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Chelsea Deppert

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BITCOIN* AND BANKRUPTCY: PUTTING THE BITS TOGETHER

ABSTRACT

Virtual currency has become increasingly prevalent as a method of payment, and of the numerous virtual currencies, Bitcoin has gained the greatest global popularity. Despite Bitcoin's wide use, legal entities in the United States have struggled with whether to classify and treat bitcoins as a commodity or a currency. Governmental entities have made uncoordinated efforts to provide guidance on the treatment of bitcoins, and the courts have been largely silent on this classification issue.

Bitcoin's categorization has far-reaching implications in the context of bankruptcy because the Bankruptcy Code (the "Code") affords greater protections to assets classified as currencies than assets classified as commodities. As of October 2015, no bankruptcy court has affirmatively ruled on how to treat bitcoins under the Code. However, with Bitcoin's prominent use by both individuals and businesses, it is only a matter of time before the question is presented to bankruptcy courts. A uniform classification system must be implemented to prevent bankruptcy courts from reverse-engineering classifications based upon the particular facts of any given case.

In response to recent illegal activities facilitated by bitcoin use, states are beginning to propose Bitcoin regulations. These Bitcoin regulations generally require individuals and businesses that use bitcoins in business processes to obtain licenses. However, the regulations make an exception for individuals and businesses that only use bitcoins to buy and sell goods and services; such use does not require a license.

This Comment proposes that licensed bitcoins should have the classification of currency under the Code, while non-licensed bitcoins should have the less-protected classification of commodity. Under a license-based

* With capitalization, "Bitcoin" is used when describing the concept of Bitcoin, or the entire network itself. E.g., "I was learning about the Bitcoin protocol today." Without capitalization, "bitcoin" is used to describe bitcoins as a unit of account. E.g., "I sent ten bitcoins today." BITCOIN, <https://bitcoin.org/en/vocabulary> (last visited Nov. 14, 2015).

classification system, bitcoins would only receive heightened protections afforded to currencies under the Code if a debtor has satisfied the regulatory requirements for obtaining a license. This system would not require onerous changes to the Code and would allow the Code to honor states' policy judgments because the nuanced requirements of obtaining the license would be left to state regulatory entities.

INTRODUCTION

The American economy has been, and will always be, in a continuous state of evolution. This natural progression includes where we draw the line between commodities and currencies, and what we will allow to constitute currency. In the 1930s, Congress enacted a joint resolution nullifying creditors' right to demand payment in gold.¹ Then, in the 1970s, President Richard Nixon abandoned any remnants of the gold standard when he declared that the United States would no longer exchange dollars and gold at a fixed value.² These developments were highly controversial but were necessary due to societal and economic changes.³ Today, technology allows for individuals to exchange currency faster and more efficiently with virtual currencies like Bitcoin. The bankruptcy system must address the virtual currency phenomenon that Bitcoin presents to keep up with present societal changes.

The birth of Bitcoin has provoked many questions and controversies. Among these issues is whether to classify bitcoins as currencies or commodities. This has far-reaching implications in the context of bankruptcy because the Bankruptcy Code (the "Code") generally affords greater protections to currencies than to commodities.⁴ Some agencies have issued guidance in an effort to bring clarity to the treatment of Bitcoin, but many agencies' efforts have been uncoordinated.⁵ Meanwhile, courts have largely

¹ H.R. Res. 192, 73d Cong. (1933) (enacted); Brian Domitrovic, *August 15, 1971. A Date Which Has Lived in Infamy*, FORBES (Aug. 14, 2011, 7:36 PM), <http://www.forbes.com/sites/briandomitrovic/2011/08/14/august-15-1971-a-date-which-has-lived-in-infamy/>.

² Domitrovic, *supra* note 1.

³ *See id.*

⁴ *See* 11 U.S.C. §§ 362(b)(17), 546(g), 548 (2012); 5 COLLIER ON BANKRUPTCY ¶ 560.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012); Casey Doherty, *Bitcoin and Bankruptcy*, 33 AM. BANKR. INST. J. 38, 38–40 (2014).

⁵ Most governmental, agency, and other guidance refer to the broader category of "virtual currency." Although this Comment primarily addresses bitcoin, which is currently the most widely-utilized virtual currency, this analysis is adaptable to any similar virtual currency. *See* I.R.S. News Release IR-2014-36 (Mar. 25, 2014); CONSUMER FIN. PROT. BUREAU, CONSUMER ADVISORY: RISKS TO CONSUMERS POSED BY VIRTUAL

been silent on the issue. The few courts that have had to classify Bitcoin have made highly fact-specific determinations without any broader policy considerations.⁶

A consistent approach is necessary to prevent further confusion. With the growing use of Bitcoin,⁷ it is only a matter of time before bankruptcy courts will have to define its financial status in bankruptcy. An affirmative classification system would prevent patchwork solutions and would give debtors, creditors, and the court system guidance on how to treat bitcoin in bankruptcy.⁸

A practical solution to the categorization of Bitcoin in the bankruptcy context is to create a license-based classification system. Under such a system, a license would be required if bitcoins are intertwined with business processes. On the other hand, a license would not be required if bitcoins are merely used to buy and sell goods or services. As a result, a distinction could be drawn between bitcoins associated with licensed use and non-licensed use—licensed bitcoins would have the classification of “currency,” and non-licensed bitcoins would have the classification of “commodity.”⁹

For example, if a business specializes in exchanging bitcoins for U.S. dollars, then this use of bitcoins would need to be licensed. This licensed use

CURRENCIES (2014), http://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf; U.S. SEC. & EXCH. COMM’N, INVESTOR ALERT: BITCOIN AND OTHER VIRTUAL CURRENCY-RELATED INVESTMENTS (2014), http://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html#.VOOuh_nF_sY.

⁶ For instance, in seeking to obtain SEC jurisdiction over a bitcoin-for-bitcoin Ponzi scheme, a court dubbed bitcoin “money” because it was “used as money . . . to purchase goods and services.” S.E.C. v. Shavers, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *4 (E.D. Tex. Aug. 6, 2013). The court, however, arguably had a prevailing interest in categorizing bitcoin as money in order to take a stand against bitcoin operators and make known that they cannot blatantly skirt regulatory safeguards.

⁷ See Matthew Kien-Meng Ly, Note, *Coining Bitcoins’s “Legal-Bits”: Examining the Regulatory Framework for Bitcoin and Virtual Currencies*, 27 HARV. J.L. & TECH. 587, 591 (2014).

⁸ Other countries have already tackled the obstacle of classifying bitcoin, including China, Japan, and Finland. Doherty, *supra* note 4, at 38–39 (stating that China, Japan, and Finland have each officially classified bitcoin as a commodity).

⁹ A commodity is generally defined as a “basic good used in commerce that is interchangeable with other commodities of the same type[,] . . . essentially uniform across producers . . . [and] exchanged during commerce, which includes goods traded on a commodity exchange. *Commodity*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/commodity.asp> (last visited Oct. 10, 2015). Common commodities include gold, oil, coal, and precious stones like diamonds. In contrast, a currency is generally defined as a “generally accepted form of money, including coins and paper notes, which is issued by a government[,] . . . circulated within an economy . . . [and] used as a medium of exchange for goods and services.” Common currencies include the U.S. dollar, the euro, the British pound, and the Japanese yen.

would consequently classify the business's bitcoins as currency. The bitcoins would then receive all of the protections afforded to currencies under the Code. However, if an individual debtor only uses bitcoins to buy goods from online retailers, then those bitcoins would not need to be licensed. This non-licensed use would classify the bitcoins as a "commodity," and the debtor's bitcoins would receive that respective treatment.

The New York Department of Financial Services ("NYDFS") recently proposed a licensing framework to regulate virtual currency use.¹⁰ Although the suggested framework primarily seeks to address consumer protection, anti-money laundering, and cyber-security, the suggested framework also establishes a basic license-based classification system that bankruptcy courts could utilize to impose structure on bitcoins' classification.

While the effects of this classification system would be extensive, this Comment will focus on the effects of this suggested treatment of bitcoins in the context of bankruptcy. First, this Comment will explore what bitcoins are and the present status of the currency versus commodity debate. Second, this Comment will examine the current legal treatment of bitcoins and Bitcoin-specific issues in bankruptcy. Finally, this Comment will suggest why the affirmative classification of bitcoins is necessary, propose a licensing solution to bitcoins' classification, and explore the effects of this solution in bankruptcy.

I. BACKGROUND

The process of defining "Bitcoin" is complicated and controversial, and many people do not technically understand the concept of Bitcoin. The determination of whether bitcoin is a "currency" or "commodity" will have pervasive effects in the context of bankruptcy, and there are compelling arguments on both sides of the debate. Some legal entities have weighed in on this debate; however, Bitcoin's classification has been inconsistent.

¹⁰ The New York Department of Financial Services published a proposed regulatory framework in the State Registrar's July 23, 2014, edition that would require virtual currency businesses to obtain licenses and meet certain regulatory compliance obligations regarding consumer protection, anti-money laundering, and cyber security. N.Y. DEP'T OF FIN. SERVS., NY DFS RELEASES PROPOSED BITLICENSE REGULATORY FRAMEWORK FOR VIRTUAL CURRENCY FIRMS (2014), <http://www.dfs.ny.gov/about/press/pr1407171.html> [hereinafter NYDFS PROPOSED BITLICENSE].

A. *Technically, What Is Bitcoin?*

Bitcoin is a decentralized virtual “currency” that was created in 2009.¹¹ Bitcoin is decentralized because it is not monitored, controlled, or administered by any legal or governmental entity.¹² Although each bitcoin has no inherent value, each is unique and held by a single entity at a time.¹³ Bitcoin operates on a public ledger called the “blockchain,” which keeps track of every bitcoin created and who owns it.¹⁴ Each user’s bitcoins are stored in his or her “digital wallet,” which is only accessible by entering a sixty-four character alphanumeric “private key.”¹⁵ This interface is functionally similar to accessing bank funds through a customer’s banking portal. However, unlike a banking password, if a user were to lose his or her private key, those bitcoins would be forever inaccessible because there is no way to track or recover a lost key.¹⁶

Bitcoin originates through a process called “mining.”¹⁷ When mining, users provide computing power to process bitcoin transactions. Mining consists of running a continuous series of computations that add transactions to the blockchain.¹⁸ The supercomputers that compute the tremendous amount of data necessary to produce the bitcoins are referred to as “rigs,” and the individuals that oversee the rigs are called “miners.”¹⁹

In addition to mining, the other main categories of participants in the Bitcoin industry are Bitcoin exchanges and merchants who accept bitcoins as payment.²⁰ Bitcoins, once mined, can be exchanged for government-issued currencies on online exchanges, used to purchase goods and services from merchants who accept bitcoins as payment, or transferred from one user to

¹¹ Kien-Meng Ly, *supra* note 7, at 590; *see also* Reuven Cohen, *The Top 30 Crypto-Currency Market Capitalizations in One Place*, FORBES (Nov. 27, 2013, 10:41 AM), <http://www.forbes.com/sites/reuvencohen/2013/11/27/the-top-30-crypto-currency-market-capitalizations-in-one-place/> (stating that although bitcoin is the most popular virtual currency, other virtual currencies that have gained wide acceptance include “Litecoin” and “Peercoin”).

¹² *See* Kien-Meng Ly, *supra* note 7, at 590.

¹³ Doherty, *supra* note 4, at 38.

¹⁴ Hobson, *What is Bitcoin?*, 20 XRDS 40, 42 (2013).

