceptible to unauthorized transfers of pledged virtual currency. To compound the problem, most virtual currencies are transferred between parties in an anonymous fashion that, in all likelihood, make it impossible for the

creditor to identify the recipient or take possession of the transfers. Further, a general intangible cannot be perfected by use of a contract agreement because virtual currency is not held in a deposit account.

This leads to other problems for transferees of virtual currencies. UCC §§ 9-315(a) and 9-332 provide that a security interest travels with a general intangible to transferees and subsequent transferees unless the secured party authorizes the disposition free of the security interests. While lenders can easily authorize such dispositions for ordinary course operations, it is impossible for transferees to know what liens, if any, are attached to the cryptocurrencies it stands to receive.

In order to assist in the trustee’s administration of virtual currency assets, courts will not only need to apply new remedies, but expand existing ones.

What Are the Recovery Issues?

Bankruptcy trustees have an affirmative duty to investigate a debtor’s finances and gather and liquidate property of the estate for the benefit of the creditors.⁸ In the fast-evolving industry of cryptocurrency, trustees face challenges of identifying who holds the assets and is securing them. If data is on a cloud server, it might be in another jurisdiction halfway around the world. It is also easy for a debtor to transfer cryptocurrency to a recipient address owned by someone outside the court’s jurisdiction, including overseas. There are limited ways for a trustee to identify either the owner or location of a transferee’s cryptocurrency address. In some cases, the debtor can honestly state that he/she does not know the identity of the individual who received his/her cryptocurrency transfers.

Identifying the Holder

With a cooperative debtor (or adverse party), the private key will simply be turned over to the trustee at the § 341 meeting in order to access the virtual wallet and liquidate the cryptocurrency through the exchange platform. In cases where the debtor attempts to conceal the existence of a virtual wallet, a trustee might be able to discover evidence from the debtor’s “traditional” financial records (account or credit card statements) of the debtor “cashing in” or “cashing out” on that platform. At that point, the trustee could leverage his/her rights under the Bankruptcy Code and the court’s contempt powers to coerce compliance (*i.e.*, a U.S. court could compel a debtor to turn over the account or transaction information). Without the complete private key, no court or legal authority can manipulate ownership of a blockchain asset — but arrest and incarceration can be utilized on the key-holder.⁹

³ See 11 U.S.C. § 101(25)(A).

⁴ 209 F. Supp. 3d 698, 707 (S.D.N.Y. 2016).

⁵ *Id.*; see also *United States v. Mansy*, 2017 U.S. Dist. Lexis 71786 (D. Me. May 11, 2017); *United States v. Faiella*, 39 F. Supp. 3d 544 (S.D.N.Y. 2014).

⁶ See 11 U.S.C. § 101(53B)(A)(i)(I) and (II).

⁷ *Hashfast Tech. LLC v. Lowe* (*In re Hashfast Tech. LLC*), Adv. No. 15-3011 DM (Bankr. N.D. Cal. Feb. 19, 2016).

⁸ See, e.g., 11 U.S.C. §§ 704, 1302 and 1304.

⁹ See *Lawrence v. Goldberg* (*In re Lawrence*), 279 F.3d 1294, 1300 (11th Cir. 2002) (with respect to an offshore account).

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Fortunately, in most cases, the debtor will have adequate incentive to reveal its cryptocurrency. Under § 727 of the Bankruptcy Code, a debtor might be completely denied discharge if he/she transfers or conceals cryptocurrency, or destroys any associated records.¹⁰ Clearing trustees' obstacles to identifying other account-holders or transfer recipients is a much more difficult task. Typically, offshore fiduciaries maintain the servers, private keys and/or wallets. Absent jurisdictional authority, U.S. courts are powerless to compel the fiduciary to turn over assets.

Foreign Discovery and Seizure

For asset-protection planning purposes, cryptocurrency accounts function similarly to offshore banking accounts prior to the IRS's crackdown of anonymous personal foreign accounts. A U.S. citizen can now open and maintain a crypto-financial account that has the creditor-protection features of anonymity and location outside the geographical jurisdiction of domestic courts. There are three equitable remedies that exist under English common law that could be flexibly applied to overcome the obstacles of identifying holders and recipients of cryptocurrency regardless of the international nature of the transaction.