¹⁵ CONSUMER FIN. PROT. BUREAU, *supra* note 5.

¹⁶ *See id.*

¹⁷ *See* Hobson, *supra* note 14, at 42–43, for a more technical breakdown of “mining” and why hackers cannot overtake the bitcoin network.

¹⁸ Hobson, *supra* note 14, at 42–43.

¹⁹ Doherty, *supra* note 4, at 38.

²⁰ Kien-Meng Ly, *supra* note 7, at 591.

another.²¹ Also, numerous other Bitcoin-centric entrepreneurial endeavors have emerged, including an investment company that manages a bitcoin mutual fund and game developers who use bitcoins in online social games.²²

Bitcoin's anonymity is one of its most prized features.²³ Despite the fact that bitcoin transactions are tracked on a public ledger that is accessible to anyone, bitcoin ownership and use is substantially anonymous because the only identifying information associated with a transaction is the user's private key.²⁴ This aspect of Bitcoin, however, also attracts those who desire anonymity for nefarious purposes. Criminals have used bitcoins to transact illegal goods and services globally.²⁵ The most notable example of this is Silk Road, an online black market where more than \$2 million worth of bitcoins contributed to the buying and selling of guns, drugs, forged documents, prostitution, and more over the course of a single year.²⁶ However, the federal government shut down Silk Road in the fall of 2013 and seized its bitcoins—144,000 bitcoins from the online black market's "kingpin" and 30,000 bitcoins from customers' Silk Road accounts.²⁷ Silk Road's seizure did not deter others wishing to transact illegal goods from following suit, and the successor, named "Silk Road 2.0," emerged shortly after the federal government shut down the original.²⁸

Bitcoin is susceptible to drastic price fluctuations because no governmental entity issues or insures it, and its value is dependent on public trust and perception.²⁹ In 2013, the price of bitcoins saw a sixty-one percent drop in a single day, and in 2014, there was a single-day price drop of eighty percent.³⁰ The instability of bitcoins' value is also influenced by the activity of hackers

²¹ *Id.* at 590.

²² *Id.* at 593–94.

²³ See Hobson, *supra* note 14, at 41.

²⁴ *Id.* at 41.

²⁵ *Id.* at 44.

²⁶ *Id.* at 44.

²⁷ Kashmir Hill, *Silk Road Bitcoin on the Move for Government Auction of \$18 Million Worth at End of the Month*, FORBES (June 12, 2014, 4:55 PM), <http://www.forbes.com/sites/kashmirhill/2014/06/12/silk-road-bitcoin-on-the-move-as-government-prepares-to-auction-off-18-million-worth/>. See generally Kashmir Hill, *Silk Road Bitcoin Auction Winner Tim Draper Won't Say How Many Millions He Paid*, FORBES (July 2, 2014, 5:52 PM), <http://www.forbes.com/sites/kashmirhill/2014/07/02/tim-draper-silk-road-bitcoin-auction/>.

²⁸ Nermin Hajdarbegovic, *Silk Road 2.0 Hit by "Sophisticated" DDoS Attack*, COINDESK (Sept. 15, 2014), <http://www.coindesk.com/silk-road-2-0-shrugs-sophisticated-ddos-attack/> (discussing that Silk Road 2.0, along with fellow online black market "Agora," have been the target of numerous attacks by hackers).

²⁹ See BITCOIN PRICE INDEX CHART, <http://www.coindesk.com/price/> (last visited Oct. 10, 2015) (showing up-to-date changes in the price of bitcoins); Kien-Meng Ly, *supra* note 7, at 590.

³⁰ CONSUMER FIN. PROT. BUREAU, *supra* note 5.

because most bitcoin exchanges are simply websites that convert deposited bitcoins into numbers in a database.³¹ These websites are just as vulnerable to hackers as any other website.³²

For example, in February 2014, Mt. Gox, a Japanese bitcoin exchange, was the target of a sophisticated hacker attack that froze customers' accounts and resulted in the loss of nearly \$400 million in bitcoin funds.³³ Unlike when funds are moved through a *secured* wire transfer, which passes through the Federal Reserve Bank, bitcoins move from *peer-to-peer*,³⁴ which makes tracking any given transaction nearly impossible without the users' private keys.³⁵ Because of Bitcoin's anonymity and the impossibility to retrieve lost bitcoins, neither Mt. Gox nor the bitcoins' owners had any record after the bitcoins disappeared. The Mt. Gox attack contributed to the disappearance of six percent of the world's bitcoins.³⁶

Despite the volatility and instability of bitcoin, and the fact that it does not have legal tender status in any jurisdiction,³⁷ many reputable retailers such as Overstock.com, Home Depot, and CVS accept the virtual currency as payment.³⁸ Integrating Bitcoin as a payment option for customers is a complex endeavor because many of the operational and legal requirements surrounding Bitcoin, including tax-accounting and regulatory compliance, are in a state of flux.³⁹

³¹ Hobson, *supra* note 14, at 42–44.

³² *Id.*

³³ CONSUMER FIN. PROT. BUREAU, *supra* note 5; Doherty, *supra* note 4, at 38–39. See Beth Winegarner, *Mt. Gox's Chapter 15 Bid Wins Texas Judge's Approval*, LAW360 (June 17, 2014), <http://www.law360.com/articles/549158/mt-gox-s-chapter-15-bid-wins-texas-judge-s-approval>, for a discussion of Mt. Gox's chapter 15 bankruptcy.

³⁴ See U.S. SEC. & EXCH. COMM'N, *supra* note 5 (defining Bitcoin as a “decentralized, peer-to-peer virtual currency that is used like money”).

³⁵ See CONSUMER FIN. PROT. BUREAU, *supra* note 5.

³⁶ Doherty, *supra* note 4, at 38–39. None of these bitcoins have yet been recovered by Mt. Gox or its customers. CONSUMER FIN. PROT. BUREAU, *supra* note 5. The loss of ninety-nine percent of the missing bitcoins is believed to have been the product of internal system manipulation rather than an external hacker's attack. Jon Southurst, *Missing Mt Gox Bitcoins Likely an Inside Job, Say Japanese Police*, COINDESK (Jan. 1, 2015), <http://www.coindesk.com/missing-mt-gox-bitcoins-inside-job-japanese-police/>.

³⁷ CONSUMER FIN. PROT. BUREAU, *supra* note 5.

³⁸ Clare O'Connor, *How to Use Bitcoin to Shop at Amazon, Home Depot, CVS and More*, FORBES (Feb. 2, 2014, 11:47 AM), <http://www.forbes.com/sites/clareoconnor/2014/02/17/how-to-use-bitcoin-to-shop-at-amazon-home-depot-cvs-and-more/>.

³⁹ Stephen T. Middlebrook, *Bitcoin for Merchants: Legal Considerations for Businesses Wishing to Accept Bitcoin as a Form of Payment*, BUS. LAW TODAY (Nov. 2014), http://www.americanbar.org/publications/blt/2014/11/02_middlebrook.html.

Bitcoin Merchant Service Providers have emerged in response to the problem of retailers that want to offer customers the ability to pay in bitcoins but lack sufficient resources to keep up with Bitcoin's regulatory dance.⁴⁰ Bitcoin Merchant Service Providers are third-party vendors that act as intermediaries, accepting customers' bitcoins and converting them into dollars or another government-issued currency to pay the retailer.⁴¹ Outsourcing this business function allows customers to pay with bitcoin without the retailer ever holding or receiving the bitcoin itself, freeing retailers from having to keep abreast of Bitcoin's regulatory and legal considerations.⁴²

Consumers also have significant access to bitcoins for use in the non-virtual marketplace through public places offering bitcoin ATMs.⁴³ These ATMs allow users to exchange cash for bitcoins at public kiosks.⁴⁴ Because the kiosks are more comparable to public computers than ATMs, these kiosks lack the typical safeguards of a classic ATM.⁴⁵

B. Bitcoin and Its Classification in Bankruptcy

The Code holds a broad range of assets susceptible to inclusion in the bankruptcy estate. Section 541 of the Code states that "all legal or equitable interests of the debtor in property as of the commencement of the case" are included in the bankruptcy estate with a handful of delineated exceptions.⁴⁶ Because "Congress intended a broad range of property to be included in the estate,"⁴⁷ there is little debate that a debtor's bitcoins would qualify as property of the debtor's bankruptcy estate and thus be subject to creditors' claims.⁴⁸ Thus, bankruptcy courts need to decide what to do with bitcoins.

⁴⁰ *Id.*

⁴¹ Utilization of a Bitcoin Merchant Service Provide ("BMSP") typically takes the form of adding a "pay with bitcoin" option to the merchant's online checkout page, and, if used, the customer then interacts with the BMSP to complete his or her payment with bitcoin. The BMSP later settles-up with the merchant according to a predetermined schedule by electronically transferring government-issued currency into the merchant's bank account. *Id.*

⁴² *See id.*

⁴³ *See* CONSUMER FIN. PROT. BUREAU, *supra* note 5; BITCOIN ATM ROAD MAP, <http://www.coindesk.com/bitcoin-atm-map/> (last visited Oct. 10, 2015).

⁴⁴ *See* CONSUMER FIN. PROT. BUREAU, *supra* note 5.

⁴⁵ *Id.*

⁴⁶ *See* 11 U.S.C. § 541(a)(1) (2012).

⁴⁷ *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 (1983).

⁴⁸ David E. Kronenberg & Daniel Gwen, *Bitcoins in Bankruptcy: Trouble Ahead for Investors and Bankruptcy Professionals?*, 3 PRATT'S J. BANKR. L. 3 (2014); *see also* I.R.S. News Release, *supra* note 5 (classifying virtual currency as property for federal tax purposes). *But see* *Butner v. United States*, 440 U.S.

Because the Code affords different protections to assets classified as a currency and assets classified as a commodity, the determination of whether bitcoin is a currency or a commodity will dictate bitcoins' treatment in bankruptcy. If bitcoins were classified as currency, bitcoin transactions would receive greater protections, including certain immunities from both the automatic stay and being deemed a constructive fraudulent transfer.⁴⁹

On the other hand, if bitcoins were classified as a commodity, the Code would not automatically afford such protections,⁵⁰ generally only extending substantial protections to those bitcoin transactions that constitute a "forward contract."⁵¹ A "forward contract" is made in the limited circumstances when the parties to a bitcoin transaction contractually agree that the bitcoins will be delivered at least two days before their payment is due.⁵²

C. *The Currency vs. Commodity Debate*

The analysis below provides an overview of the currency or commodity debate. However, there are also experts who consider bitcoin to be a new class of asset that cannot neatly fit into either category because it possesses "characteristics of both, as well as characteristics of neither."⁵³

"Currency" is broadly defined as a "generally accepted form of money, including coins and paper notes, which is issued by a government[,]. . . . circulated within an economy . . . [and u]sed as a medium of exchange for goods and services."⁵⁴ Like currency, bitcoin is accepted by major retailers as payment, is circulated through the international economy, and can be exchanged for U.S. dollars, yen, goods, and services.⁵⁵ However, the strongest

48, 55 (1979) (stating that the ultimate determination of whether the debtor has a property interest is a matter of state law).

⁴⁹ See 11 U.S.C. §§ 362(b)(17), 546(g), 548; 5 COLLIER ON BANKRUPTCY, *supra* note 4.

⁵⁰ See Doherty, *supra* note 4, at 38 (citing Lightfoot v. MXEnergy Elec. Inc. (*In re* MBS Mgmt Servs.), 690 F.3d 352, 356–57 (5th Cir. 2012)).

⁵¹ See 11 U.S.C. § 101(25)(A) (defining forward contracts); 11 U.S.C. § 362(b)(6) (excepting forward contract merchants from the automatic stay); 11 U.S.C. § 556 (preserving a party's contractual right to liquidate, terminate, or accelerate a commodities contract or forward contract).

⁵² See 11 U.S.C. § 101(25)(A).

⁵³ TEX. DEP'T OF BANKING, SUPERVISORY MEMO 1037, REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE TEXAS MONEY SERVICES ACT at 1, 3 (2014), <http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf>.

⁵⁴ *Currency*, INVESTOPEdia, <http://www.investopedia.com/terms/c/currency.asp> (last visited Oct. 10, 2015). See *generally About Investopedia*, INVESTOPEdia, <http://www.investopedia.com/corp/about.aspx> (last visited Oct. 10, 2015).

⁵⁵ See Doherty, *supra* note 4, at 38–39; O'Connor, *supra* note 38.

argument against bitcoins' classification as currency is that bitcoins are neither issued by any government nor required to be accepted as payment.⁵⁶ Furthermore, bitcoins have no intrinsic value, which has raised skepticism from esteemed investors such as Warren Buffet.⁵⁷ However, government-issued paper currency arguably has no intrinsic value either. Rather, its value is a manifestation of the public's perception that others will view the paper currency as valuable and thus will trade other things of value for it.⁵⁸

In comparison, a "commodity" is broadly defined as a "basic good used in commerce that is interchangeable with other commodities of the same type[,] . . . essentially uniform across producers . . . [and] exchanged during commerce, which includes goods traded on a commodity exchange."⁵⁹ Although each bitcoin mined is unique, it has a uniform value, and traders do not favor one bitcoin over another.⁶⁰ Thus, like a commodity, bitcoins are generally interchangeable and uniform across producers. Moreover, like gold, diamonds, or any other commodity, the finitude has an undeniably controlling effect on bitcoins' perceived value.⁶¹ There is a finite amount because developers plan to only produce twenty-one million bitcoins, which will be distributed in smaller and smaller quantities until 2140.⁶² Mining bitcoins is limited over time because the "reward" for mining diminishes by half every four years.⁶³ Producing additional bitcoins will eventually exceed any miner's capability because of the impossibly high computing capacity required.⁶⁴ This limitation provides great incentive for miners to promptly invest substantial capital in their rigs so they have the computing power necessary to secure the finite number of bitcoins and beat out other rigs with lesser computing power.⁶⁵ Unlike most commodity producing operations, however, the rigs

⁵⁶ CONSUMER FIN. PROT. BUREAU, *supra* note 5.

⁵⁷ Kashmir Hill, *Bitcoin Battle: Warren Buffet vs. Marc Andreessen*, FORBES (Mar. 26, 2014), <http://www.forbes.com/sites/kashmirhill/2014/03/26/warren-buffett-says-bitcoin-is-a-mirage-why-marc-andreessen-thinks-hes-wrong/>.

⁵⁸ *See* Doherty, *supra* note 4, at 39.

⁵⁹ INVESTOPEDIA, *Commodity*, *supra* note 9.

⁶⁰ Doherty, *supra* note 4, at 38.

⁶¹ *Id.* at 38–39.

⁶² *Id.* at 38; Hobson, *supra* note 14, at 41–42.

⁶³ Hobson, *supra* note 14, at 42.

⁶⁴ *See* Hobson, *supra* note 14, at 42.

⁶⁵ *See id.* at 41–42.

themselves are the ultimate source of value for bitcoin producers because the bitcoins would not exist but for the mining rigs.⁶⁶

D. Legally, What Is Bitcoin?

Adding to the controversy of how to treat bitcoins, different legal entities have classified bitcoins differently. For example, after a Texas district court tried to classify bitcoins in 2013, the Texas Department of Banking issued contradictory guidance.⁶⁷ Early attempts to classify bitcoins focused more on how Bitcoin users and bitcoin transactions should be classified, rather than bitcoins themselves. However, there has been a new development that holds substantial promise of finally bringing clarity to the classification of virtual currency—the “Bitlicense.”

1. Recognizing the Need for a Classification

The Department of the Treasury Financial Crimes Enforcement Network (“FinCEN”) was one of the first governmental entities to issue agency guidance on virtual currency.⁶⁸ FinCEN stated that while a mere user of virtual currency is not considered a Money Services Business (“MSB”), an “administrator”⁶⁹ or an “exchanger”⁷⁰ is considered a MSB, and thus is subject to regulations concerning registering, reporting, and record keeping.⁷¹ However, FinCEN’s line-drawing only served to categorize virtual currency *users*, not the virtual currency itself, and thus ultimately shed no light on bitcoins’ status.

In the bankruptcy context, debtors and creditors have struggled to determine how to classify bitcoins in contractual arrangements. This difficulty was evident in *In re CLI Holdings*, where the debtor and creditor treated bitcoins like a “subterranean” commodity, such as gas or oil, and the bankruptcy court subsequently grappled with how to honor this arrangement.⁷²

⁶⁶ See Doherty, *supra* note 4, at 82.

⁶⁷ See *S.E.C. v. Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. Aug. 6, 2013); TEX. DEP’T OF BANKING, *supra* note 58, at 1–2.

⁶⁸ See DEP’T OF THE TREAS., FIN. CRIMES ENF’T NETWORK, FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013).

⁶⁹ *Id.* (stating that an administrator is a person that moves virtual currency into and out of circulation in his or her business activities).

⁷⁰ *Id.* (stating that an exchanger is a person that exchanges virtual currency for real currency or other virtual currency in his or her business activities).

⁷¹ *Id.*

⁷² Doherty, *supra* note 4, at 39.

In *CLI Holdings*, the debtor, a bitcoin miner, borrowed \$75,000 from a bitcoin-financing entity to purchase mining equipment.⁷³ In return, the miner contracted to repay the loan with the first 7,984 bitcoins produced, secured by an interest in the mining equipment.⁷⁴ This type of arrangement, called an overriding royalty interest (“ORRI”), is common among the oil and gas industries.⁷⁵ The bitcoin miner was unable to pay back the ORRI and filed for bankruptcy under chapter 11.⁷⁶ In the bankruptcy petition, the debtor projected that the financial return for mining was trending downwards so as to urge the court to reject its ORRI contract with the creditor, freeing CLI Holdings to sell its mining rigs unencumbered to generate funds to pay off creditors.⁷⁷ However, the court upheld the contract and treated bitcoins as any commodity subject to an ORRI.⁷⁸

Treating the debtor’s bitcoins as a commodity arguably did not have a detrimental effect on either party in *CLI Holdings*, as the court simply required the parties to honor their contract as written. Though, as will be discussed in later sections, if the debtor had liquidated its bitcoins prior to bankruptcy because of Bitcoin’s anticipated drop in value, the creditor may have fought for the bitcoins to be treated as currency so that the liquidation would not be in danger of being reversed.⁷⁹ Such fact-specific justifications to bitcoins’ classification confuse any attempt to establish a uniform treatment of virtual currency. Also, if the status and treatment of bitcoin under the Code had been established prior to the parties’ entry into their debtor-creditor relationship, the parties could have entered into a more mutually beneficial contract at the onset than an ORRI.

2. *An Attempt to Classify Bitcoin as Currency*

Few courts have addressed the issue of bitcoins’ status as a currency or a commodity, and as of October 2015, no bankruptcy court had definitively ruled

⁷³ *Id.*

⁷⁴ Doherty, *supra* note 4, at 39.

⁷⁵ *Id.*

⁷⁶ See Voluntary Petition at 1, *In re CLI Holdings, Inc.*, (Bankr. W.D. Wash. 2013) (No. 13-19746-KAO).

⁷⁷ See Am. Decl. of Peter Vessenes in Supp. of Ex Parte Mot. for Order to Shorten Time to Hear Mot. for Bidding Procedures Order and for Sale of Assets at ¶ 3, *In re CLI Holdings, Inc.* (Bankr. W.D. Wash. 2013) (No. 13-19746-KAO); Doherty, *supra* note 4, at 39.

⁷⁸ See Doherty, *supra* note 4, at 39. The parties in *CLI Holdings* ultimately settled their dispute outside the courtroom. Doherty, *supra* note 4, at 82.

⁷⁹ See 11 U.S.C. §§ 546(g), 548 (2012).

on the issue. The only court thus far to classify bitcoins as currency is the United States District Court for the Eastern District of Texas in *SEC v. Shavers*.⁸⁰ In *Shavers*, the SEC sought jurisdiction to punish the perpetrator of a bitcoin-for-bitcoin Ponzi scheme.⁸¹ The Texas district court asserted that the Ponzi scheme involved an investment of money/currency because bitcoins “can be used as money . . . to purchase goods and services,”⁸² and as was done specifically in *Shavers*, “to pay for individual living expenses.”⁸³ Once the court classified bitcoins as currency, the bitcoin investments could be considered securities under federal securities laws, and thus, the court concluded that bitcoins were subject to SEC regulation, and *Shavers* was subject to SEC penalties.⁸⁴ The fact that bitcoins are not universally accepted did not weigh heavily on the decision. Rather, what the court found to be important was that bitcoins can be exchanged for conventional, government-issued currency.⁸⁵ The court, however, may have been incentivized to classify bitcoins as money to show Bitcoin operators that they cannot blatantly skirt regulatory safeguards. In doing so, the court may not have fully contemplated the broader repercussions of its holding.

The Texas Department of Banking⁸⁶ subsequently recognized the district court’s deficient analysis and responded with a Supervisory Memorandum asserting that “cryptocurrency,”⁸⁷ such as Bitcoin, is *not* money/currency under the Texas Money Services Act.⁸⁸ The memo further stated that an exchange of

⁸⁰ See No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *5 (E.D. Tex. Aug. 6, 2013).

⁸¹ *Id.*

⁸² *Id.* at *4.

⁸³ *Id.*

⁸⁴ *Id.* at *5.

⁸⁵ See *id.*

⁸⁶ See TEX. DEP’T OF BANKING LAWS & REGULATIONS, <http://www.dob.texas.gov> (last visited Jan. 10, 2016). The Texas Department of Banking is responsible for maintaining the soundness of Texas’s financial services. The Texas Department of Banking is responsible for chartering, licensing, and supervising financial services within the state of Texas, including State-Chartered Banks and Money Services Businesses, as well as issuing legal opinions and supervisory guidance that applies to the entities it regulates.

⁸⁷ TEX. DEP’T OF BANKING LAWS & REGULATIONS, MEMORANDUM ON REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE TEXAS MONEY SECURITIES ACT TO ALL VIRTUAL CURRENCY COMPANIES OPERATING OR DESIRING TO OPERATE IN TEXAS, at 1–2 (Apr. 3, 2014), <http://www.dob.texas.gov/public/uploads/files/consumer-information/sm/1037.pdf> (defining cryptocurrency as any electronic currency created in the context of a “peer-to-peer network” where computer calculations result in the generation of new units of the currency—including bitcoin, Litecoin, Peercoin, and Namecoin).