Norwich Pharmacal: One existing remedy is the equitable pre-trial discovery device known as a *Norwich Pharmacal* order, which requires (usually innocent) third parties to disclose information to identify a wrongdoer, trace funds or assist parties in determining whether a cause of action exists.¹¹ *Norwich Pharmacal* relief does not create a property right but is a means to discover assets and recover information — as a party who becomes involved in the potentially actionable conduct of another is under a duty to disclose information to the victim.

Certain exchange platforms could have identifying “know your customer” information, and proceedings could be initiated against “the Bitcoin holder with key number.” Further, if a virtual currency customer “cashed in” or “cashed out” of the exchange, there might be a trail to a traditional financial account that could ultimately serve to identify that customer.

Anton Piller: The second remedy is based on *Anton Piller K.G. v. Manufacturing Processes*, which allows for limited discovery prior to commencement of an action.¹² The party who is a beneficiary of an *Anton Piller* order has certain rights to seize and secure evidence so that the judicial process is not rendered useless. The victim must show that he/she had a business relationship with a defendant who is likely to be in possession of documents that can help prove the claim. The applicant must also be able to plead a strong *prima facie* case with demonstrably serious potential or actual damage. The defendant respondents must possess or control evidence

that inculpates them with the underlying claim and that they could destroy that evidence before the typical discovery process can be pursued and completed.

Practically speaking, to obtain an *Anton Piller* order, the matter needs to be replete with bad dealings and dishonesty on the part of the target. There would need to be strong evidence that the foreign holder of the virtual wallet would likely destroy or transfer the evidence and that that evidence is necessary to recover assets of the estate.

Worldwide Injunction: The third equitable remedy is injunctive relief. Courts have granted worldwide injunctions, called *Mareva* injunctions, when the impugned conduct occurs globally.¹³ *Mareva* injunctions do not create property rights but freeze assets in the possession of third parties in foreign countries until subsequent adjudication.¹⁴ To obtain a *Mareva* injunction, an applicant must show a good case and a serious risk that the respondent will either remove or dissipate assets to frustrate any judgment ultimately obtained.

In *Google Inc. v. Equustete*, the Supreme Court of Canada recently held that injunctive relief can be ordered against somebody who is not a party to the underlying lawsuit — even if that third party is not guilty of wrongdoing.¹⁵ Google was ordered to stop displaying search results globally for any websites that mislead consumers, opining that as the internet is naturally global, the only way to ensure that the interlocutory injunction attained its objective was to apply it where Google operates: globally.¹⁶ Extending this doctrine, if a third party to the blockchain transaction can be identified, there might be a remedy to enjoin the third-party operations, even if those operations are global.

Conclusion

In order to assist in the trustee's administration of virtual currency assets, courts will not only need to apply new remedies, but expand existing ones. Anti-money-laundering laws and know-your-customer rules requiring the collection of personal data of customers are being imposed on certain cryptocurrency exchanges. However, trustees' challenges of recovery will still require creativity and experience as rules and regulations catch up to this evolving technology. In the meantime, trustees do have potential strategies to act against (1) domestic parties whose identities are known, but whose cryptocurrency holdings are not; and (2) the unknown account-holders or recipients of cryptocurrency transfers by seeking relief through the exchange platforms where they initiate transactions. **abi**

¹³ See *Mareva Compania Naviera SA v. Int'l Bulk Carriers SA* (1980), 1 All ER 213 (Eng.).

¹⁴ See *Cretanor Maritime Co. Ltd. v. Irish Marine Mgmt. Ltd.* (1978), 1 WLR 966 (Eng.).

¹⁵ 2017 S.C.C. 34.

¹⁶ On an unopposed complaint, a U.S. district court held the injunction unenforceable in the U.S. as contrary to the Constitution and legislative immunity to interactive service providers. *Google LLC v. Equustek Sols. Inc.*, Case No. 17-CV-4207, (N.D. Cal. Dec. 14, 2017). The Supreme Court of British Columbia subsequently held its ground and refused to vary the terms of the injunction. *Equustek Sols. Inc. v. Jack*, 2018 BCSC 610 (April 16, 2018).

¹⁰ See 11 U.S.C. § 727(A)(2)-(3).

¹¹ *Norwich Pharmacal Co. v. Comm. of Custom and Excise* (1973), 3 WLR 164 (Eng.), 2 All E.R. 943 (Eng.).

¹² (1976) 2 WLR 162 (Eng.).

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