⁸⁸ TEX. DEP’T OF BANKING, *supra* note 58, at 2 (Apr. 3, 2014), <http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf> (stating that “coin and paper money of the United States or any country that is designated as legal tender and circulated and is customarily used and accepted as a medium of exchange in the country of issuance”).

bitcoins for dollars is not considered “money transmission,” but rather “a sale of goods,” with the government-issued currency being exchanged for the non-money good.⁸⁹ The memo requires cryptocurrency businesses that conduct money transmissions to comply with state licensing and regulatory provisions.⁹⁰ The only cryptocurrency-related exchanges that were expressly identified as money transmissions were (1) the exchange of cryptocurrency for sovereign currency through a third party exchanger⁹¹ and (2) the exchange of cryptocurrency for sovereign currency through an ATM.⁹² The Texas Department of Banking’s memorandum clearly classified virtual currency as a good/commodity; however, the express purpose of the Texas Department of Banking’s memo was “only to establish the regulatory treatment of virtual currencies under existing statutory definitions.”⁹³ Thus, the door was deliberately left open for regulatory change, and more specifically, for the regulatory classification of virtual currencies such as Bitcoin.

Although the *Shavers* decision gave support for the position of Bitcoin as a currency, the logic of the court was heavily imbued with public policy concerns over consumer protection and did not fully contemplate the repercussions of deeming Bitcoin a currency, as evidenced by the Texas Department of Banking’s memo.⁹⁴ However, when *Shavers* later filed a motion to dismiss the SEC’s claims against him in June 2014, citing the Texas Department of Banking’s memo, the Texas district court denied the motion.⁹⁵ The court posited that the Department of Banking’s definition of Bitcoin was limited to determining whether the “exchangers and transmitters of a virtual currency” were required to be licensed under Texas’ current laws, and that the memo was not making the general assertion that Bitcoin is not currency.⁹⁶

⁸⁹ *Id.* at 3.

⁹⁰ *Id.* at 4.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* at 1.

⁹⁴ *See id.* at 4; S.E.C. v. *Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *5 (E.D. Tex. Aug. 6, 2013).

⁹⁵ Motion for Reconsideration at 12–13, S.E.C. v. *Shavers*, 2014 U.S. Dist. LEXIS 130781 (E.D. Tex. 2014) (No. 4:13cv416).

⁹⁶ Miriam Rozen, *Bitcoin: Daylight Between Definitions Used by Federal Court and State Agency?*, TEX. LAWYER (Sept. 29, 2014), <http://www.texaslawyer.com/id=1202671415453/Bitcoin-Daylight-Between-Definitions-Used-by-Federal-Court-and-State-Agency?slreturn=20140907103023> (comparing and pointing out the inconsistency between the holding in *Shavers* and the Texas Department of Banking’s Memorandum from April 3, 2014). The Texas district court refused to reverse its ruling, despite the defendant’s argument that subsequent guidance by state and federal agencies had rendered the decision unsound, asserting that none of the guidance definitively classified Bitcoin nor dictated its treatment under federal securities law. Kurt Orzech,

3. *Subsequent Governmental Guidance and Statutory Schemes*

Subsequent to these initial attempts at classifying Bitcoin, other governmental guidance and statutory schemes aimed at defining Bitcoin in various contexts have laid a disorganized and confusing path for creditors and debtors to follow when trying to determine the status of bitcoins. Articles 9⁹⁷ and 8⁹⁸ of the Uniform Commercial Code, which has been adopted by all fifty states with minor variations,⁹⁹ both address the potential classification of bitcoins. Article 9 governs security interests in personal property, including “general intangibles” and “payment intangibles.”¹⁰⁰ Arrangements in which creditors secure their loans with “inventory, goods, equipment, accounts, and general intangibles” are commonly referred to as “blanket liens.”¹⁰¹ When a portion of the debtor’s “general intangibles” includes bitcoins, the bitcoins become subject to the blanket lien in which the creditor has a secured interest, assuming the lien has been perfected.¹⁰² However, if the debtor uses the bitcoins to purchase inventory, such as equipment or raw materials, the creditor maintains a security interest in those bitcoins, which persists for subsequent transfers.¹⁰³ A transferee down the chain would unknowingly receive the bitcoins encumbered by the initial creditor’s secured interest, substantially undercutting Bitcoin’s utility as a medium of exchange.¹⁰⁴

On the other hand, the transfer of “money” cannot be encumbered by preexisting security interests, thus promoting its alienability and circulation.¹⁰⁵ Bitcoin, however, does not fit the UCC’s definition of money:¹⁰⁶ “a medium of exchange authorized or adopted by a domestic or foreign government.”¹⁰⁷ As of now, no government has officially authorized or adopted bitcoins as

Bitcoin Again Found Subject to Securities Laws in Scam Suit, LAW360 (Aug. 26, 2014), <http://www.law360.com/articles/571342/bitcoin-again-found-subject-to-securities-laws-in-scam-suit>.

⁹⁷ U.C.C. § 9 (2014).

⁹⁸ U.C.C. § 8.

⁹⁹ Bob Lawless, *Is UCC Article 9 the Achilles Heel of Bitcoin?*, CREDIT SLIPS (Mar. 10, 2014, 8:17 PM), <http://www.creditslips.org/creditslips/2014/03/is-ucc-article-9-the-achilles-heel-of-bitcoin.html> [hereinafter, Lawless, *UCC Article 9*].

¹⁰⁰ See U.C.C. §§ 9-102(a)(42) & (61).

¹⁰¹ Lawless, *supra* note 99.

¹⁰² See *id.*

¹⁰³ See U.C.C. § 9-325.

¹⁰⁴ Lawless, *UCC Article 9*, *supra* note 99.

¹⁰⁵ See U.C.C. § 9-332.

¹⁰⁶ Lawless, *UCC Article 9*, *supra* note 99.

¹⁰⁷ U.C.C. § 1-201(b)(24).

“currency,”¹⁰⁸ although India’s Central Bank has expressly not ruled out adopting virtual currency at some point in the future.¹⁰⁹ Some countries, such as China, Japan, and Finland, have officially classified bitcoins as commodities.¹¹⁰

Under Article 8, if classified as a “security,” bitcoins would not be perpetually encumbered by previous creditors’ security interests.¹¹¹ The UCC defines a “security interest” as “an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer.”¹¹² Bitcoins fit this definition if they are understood to reflect an “enterprise of [the] issuer.”¹¹³ Supporting this interpretation, Bitcoin is the accumulated product of many individuals, who often combine their individual capacities to compute tremendous amounts of data. Those with the greatest computing capabilities retrieve new bitcoins.¹¹⁴ These bitcoins can then be sold to outside investors who want to have an interest in the Bitcoin enterprise.¹¹⁵ Viewed from this perspective, bitcoins may be construed as shares of a greater commercial enterprise, qualifying them as a “security” and freeing them from the constraints of previous secured interests.¹¹⁶ This perspective would make Bitcoin more practical as a medium of exchange because of increased alienability.¹¹⁷

The Internal Revenue Service has advised that virtual currency constitutes “property” for tax purposes and is subject to capital gains taxation.¹¹⁸

¹⁰⁸ See Kashmir Hill, *Bitcoin’s Legality Around The World*, FORBES (Jan. 31, 2014), <http://www.forbes.com/sites/kashmirhill/2014/01/31/bitcoins-legality-around-the-world/>.

¹⁰⁹ Nermin Hajdarbegovic, *India’s Central Bank Could One Day Use Digital Currency, Chief Says*, COINDESK (Dec. 30, 2014), <http://www.coindesk.com/indias-central-bank-one-day-use-digital-currency-chief-says> (discussing the Chief of India’s Central Bank’s statement that a digital currency system may be adopted by the Central Bank in the next ten to fifteen years).

¹¹⁰ Kati Pohjanpalo, *Bitcoin Judged Commodity in Finland After Failing Money Test*, BLOOMBERG BUSINESS (Jan. 20, 2014), <http://www.bloomberg.com/news/2014-01-19/bitcoin-becomes-commodity-in-finland-after-failing-currency-test.html> (asserting that Bitcoin is not currency because “a payment instrument must have an issuer responsible for its operation”); Doherty, *supra* note 4, at 39.

¹¹¹ Bob Lawless, *Is UCC Article 8 Bitcoin’s Savior (for Commercial Law)?*, CREDIT SLIPS (Mar. 28, 2014, 3:47 PM), <http://www.creditslips.org/creditslips/2014/03/is-ucc-article-8-bitcoins-savior-for-commercial-law.html> [hereinafter Lawless, *UCC Article 8*].

¹¹² U.C.C. § 8-102(a)(15).

¹¹³ *Id.*

¹¹⁴ Lawless, *UCC Article 8*, *supra* note 111.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ See Lawless, *UCC Article 9*, *supra* note 99.

¹¹⁸ I.R.S. News Release, *supra* note 5.

Consequently, any payment in virtual currency “is subject to information reporting to the same extent as any other payment made in property.”¹¹⁹ Unlike currency, bitcoins are non-fungible because “the purchase price of the bitcoin determines the capital gain ([or] loss) on the bitcoin”¹²⁰ when it is exchanged. It is difficult to deem Bitcoin a workable medium of exchange if each unit is treated differently. For example, imagine a scenario where one ten dollar bill was taxed differently than another ten dollar bill.¹²¹

In August 2014, the Consumer Financial Protection Bureau (“CFPB”)¹²² released a consumer advisory report, asserting that “virtual currencies aren’t regular money.”¹²³ Virtual currencies are not government-issued, and no merchant is required to accept them as payment.¹²⁴ The CFPB’s mission is to make financial markets safe for consumers; thus, by warning consumers of Bitcoin’s pitfalls and allowing consumers to submit financial product or service complaints regarding bitcoins, the CFPB has raised consumer interactions with bitcoins to the status of any other financial transaction dealing with currency.¹²⁵

4. *A New Approach to Bitcoin: The “Bitlicense”*

Despite the cumbersome path that Bitcoin has traveled in trying to find a place in the economic marketplace, there has been a recent development that holds the potential to finally bring substantial clarity to Bitcoin’s status. The NYDFS¹²⁶ released a proposed framework in July 2014 to combat the regulatory ambiguity surrounding Bitcoin and virtual currency more generally.¹²⁷ This framework requires virtual currency businesses to obtain

¹¹⁹ *Id.*

¹²⁰ Adam Levitin, *Bitcoin Tax Ruling*, CREDIT SLIPS (Mar. 26, 2014, 9:56 AM), <http://www.creditslips.org/creditslips/2014/03/bitcoin-tax-ruling.html#more>.

¹²¹ *See id.*

¹²² The CFPB is a federal agency that monitors banks, credit unions, and other financial companies to ensure compliance with federal consumer financial laws. *About us*, CONSUMER FIN. PROT. BUREAU (Aug. 19, 2015), <http://www.consumerfinance.gov/the-bureau/>.

¹²³ CONSUMER FIN. PROT. BUREAU, *supra* note 5; *see* EUR. BANKING AUTH., WARNING TO CONSUMERS ON VIRTUAL CURRENCIES (2013), <https://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf>.

¹²⁴ CONSUMER FIN. PROT. BUREAU, *supra* note 5.

¹²⁵ *Id.*

¹²⁶ *Who We Supervise*, N.Y. DEP’T OF FIN. SERVS. (July 11, 2014), <http://www.dfs.ny.gov/about/whowesupervise.htm> (stating that NYDFS supervises and regulates New York institutions and institutions that do business in New York).

¹²⁷ NYDFS PROPOSED BITLICENSE, *supra* note 10; *see also* Virtual Currencies, N.Y. COMP. CODES R. & REGS. tit. 23, § 200 (2015), <http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf>.

licenses and meet certain regulatory compliance obligations regarding consumer protection, anti-money laundering, and cyber security, and consequently has been dubbed the “Bitlicense.”¹²⁸ Section 200.3 states that “[n]o Person shall, without a license obtained from the superintendent as provided in this Part, engage in any Virtual Currency Business Activity.”¹²⁹ The regulation defines “Virtual Currency Business Activity” broadly, save one exception:

[T]he conduct of any one of the following types of activities involving New York or a New York Resident:

- (1) receiving Virtual Currency for transmission or transmitting the same;
- (2) securing, storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;
- (3) buying and selling Virtual Currency as a customer business;
- (4) performing retail conversion services, including the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency; or
- (5) controlling, administering, or issuing a Virtual Currency.¹³⁰

“[M]erchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services” are exempted from the licensing requirement.¹³¹ While the regulation applies only to New York, it is expected to spark a regulatory domino effect, and other jurisdictions are likely to follow suit with similar regulations.¹³²

The NYDFS Bitlicense regulation was met with substantial backlash from the Bitcoin community.¹³³ Concerns included heightened barriers to entry for new or financially unsupported industry players, overly broad definitions of

¹²⁸ NYDFS PROPOSED BITLICENSE, *supra* note 10; *see also* Virtual Currencies, tit. 23, § 200.

¹²⁹ *Id.*

¹³⁰ *Id.* A “fiat currency” is any currency that is not backed by a commodity, which comprises most currencies today. Pascal-Emmanuel Gobry, *All Money Is Fiat Money*, FORBES (Jan. 8, 2013), <http://www.forbes.com/sites/pascalemanuelgobry/2013/01/08/all-money-is-fiat-money/>.

¹³¹ Virtual Currencies, tit. 23, § 200.

¹³² *See* Matt Clinch, *China Bitcoin Firms Warn New York on Regulation*, CNBC (Aug. 21, 2014), <http://www.cnbc.com/id/101935839>.

¹³³ Jon Southurst, *Industry Reactions to New York's BitLicense Proposal*, COINDESK (Aug. 10, 2014), <http://www.coindesk.com/new-york-bitlicense-views-inside-bitcoin-industry/> [hereinafter Southurst, *Industry Reaction*].

“virtual currency” and “virtual currency business activity,” and the likelihood of licensing destroying user anonymity and privacy.¹³⁴ Further, fearing that the Bitlicense system would have far-reaching effects on global exchanges, China’s three biggest bitcoin exchanges sent a joint letter to New York regulators in August of 2014.¹³⁵ The letter voiced concerns over the NYDFS’s access to Bitcoin information from both licensed companies and their affiliates.¹³⁶

A regulatory overhaul like the Bitlicense also raises concerns over whether increasing compliance requirements will cause bitcoin exchanges to flee to countries with lower regulatory compliance standards, ultimately rendering consumers less protected than they are now.¹³⁷

Despite these concerns, the benefits of regulation arguably outweigh the risks because increasing Bitcoin’s transparency through additional regulation will protect current users as well as give new and existing users confidence in Bitcoin use.¹³⁸ This additional protection and consumer confidence will consequently enhance Bitcoin’s overall stability in the marketplace.¹³⁹

II. ANALYSIS

Given the disparate approaches taken so far to the treatment of Bitcoin, a uniform classification system is necessary to bring consistency. Bitcoin’s classification should be proactively established, rather than reactively established in the courtroom where a judge may make a narrow determination based upon the facts presented.

There are bankruptcy-specific issues that must be taken into consideration when contemplating a uniform classification system for Bitcoin. These issues include Bitcoin’s volatile price fluctuations, the difficulty in adequately protecting creditors’ bitcoin-secured interests over the duration of bankruptcy proceedings, and the extent to which Bitcoin transactions should be protected

¹³⁴ *Id.*

¹³⁵ Clinch, *supra* note 132.

¹³⁶ *Id.*

¹³⁷ See Nicole D. Swartz, *Bursting the Bitcoin Bubble: The Case to Regulate Digital Currency as a Security or Commodity*, 17 TUL. J. TECH. & INTELL. PROP. 319, 327 (2014) (citing Joshua J. Doguet, *The Nature of the Form: Legal and Regulatory Issues Surrounding the Bitcoin Digital Currency System*, 73 LA. L. REV. 1119, 1149 (2013)).

¹³⁸ *Id.* at 329–35 (discussing the economic bubble created by Bitcoin and the reasons to regulate Bitcoin).

¹³⁹ See *id.* (discussing the economic bubble created by Bitcoin and the reasons to regulate Bitcoin).

from reversal. This section will suggest a license-based solution to categorizing Bitcoin that builds on a categorization similar to that of the NYDFS's Bitlicense. The suggested solution draws a distinction between bitcoins that are involved in licensed-use and bitcoins that are not, and then classifies the former as currency and the latter as commodity. This license-based solution is not only more efficient and practical than the ad hoc approach currently taken, but it is also supported by public policy. Public policy generally endorses solutions that protect consumers in the marketplace. Accordingly, the license-based solution presented here incentivizes entities to improve consumer safeguards because those safeguards are required to maintain the benefits of a licensed-use.

A. Is a Unified Rule of Treatment Even Necessary?

One initial question is whether a uniform classification scheme is necessary. Entities could proceed with ad hoc determinations, applying a flexible approach to justify whatever result is sought in that specific situation; but to approach Bitcoin's categorization in bankruptcy from this result-oriented perspective would only add to a long list of uncoordinated efforts. Lack of a consistent classification scheme produces self-interested results, such as the court in *Shavers* deeming bitcoins "money" to obtain jurisdiction to punish¹⁴⁰ and the IRS deeming bitcoins "property" subject to taxation.¹⁴¹ Thus, this section begins with an initial determination of whether the goals served by an ad hoc approach to classifying Bitcoin in each respective non-bankruptcy area is outweighed by the overarching consistency that a uniform classification would provide.

A uniform rule is necessary and helpful but only if it does not hinder the underlying goals of bankruptcy. Bankruptcy provides a collective forum that creates value through optimizing distressed debtors' assets to repay creditors.¹⁴² Reciprocally, bankruptcy absolves debtors of personal liability for past debts, allowing for an economically productive fresh start.¹⁴³ Although a uniform rule is necessary to bring consistency to Bitcoin's treatment and

¹⁴⁰ See *S.E.C. v. Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *5 (E.D. Tex. Aug. 6, 2013).

¹⁴¹ See I.R.S. News Release, *supra* note 5.

¹⁴² See ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 115 (6th ed. 2009).

¹⁴³ See *id.*

reduce unwanted forum shopping,¹⁴⁴ policy may actually want to incentivize entities with distressed bitcoin-based assets to seek out a specific bankruptcy forum to optimize their assets among creditors and create overall greater economic productivity.¹⁴⁵ Consequently, this analysis proceeds from the perspective that Bitcoin's treatment in bankruptcy should maximize a debtor's bitcoins for the benefit of all associated parties but not at the expense of foregoing an overarching framework. If a single framework is not established for legal entities to utilize when developing more specific policies and procedures, a uniform classification soon may not be possible.¹⁴⁶

B. Issues with Bitcoin in the Bankruptcy Code

Bitcoin plays a unique role in the bankruptcy estate and presents significant difficulties providing secured creditors with adequate protection. Moreover, if Bitcoin is classified as a currency, the Code would offer significant protections to bitcoin transactions, including safeguards against constructive fraudulent transfers and restraint by the automatic stay. However, if Bitcoin is instead classified as a commodity, it would not automatically receive these protections.

1. Bitcoin's Role in the Bankruptcy Estate

Generally, § 541 of the Code includes “all legal or equitable interests of the debtor in property as of the commencement of the case” in the debtor's bankruptcy estate.¹⁴⁷ After bankruptcy proceedings commence, the trustee gathers all of the debtor's assets that comprise the estate.¹⁴⁸ Because Bitcoin transactions are unrecorded exchanges between anonymous digital addresses, problems may arise in accounting for this elusive asset.¹⁴⁹ Bitcoin's prized anonymity may create inefficiencies by forcing the trustee to track down

¹⁴⁴ The type of forum shopping discussed here is not the typical analysis of comparing different states to lay venue, but rather which forum—bankruptcy or otherwise—the debtor may seek to restructure its assets and minimize creditor liability. *See also* COMM. ON BANKR. & CORP. REORG., N.Y.C. B. ASS'N, NON-BANKRUPTCY ALTERNATIVES TO RESTRUCTURINGS AND ASSET SALES (2010), <http://www.nycbar.org/pdf/report/uploads/20072001-NonBankruptcyAlternativestoRestructuringsandAssetSales.pdf>. (discussing non-bankruptcy alternatives to restructuring and asset sales).

¹⁴⁵ *See* WARREN & WESTBROOK, *supra* note 142.

¹⁴⁶ *See* Peter Van Valkenburgh & Jerry Brito, *State Digital Currency Principles and Framework*, COIN CENTER REPORT, at 1–2 (May 2015), <https://coincenter.org/2015/04/state-principles-and-framework/> (proposing model language for the “essential components” of any digital currency law, including “who must be licensed, how are start-ups encouraged, how is solvency guaranteed, etc.”).

¹⁴⁷ *See* 11 U.S.C. § 541(a)(1) (2012).

¹⁴⁸ *See id.*

¹⁴⁹ Kronenberg & Gwen, *supra* note 48.

bitcoins that the debtor may have hidden under a private key.¹⁵⁰ There is a pervasive effort in bankruptcy to avoid spending money from the debtor's estate on litigation, especially when the amount in dispute is inconsequential.¹⁵¹ Thus, the small amount of bitcoins that an individual retains for online retail transactions may not even be worth the hassle of tracking down. However, when dealing with a business that commonly transacts in and maintains a large quantity of bitcoins, the potential value that may be recovered sufficiently justifies the expense and effort necessary to reveal any hidden Bitcoin accounts.

Fortunately, in most cases, the debtor will have an incentive to reveal its bitcoins, and the bankruptcy trustee should not have to track the bitcoins down. Under § 727 of the Code, a debtor may be completely denied discharge if he or she transfers, removes, destroys, mutilates, or conceals bitcoins or any associated records.¹⁵² Thus, although some debtors may be tempted to conceal their bitcoins, most debtors should be motivated to disclose even small, relatively untraceable amounts of bitcoins for fear of being denied discharge.¹⁵³

Additionally, bitcoin is an unreliable asset for distribution because its value is extremely volatile.¹⁵⁴ The value of a debtor's bitcoins could change dramatically from the moment of filing the petition until dismissal or discharge.¹⁵⁵ Thus, the determination of when to liquidate a debtor's bitcoins must balance the creditors' current interest in repayment and any future interest the debtor may have in the bitcoins.

2. *Bitcoin and Adequate Protection*

Another aspect of bankruptcy in which Bitcoin raises significant concerns is providing creditors with adequate protection under chapters that involve a long-term repayment plan rather than immediate liquidation of bitcoins. The theory behind adequate protection is that creditors should not be disadvantaged simply because the debtor filed for bankruptcy under one chapter as opposed to

¹⁵⁰ See Hobson, *supra* note 14, at 42–44.

¹⁵¹ See WARREN & WESTBROOK, *supra* note 142, at 218–19.

¹⁵² 11 U.S.C. § 727(a)(2)–(3); see also Complaint at 3–8, U.S. Trustee v. Katz (*In re Katz*), Ch. 7 Case No. 13-62408, Adv. No. 14-06037 (Bankr. W.D. Va. May 29, 2014) (discussing a filing in which debtors failed to disclose their Bitcoin wallets, Bitcoin accounts, and Bitcoin-related activity, such as buying and selling bitcoins on exchanges).

¹⁵³ See 11 U.S.C. § 727; WARREN & WESTBROOK, *supra* note 142, at 229.

¹⁵⁴ Kronenberg & Gwen, *supra* note 48.

¹⁵⁵ See Doherty, *supra* note 4, at 39, 82; 11 U.S.C. §§ 541(a)(1), 524, 349.

another.¹⁵⁶ Under chapters 11 and 13, a secured creditor becomes vulnerable if its collateral depreciates after the repayment plan confirmation date.¹⁵⁷ If the case is converted to chapter 7, the creditor would be under-secured and not recover what it would have if the collateral had been immediately liquidated.¹⁵⁸

In these circumstances, the Code requires additional protections to ensure that the value paid to the creditor over time in a repayment plan equals or exceeds the value the creditor would have received had the debtor initially filed under chapter 7.¹⁵⁹ To accomplish this goal, §§ 362, 363, and 364 each require that a creditor's interest be adequately protected.¹⁶⁰ If there is inadequate protection, then the debtor must provide adequate protection in the form of (1) a cash payment or periodic cash payments, (2) an additional or replacement lien, or (3) any other relief that adequately protects the creditor's interest, other than promoting the creditor's interest to a highly prioritized administrative expense.¹⁶¹ Under either chapters 11 or 13, a creditor's interest may be deemed inadequately protected if there is a significant risk that the value of the creditor's collateral may plummet after the petition date.¹⁶²

Bitcoins' volatile price fluctuations will make it difficult to determine whether a creditor's interest that is secured by bitcoins is adequately protected over the life of a debtor's repayment plan.¹⁶³ For example, if the Bitcoin market is inflated when a repayment plan is confirmed, meaning the bitcoins are overvalued, then the creditor will become more and more under-secured as the price falls to a normal level, leaving the creditor vulnerable and in need of adequate protection.¹⁶⁴

In contrast, if the bitcoins are undervalued, then the debtor may agree to adequate protection payments that are soon rendered unnecessary because the

¹⁵⁶ See 8 COLLIER ON BANKRUPTCY ¶ 1325.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012) (“[A] chapter 13 plan must provide for property to be distributed in settlement of each allowed unsecured claim in an amount not less than the amount that would be paid if the estate of the debtor were liquidated under chapter 7.”).

¹⁵⁷ See 3 COLLIER ON BANKRUPTCY ¶ 361.04 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012).

¹⁵⁸ See *id.*

¹⁵⁹ See 11 U.S.C. § 1325(a)(5)(B)(ii).

¹⁶⁰ 11 U.S.C. §§ 362–364.

¹⁶¹ *Id.*

¹⁶² See 3 COLLIER ON BANKRUPTCY, *supra* note 157. This Comment does not address the specific implications of Bitcoin when the debtor is an individual filing under chapter 11.

¹⁶³ A debtor's repayment plan lasts between three and five years in chapter 13 proceedings. See 11 U.S.C. § 1322(d). There are longer time limitations for repayment plans under chapter 11. See 11 U.S.C. § 1123.

¹⁶⁴ See 11 U.S.C. §§ 361, 1127, 1329.

creditor will become fully-secured, or even over-secured, as time progresses and the bitcoins appreciate. If the creditor becomes over-secured, it may be entitled to receive additional funds from the debtor that it was not granted under the initial plan, including post-petition interest and attorneys' fees.¹⁶⁵ These additional entitlements prevent the debtor from knowing with certainty how his or her assets will be treated over the course of the bankruptcy proceedings.

Adequate protection is also a concern when dealing with cash collateral. Section 363 of the Code defines "cash collateral" 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."¹⁶⁶ A trustee or debtor in possession¹⁶⁷ may use cash collateral only if either the court authorizes its use, or the creditor with the secured interest in the cash collateral consents.¹⁶⁸ However, even with authorization or consent, a debtor cannot use cash collateral unless the creditor's secured interest is adequately protected.¹⁶⁹

3. *Bitcoin as Currency Under the Bankruptcy Code*

If bitcoins were classified as currency, then Bitcoin transfers would receive particularly beneficial protections as swap agreements ("swaps").¹⁷⁰ As currency, the exchange of bitcoins for U.S. dollars, or other governments' currencies, would also be categorized as swaps.¹⁷¹ Under the Code, swaps include any "cross-currency rate swap"¹⁷² and any "currency swap, option, future, or forward agreement."¹⁷³ So long as a transaction falls within the literal language of this statutory definition, courts generally treat the

¹⁶⁵ See 11 U.S.C. § 506(b). *But see* Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co, 549 U.S. 443 (2007); Ogle v. Fid. & Deposit Co. of Md., 586 F.3d 143 (2d Cir. 2009) (stating that attorneys' fees, and other reasonable fees, are only permitted to be paid to over-secured creditors if the parties' pre-bankruptcy agreement or state law provides for the fees).

¹⁶⁶ 11 U.S.C. § 363(a).

¹⁶⁷ See 11 U.S.C. § 1107(a) ("The debtor in possession is permitted to use cash collateral subject to the requirements of section 363(c)(2)"); 7 COLLIER ON BANKRUPTCY ¶ 1107.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012).

¹⁶⁸ 11 U.S.C. § 363(c)(2).

¹⁶⁹ 11 U.S.C. § 363(e).

¹⁷⁰ Doherty, *supra* note 4, at 38.

¹⁷¹ *Id.*

¹⁷² 11 U.S.C. § 101(53B)(A)(i)(I).

¹⁷³ 11 U.S.C. § 101(53B)(A)(i)(III).

transaction as a swap.¹⁷⁴ 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.¹⁷⁵ Thus, treating bitcoins as currency would give bitcoin traders the same substantial protection under the Code as if they were exchanging U.S. dollars and euros.¹⁷⁶

Swaps are protected from being deemed constructive fraudulent transfers.¹⁷⁷ Under § 548, a transfer made by the debtor within two years of filing for bankruptcy can be reversed if it is deemed constructively fraudulent.¹⁷⁸ Section 548 simply allows for the unwinding of transfers made within two years prior to filing bankruptcy if the debtor “(1) transferred an interest in its property; (2) was insolvent at the time of the transfer or was rendered insolvent thereby; and (3) received less than reasonably equivalent value in exchange for such transfer.”¹⁷⁹

Section 546(g) protects swaps by prohibiting the trustee from avoiding preferential transfers made before filing for bankruptcy, unless the transferor actually intended to hinder, delay, or defraud creditors.¹⁸⁰ Thus, participants in swaps may engage in lawful pre-bankruptcy planning to optimize creditors’ claims and the debtor’s fresh start without fearing that these pre-bankruptcy transfers will be deemed constructively fraudulent and reversed. For example, a subsidiary business could sell its bitcoins for U.S. dollars to its parent company within two years of filing for bankruptcy without the bitcoins later being seized by the bankruptcy estate as part of a constructively fraudulent transfer.

Additionally, to the extent defined in § 560, § 362(b)(17) provides swaps with broad protection from the automatic stay.¹⁸¹ Section 560 provides that contractual rights of swap participants to liquidate, terminate, or accelerate a swap agreement cannot be suspended by the automatic stay or otherwise

¹⁷⁴ See 5 COLLIER ON BANKRUPTCY, *supra* note 4, at ¶ 560.02.

¹⁷⁵ See Doherty, *supra* note 4, at 38; see also Brett A. Axelrod & Gordon Goolsby, *Swaps and the Bankruptcy Code*, BLOOMBERG L. REP. (2011) (stating that despite the automatic stay, the non-debtor counterparty to the swap agreement may terminate the swap and seize its collateral under §§ 362 and 560 of the Code).

¹⁷⁶ See Doherty, *supra* note 4, at 38.

¹⁷⁷ See 11 U.S.C. §§ 548, 546(g).

¹⁷⁸ See 11 U.S.C. § 548.

¹⁷⁹ Steven S. Flores, Leo Muchnik, & Neil Berger, *Constructive Fraudulent Transfers Claims Under § 548*, 33 AM. BANKR. INST. J. 33 (2014); see also 11 U.S.C. § 548.

¹⁸⁰ 11 U.S.C. § 546(g).

¹⁸¹ 11 U.S.C. §§ 362(b)(17), 560.

limited by the Code, a court, or an administrative agency.¹⁸² Thus, if Bitcoin is classified as a currency, and consequentially exchanging bitcoins-for-bitcoins or bitcoins-for-dollars is classified as a swap, then any party to a transaction of this nature, despite the automatic stay, could (1) sue to enforce the provisions of the parties' contract and (2) offset any debt owed by party A to party B, by any debt owed by party B to party A.¹⁸³ This latter benefit would be especially helpful for businesses, which often already "net out" opposing debts when determining their credit exposure in respect to a swap agreement.¹⁸⁴

4. *Bitcoin as a Commodity Under the Bankruptcy Code*

If Bitcoin were classified as a commodity, it would be extended fewer protections under the Code.¹⁸⁵ The Code affords commodity transactions significant protections only if the transaction's contract constitutes a "forward contract," providing for the commodity's delivery two days in advance of the contract's maturity date.¹⁸⁶ Because forward contracts mitigate the parties' risk by hedging against price fluctuations, the contract participants are rewarded with protections, including immunity from the automatic stay,¹⁸⁷ prohibition against bankruptcy defaults,¹⁸⁸ and the ability to continue "business as usual."¹⁸⁹ Thus, if Bitcoin were classified as a commodity, then Bitcoin transfers would be substantially protected *only* if the contract for the bitcoin's transfer constitutes a forward contract.

III. A SUGGESTED SOLUTION TO BITCOIN CLASSIFICATION IN BANKRUPTCY

A uniform rule regarding the classification of Bitcoin under the Code would benefit both Bitcoin transactions and the bankruptcy process. First, a

¹⁸² 11 U.S.C. § 560 ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.") (emphasis added).

¹⁸³ See 5 COLLIER ON BANKRUPTCY, *supra* note 4.

¹⁸⁴ See *id.*

¹⁸⁵ See Doherty, *supra* note 4, at 38 (citing *Lightfoot v. MXEnergy Elec. Inc. (In re MBS Mgmt Servs.)*, 690 F.3d 352, 356–57 (5th Cir. 2012)).

¹⁸⁶ See 11 U.S.C. § 101(25)(A).

¹⁸⁷ 11 U.S.C. § 362(b)(6).

¹⁸⁸ See 11 U.S.C. § 556 (preserving a party's contractual right to liquidate, terminate, or accelerate a commodities contract or forward contract).

¹⁸⁹ D. BRENT WELLS, HOUS. ENERGY CREDIT GROUP, LATEST WORD ON THE BANKRUPTCY CODE'S "SAFE HARBOR" FOR FORWARD CONTRACTS, at 2 (2011), <http://www.wellscuellar.com/Speeches/SafeHarbor2011.PDF>.

formal rule of classification would give creditors and debtors the confidence to optimally structure their contractual relationship when bitcoins are involved. Second, a uniform rule would guide bankruptcy practitioners, trustees, and judges on how to treat a debtor's bitcoins. The analysis that follows advocates for a license-based solution, under which the Code would provide more protections to the licensed class of Bitcoin debtors. Public policy reasons support providing greater protections to debtors that are required to meet additional regulatory requirements, which are necessary to obtain and retain a licensed use.

A. The Licensed Use Classification System

A practical solution to the categorization of Bitcoin in bankruptcy is to build upon the license-based classification system that the NYDFS has already implemented.¹⁹⁰ As the earlier section discussing the NYDFS's Bitlicense proposal set forth, section 200.3 of the regulation states that no individual or business entity can engage in any "Virtual Currency Business Activity" without a license.¹⁹¹ Merchants and consumers that solely use virtual currency to buy and sell goods or services are exempted from this licensing requirement.¹⁹² With only minor adaptations, this framework could classify Bitcoin in bankruptcy such that (a) the bitcoins of entities required to obtain a license under the proposal would have the classification of "currency," and (b) the bitcoins of entities not required to obtain a license would have the classification of "commodity."

This Licensed Use Classification System ("LUCS") acknowledges both sides in the currency versus commodity debate, resolving the stand-off by recognizing that Bitcoin should be treated as a currency in some situations, while it should be treated as a commodity in others. The use of a LUCS is also consistent with the limited case law provided by *Shavers*. The Bitcoin investment business in *Shavers* would fall under the Virtual Currency Business Activities of "securing, storing, holding, or maintaining custody or control of

¹⁹⁰ See Virtual Currencies, N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3 (2015), <http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf>.

¹⁹¹ See *id.*

¹⁹² *Id.* Virtual Currency Business Activities include "receiving Virtual Currency for transmission or transmitting the same; securing, storing, holding, or maintaining custody or control of Virtual Currency on behalf of others; buying and selling Virtual Currency as customer business; performing retail conversion services, including the conversion or exchange of Fiat Currency or other value into Virtual Currency, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency; or controlling, administering, or issuing a Virtual Currency." *Id.*

Virtual Currency on behalf of others” and “buying and selling Virtual Currency as a customer business,” either of which is sufficient to trigger the licensing requirement under NYFDS’s regulation.¹⁹³ Thus, the court’s classification of the entity’s bitcoins as “money” would be appropriate under the logic of this classification system.¹⁹⁴

Because other states will likely follow New York’s lead and institute a similar regulatory framework,¹⁹⁵ a LUCS would best be implemented at the state level. States could promulgate this regulation in a manner similar to New York by (1) having a state financial agency develop a regulatory framework that requires the licensing of entities engaged in Virtual Currency Business Activities,¹⁹⁶ (2) publishing the proposed framework in the state’s code of regulation,¹⁹⁷ (3) allowing for a comment period where Bitcoin industry participants can voice their concerns,¹⁹⁸ (4) redrafting where appropriate to encompass the best interests of all industry participants,¹⁹⁹ and (5) enacting the regulation. The Code would then honor the state’s regulatory classification.

¹⁹³ *Id.*

¹⁹⁴ See *S.E.C. v. Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *5 (E.D. Tex. Aug. 6, 2013).

¹⁹⁵ See Clinch, *supra* note 132.

¹⁹⁶ See Daniel Cawrey, *New York State is Considering Issuing ‘BitLicenses’ to Bitcoin Businesses*, COINDESK (Nov. 14, 2013, 8:49 PM), <http://www.coindesk.com/new-york-bitlicenses-bitcoin-businesses/> (discussing New York’s preliminary hearings regarding licensing the business of virtual currency money transmission).

¹⁹⁷ See Stan Higgins, *New York Reveals BitLicense Framework for Bitcoin Businesses*, COINDESK (July 17, 2014, 3:35 PM), <http://www.coindesk.com/new-york-reveals-bitlicense-framework-bitcoin-businesses/> (discussing New York’s introduction of the proposed regulatory framework).

¹⁹⁸ See Southurst, *Industry Reaction*, *supra* note 133 (discussing reactions to the proposed regulation, including the perspectives of both proponents and critics of the BitLicense); Stan Higgins, *New York Extends Comment Period for BitLicense Proposal*, COINDESK (Aug. 21, 2014, 6:46 PM), <http://www.coindesk.com/new-york-extends-comment-period-bitlicense-proposals/> (discussing the extension of the comment period due to the large volume of input from a variety of sources); Tom Sharkey, *Academics Call for Revisions to New York’s BitLicense Proposal*, COINDESK (Aug. 18, 2014, 9:35 PM), <http://www.coindesk.com/academics-call-revisions-new-yorks-bitlicense-proposal/> (discussing a 14-page response from a research team from George Mason University, during the initial 45-day window for public comments, pointing out the proposed regulation’s shortcomings).

¹⁹⁹ See Nermin Hajdarbegovic, *Lawsy: Bitcoin Developers and Miners Exempt from BitLicense*, COINDESK (Oct. 15, 2014, 1:41 PM), <http://www.coindesk.com/lawsy-bitcoin-developers-miners-exempt-bitlicense/> (discussing the proponents of the regulatory framework clarified that bitcoin developers and miners would be exempt from the licensing requirement); Pete Rizzo, *Chamber of Digital Commerce Proposes Small Business Exemption for BitLicense*, COINDESK (Aug. 19, 2014, 7:25 PM), <http://www.coindesk.com/chamber-digital-commerce-proposes-small-business-exemption-bitlicense/> (discussing that small businesses should be exempt from the licensing requirement).

The implementation of a system of this nature does not necessitate any cumbersome amendments to the Code itself. The proposed licensing system allows for state-specific nuances because each state can determine exactly which businesses must obtain licenses, and consequently which businesses' bitcoins will be treated as a currency under the Code.

Taking into consideration all of their respective policy values, the states' decisions and values will be honored in bankruptcy proceedings. For example, after the initial Bitlicense proposal, New York revised the proposal to clarify that only financial intermediaries' bitcoins must be licensed.²⁰⁰ This narrow definition of Virtual Currency Business Activities is arguably due to a combination of (1) the international backlash received by the initial proposal, which included threats of taking Bitcoin-related business elsewhere, and (2) the importance of international business relations to New York regulators.²⁰¹ By comparison, a state that participates in minimal international Bitcoin-related business may instead place substantial weight on consumer protection, and correspondingly, provide a broader definition of Virtual Currency Business Activities.

Deferring to the state's regulatory classification under a LUCS would be consistent with the common thread in the Code of not displacing non-bankruptcy law.²⁰² Bankruptcy courts defer to state law in multiple areas of the Code, including determining whether the debtor has a property right,²⁰³ and determining whether the debtor must elect state exemptions or whether the debtor reserves the right to choose between state or federal exemptions.²⁰⁴

Moreover, with the recent criminal activity associated with Bitcoin transactions,²⁰⁵ states will inevitably devote regulatory resources to enact

²⁰⁰ See Tanaya Macheel, *Lawsy Outlines Revisions to New York's BitLicense in DC Speech*, COINDESK (Dec. 18, 2014, 4:31 PM), <http://www.coindesk.com/lawsy-outlines-revisions-new-yorks-bitlicense-dc-speech/>.

²⁰¹ See Clinch, *supra* note 132.

²⁰² See, e.g., *Butner v. United States*, 440 U.S. 48, 54 (1979) (asserting that the Code must defer to state law when determining what constitutes property of the bankruptcy estate); 11 U.S.C. § 522(b)(1) (2012) (permitting states to forgo the federal bankruptcy estate exemptions in favor of its own state exemptions).

²⁰³ 5 COLLIER ON BANKRUPTCY, *supra* note 4, at ¶ 541.03; see *Butner*, 440 U.S. at 54 (asserting that Congress left the determination of what constitutes property of the bankruptcy estate to state law).

²⁰⁴ See 11 U.S.C. § 522(b)(1); 4 COLLIER ON BANKRUPTCY ¶ 522.02 at n.5 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012) (asserting that § 522(b) allows states to "opt out" of the federal exemptions and limit its citizens only to electing state exemptions).

²⁰⁵ See Jonathan Lane, *Bitcoin, Silk Road, and the Need for a New Approach to Virtual Currency Regulation*, 8 CHARLESTON L. REV. 551, 556 (2014).

safeguards on bitcoin use. It would be prudent of state rule-making bodies to look beyond the immediate context of consumer protection, anti-money laundering, and cyber security, and work more broadly to bring uniform clarity to the treatment of Bitcoin in bankruptcy as well.

B. Protections for Licensed Entities Under the Bankruptcy Code

Assuming that other states implement licensing frameworks similar to New York, under a LUCS, entities will generally be required to obtain a license if its bitcoins are integrated into primary business functions.²⁰⁶ Companies that do substantial business in multiple states will likely need to be licensed in those states as well as the state in which the business was chartered. Under a LUCS, these entities' bitcoins would be classified as currency and afforded the respective protections under the Code.²⁰⁷ The protections afforded to currencies are appropriate here because failing to afford these bitcoins protection from the automatic stay could have long-lasting negative effects on the business entity. A business cannot obtain the fresh start that bankruptcy seeks to provide if it is crippled from the effects of the automatic stay.²⁰⁸ Thus, by categorizing licensed entities' bitcoins as "currency," the debtor would be afforded protections as to any transactions involving bitcoins under §§ 362(b), 546(g), and 560 from avoidance as constructive fraudulent transfers and from the constraints of the automatic stay.²⁰⁹

Because many of the licensed entities engaging in Virtual Currency Business Activities are corporations, most of these entities will file for bankruptcy under chapter 11, as there are no advantages for a corporate debtor in liquidation.²¹⁰ Chapter 11 is typically used by businesses filing for bankruptcy that wish to continue business operations and repay creditors concurrently.²¹¹ Chapter 11 allows a business to propose a plan for reorganization and consolidate its debt so that it may return to economic

²⁰⁶ See Virtual Currencies, N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.2 (h) & (n) (2015), <http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf>.

²⁰⁷ But see Middlebrook, *supra* note 39, for a discussion of using a BMSPT to avoid licensing under regulatory requirements.

²⁰⁸ See WARREN & WESTBROOK, *supra* note 142, at 115.

²⁰⁹ Doherty, *supra* note 4, at 38; see Axelrod & Goolsby, *supra* note 175.

²¹⁰ See WARREN & WESTBROOK, *supra* note 142, at 388–89 (“In corporate liquidation there are no exemptions and no discharge from debt.”).

²¹¹ BANKR. JUDGES DIV., ADMIN. OFF. OF THE U.S. CTS., BANKRUPTCY BASICS 7 (3d ed. Nov. 2011), <http://www.uscourts.gov/file/17762/download?token=ckTAh35M>.

productivity.²¹² Although creditors may request a court-appointed trustee to assume control of the debtor's business in a chapter 11 proceeding,²¹³ *CLI Holdings*²¹⁴ demonstrated that bitcoin mining is a highly technical business function that is outside the expertise of the average trustee.²¹⁵ Therefore, it is unlikely for court-appointed trustees to take control of businesses engaging in Virtual Currency Business Activities unless a party in interest shows that the business' current management has engaged in "fraud, dishonesty, incompetence, or gross mismanagement."²¹⁶

As noted earlier, with protection from avoidance as constructive fraudulent transfers, debtors can transfer their bitcoins prior to filing without fear that the transfer will be reversed, even if such transfers are later deemed to have diminished the debtor's assets to the derogation of creditors.²¹⁷ However, this protection only exists so long as the transfer was not intended to be fraudulent.²¹⁸ This allows the debtor to engage in effective pre-bankruptcy planning in regard to its bitcoins.

The "currency" classification afforded to a licensed entity's bitcoins would provide less substantial protection to entities engaging in Virtual Currency Business Activities that wish, or are involuntarily forced,²¹⁹ to file for chapter 7 liquidation.²²⁰ These debtors, however, can still rely on bankruptcy exemptions to protect their bitcoins from coming into the bankruptcy estate, and consequently from liquidation.²²¹ Filing for bankruptcy under chapter 7 is considered a death sentence for businesses because § 704 requires the bankruptcy trustee to expeditiously liquidate the bankruptcy estate.²²² Because

²¹² *Id.*

²¹³ See 11 U.S.C. §§ 1104(a), 1108 (2012).

²¹⁴ If a LUCS had been in place, *CLI Holdings* would have been a licensed entity because it engaged in mining, a primary Virtual Currency Business Activity. Consequently, in its chapter 11 proceedings, CLI Holding's bitcoins would have been afforded the same protections under the Code as currency. Although the subjective determination of whether the ultimate outcome of *CLI Holdings* would have been better or worse if a LUCS had in place is uncertain, there would have been no questions regarding the bitcoins' treatment. See Voluntary Petition, *supra* note 78.

²¹⁵ Doherty, *supra* note 4, at 82.

²¹⁶ See 11 U.S.C. § 1104(a).

²¹⁷ See 5 COLLIER ON BANKRUPTCY, *supra* note 4, at ¶ 548.05.

²¹⁸ See *id.*

²¹⁹ See 11 U.S.C. § 303.

²²⁰ See 11 U.S.C. § 701.

²²¹ See 11 U.S.C. § 522; 6 COLLIER ON BANKRUPTCY ¶ 704.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012) ("The trustee need not and should not collect or take possession of property that the debtor has claimed as exempt, unless the exemption claim is disallowed.").

²²² 11 U.S.C. § 704(a)(1).

freezing and liquidating these entities' bitcoins would halt business functions and potentially cause irreparable damage, the debtor may be able to effectively argue that liquidating the bitcoins is not in the parties' best interests.²²³ This argument may be especially effective if the value that the bitcoins are creating while being utilized in business processes exceed the bitcoins' liquidation value.

Finally, this licensing solution does not address the difficulty of adequately protecting a creditor's interest secured by the debtor's bitcoins. However, because licensed entities use bitcoins in business functions,²²⁴ and the debtor arguably has a substantial interest in bringing the business back to economic productivity, there is less likelihood that a debtor would convert its chapter 11 proceedings to chapter 7.²²⁵ This incentive to remain under chapter 11 provides an inherent protection that the encumbered bitcoins remain a functioning component of the debtor's business, and to an extent, limits the risk exposure that adequate protection is designed to alleviate.²²⁶

C. Protections for Non-licensed Entities Under the Bankruptcy Code

Merchants and individuals exempt from the NYDFS's licensing requirement use bitcoins only to buy and sell goods and services.²²⁷ In comparison to licensed entities, the automatic stay does not have the same negative effects because non-licensed entities use their bitcoins only in isolated transactions. Thus, because the purpose of the automatic stay is to freeze the debtor's financial position upon filing the bankruptcy petition,²²⁸ the non-licensed debtor's bitcoins should be liquidated upon filing or a short duration after. This would result in a more accurate snapshot of the debtor's financial position at the moment of filing and better protection of the bankruptcy estate against Bitcoin's extreme volatility. With no Bitcoin-related business functions in jeopardy, the automatic stay would arguably offer more

²²³ See *id.*

²²⁴ Virtual Currencies, N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.2 (h) & (n) (2015), <http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf>.

²²⁵ See 11 U.S.C. §§ 707, 1112(a); 11 U.S.C. § 704(a)(1) ("The trustee shall collect and reduce to money the property of the estate . . .").

²²⁶ See 3 COLLIER ON BANKRUPTCY, *supra* note 157; 8 COLLIER ON BANKRUPTCY, *supra* note 156 ("[A] chapter 13 plan must provide for property to be distributed in settlement of each allowed unsecured claim in an amount not less than the amount that would be paid if the estate of the debtor were liquidated under chapter 7.")

²²⁷ Virtual Currencies, tit. 23, § 200.3(c)(2).

²²⁸ See WARREN & WESTBROOK, *supra* note 142, at 128; 11 U.S.C. § 362(a).

protection than harm by prohibiting creditors from levying upon, repossessing, or collecting the bitcoins.²²⁹

Non-licensed debtors' Bitcoin transactions will receive extensive protection under the Code only if the parties enter into a forward contract requiring one of the parties to deliver the bitcoins at least two days in advance of the contract's maturity date.²³⁰ But debtors who do not meet these requirements are not left completely vulnerable. Individuals may prevent property from becoming part of the bankruptcy estate if the property falls under one of the Code's delineated exemptions in § 522.²³¹ Under the federal exemptions, a debtor may protect up to \$12,725 worth of its bitcoins under the "wildcard exemption."²³² Even if the non-licensed debtor is not eligible to file under chapter 7 and must commit to a repayment plan,²³³ the debtor may still exempt its bitcoins and reduce the amount that it must pay back to its creditors by the value of its bitcoins.²³⁴ Additionally, the non-licensed debtor's bitcoins are protected under the automatic stay, even if exempted, because the Code forbids creditors from creating, perfecting, or enforcing any lien on the debtor's property.²³⁵

Finally, as previously discussed in Section II.B.2 of this Comment, the difficulty of adequately protecting a creditor's cash collateral secured by bitcoins is less of a concern if bitcoins are not classified as "cash collateral."²³⁶ The bitcoins themselves would not need to be adequately protected because the proceeds from selling the bitcoins would likely be a more stable medium of value, such as cash. However, if the debtor keeps the encumbered bitcoins—whether it be through an exemption²³⁷ or an agreement under the chapter 13

²²⁹ See 11 U.S.C. § 362(a).

²³⁰ 11 U.S.C. § 101(25)(A).

²³¹ 11 U.S.C. § 522(d); see also 11 U.S.C. § 522(b)(1) (limiting § 522 exemptions to "individual debtor(s)," and not to business entities).

²³² See WARREN & WESTBROOK, *supra* note 142, at 179; 11 U.S.C. § 522(d)(5) (stating that the wildcard exemption allows a debtor to exempt any property, so long as the value does not exceed \$1,225); 11 U.S.C. § 522(d)(5) (stating that if the debtor has not exhausted their homestead exemption under § 522(d)(1), the debtor may additionally exempt any property valuing up to \$11,500 of any unused amount under the homestead exemption).

²³³ 11 U.S.C. § 707(b) (stating that a debtor who does not meet the means test laid must dismiss or convert to chapter 11 or 13).

²³⁴ BANKR. JUDGES DIV., *supra* note 210.

²³⁵ See 11 U.S.C. § 362(a)(5).

²³⁶ 11 U.S.C. § 363(a) (defining "cash collateral").

²³⁷ See 11 U.S.C. § 522.

repayment plan²³⁸—the difficulty of providing the creditor with adequate protection again rears its ugly head. But if the proponents for classifying Bitcoin as a commodity are correct, and if the finite number of bitcoins causes value to steadily rise, then bitcoins' gradual appreciation may create a steady equity cushion that will protect secured creditors' interest.²³⁹

D. Public Policy Considerations

As discussed above, this Comment posits that a unified rule, such as the proposed LUCS, is necessary to bring consistency and predictability to the treatment of Bitcoin. Such a system also encourages debtors to forum shop to maximize assets amongst creditors, resulting in the greatest overall economic benefit. In addition to these considerations, the public policy repercussions that such a system would cause are arguably just as important as the proposed rule.

Under the proposed LUCS, bitcoins would receive the protections afforded to currency under the Code only if the utilizing entity employs the regulatory safeguards necessary to maintain a proper licensed use. Thus, because the business entity is taking the extra precautions necessary to protect its bitcoins from hackers, meet necessary compliance requirements to prevent fraudulent behavior, and meet any other requirements that the state establishes, the entity's bitcoins are imbued with extra protections under the Code.

However, because business entities and individuals that are not required to license their Bitcoin use do not have to jump through additional regulatory hoops by implementing cyber-security, anti-fraud, and other state-established safeguards, these entities should not be entitled to the same protections. As follows, non-licensed entities' bitcoins are afforded the lesser-protected classification of commodity. But if a non-licensed entity hedges against Bitcoin's volatile price fluctuations by entering into a forward contract, then it will be rewarded with the additional protections already provided under the Code.

²³⁸ If the debtor's plan provides that the holder of a bitcoins' secured claim retain the lien, then the debtor must also provide that payments to the creditor adequately protect that creditor's interest over the life of the plan. *See* 11 U.S.C. § 1324(a).

²³⁹ *See* 3 COLLIER ON BANKRUPTCY, *supra* note 157, at ¶ 361.03 (“When a substantial equity cushion exists, a court may have a somewhat more relaxed attitude [in regard to adequate protection] than it would have if the creditor is undersecured or barely oversecured.”). An “equity cushion” is created when the value of a piece of property exceeds an entity's interest in that property and may in itself provide adequate protection and eliminate the need for periodic payments to protect the property against depreciation. Even a small equity cushion may suffice if Bitcoin's value stabilizes. *Id.*

CONCLUSION

There has been no clear winner in the ongoing debate over Bitcoin's classification as a "currency" or a "commodity". Both sides have compelling arguments. Thus, an optimal solution would not force Bitcoin to categorically fit in one box or the other but rather allow the employing entity's use of Bitcoin to determine its status. If bitcoins are integrated into business processes, then the use of those bitcoins should require a license; however, if bitcoins are simply used to buy and sell goods and services, then that use should not require a license. The debtors' bitcoins with licensed use would have the classification of "currency," and the debtors' bitcoins without licensed use would have the classification of "commodity," resulting in a LUCS.

The affirmative implementation of a classification system will (1) allow debtors and creditors to evaluate how to best structure their contractual relationship when bitcoins are involved, (2) assist practitioners in preparing bankruptcy filings for debtors with bitcoins, and (3) guide bankruptcy trustees and bankruptcy court judges when determining how to treat a debtor's bitcoins, rather than allow those parties to implement patchwork solutions independently.

There is an understandable discomfort in promoting a decentralized, electronic system of value exchange to the status of "currency" and affording it the respective protections under the Code.²⁴⁰ However, this discomfort may be pacified if entities have to meet licensing requirements to earn this heightened status for their bitcoins.

Despite concerns that a licensing requirement will heighten the Bitcoin industry's barriers to entry, disadvantage smaller and newer industry participants, and reduce the anonymity and privacy that Bitcoin users have come to prize,²⁴¹ these concerns are offset by the substantial benefits that a LUCS offers. Such benefits include providing a uniform framework that legal entities can rely upon for developing more specific policies and procedures, as well as preventing reverse-engineered, ad hoc solutions to Bitcoin's classification in bankruptcy.

²⁴⁰ See, e.g., DEP'T OF THE TREAS., *supra* note 68 ("[V]irtual currency does not have legal tender status in any jurisdiction."); CONSUMER FIN. PROT. BUREAU, *supra* note 5 ("[V]irtual currencies aren't regular money [and] . . . [n]o one is required to accept them as payment or to exchange them for traditional currencies.").

²⁴¹ See Southurst, *Industry Reaction*, *supra* note 133.

A classification system of this nature should be established proactively. It is only a matter of time before a bankruptcy court is cornered into classifying Bitcoin, and if the issue is not affirmatively addressed, debtors and creditors can only cross their fingers and hope that the court will add order and structure to the controversy, while preserving the incentives for seeking but not abusing, the bankruptcy forum.

CHELSEA DEPERT*

* Executive Symposium Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2016); B.S.B.A., *summa cum laude, with Honors*, University of Central Florida (2012). I would like to thank Professor Jennifer Mathews for her guidance in developing and writing this Comment. I would also like to thank the Staff of the *Emory Bankruptcy Developments Journal* for their work in polishing this Comment. Finally, special thanks to my family and my husband for their encouragement and support throughout my law school career.