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Investigating the Financial Affairs of a Debtor Who Has Cryptocurrency

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- Cryptocurrency assets are appearing in bankruptcy cases with more frequency.
- Trustees should develop procedures for investigating the financial affairs of a debtor with cryptocurrency.
- It is critical that trustees move quickly to safeguard cryptocurrency.
- Trustees should develop procedures for administering cryptocurrency.

Technology advancements abound. Changes are frequent, sometimes daily. And considering the technological climate in which we all live and work, it should come as no surprise that cryptocurrency has impacted a trustee's ability to examine a debtor's financial affairs. The topic of cryptocurrency and bankruptcy has been discussed during NABT trainings and written about in various trustee-related publications (including this Journal). With more and more chapter 7 trustees being assigned to administer cases where the debtors own or have used Bitcoin or other cryptocurrencies, a discussion of the impact on trustee duties and obligations seems the next logical step. These are novel, relatively new[1] financial products that combine speed, technology, and complexity, all of which can be concerning for trustees. This article reviews some basic concepts and characteristics of this revolutionary technology and briefly summarizes some of the strategies that trustees can use to identify, safeguard, and investigate the financial affairs of a debtor who has or had cryptocurrency.

Basics of Cryptocurrency

At its most basic, cryptocurrency (sometimes called virtual or digital currency) is a digital representation of value where technology is used to send or receive funds or transfer a digital asset to someone else. Cryptocurrencies are not in a physical form, only in digital form. Cryptocurrencies are not issued by any central authority, such as a government or a banking system (although cryptocurrency most closely approximates a bank or other financial account in many respects). As a result, cryptocurrencies have no legal tender status in any jurisdiction. Using cryptocurrency as a medium of exchange or a unit of account or to store value requires agreement among a wide community of users of virtual currency.

[1] The first Bitcoin transaction occurred in January 2009.

How are cryptocurrencies acquired and transferred?

Cryptocurrencies, such as Bitcoin, are acquired, stored, transferred and traded on computer networks through a peer-to-peer technology called Blockchain. This is a distributed ledger technology that allows for fast transmission and verification of transactions by a group of computers. The Blockchain keeps a permanent public record of the transactions that is tamper-proof and protects against counterfeiting and double spending. While the transactions are accessible, the true name and identity of the individuals who send or receive funds remain virtually private.

Virtual currency exchanges ("VCEs") are the mediums through which cryptocurrency is acquired, transferred, traded and stored. VCEs act much the same way that foreign exchanges do at airports and other cross-border locations. Payment for the purchase of cryptocurrency is often funded through PayPal transfers, bank ACH transfers, wire transfers or other cryptocurrency payments. In addition to swapping U.S. dollars for Bitcoin (or any other cryptocurrency), VCEs also provide custodial and transfer services for virtual currency and maintain key records that a trustee should obtain in appropriate cases.

How does the owner of cryptocurrency retain the virtual currency?

A digital wallet enables the owner to conduct transactions on the cryptocurrency account, including sending, receiving or otherwise transferring the virtual currency. There are four general types of cryptocurrency "wallets" where evidence of ownership of the cryptocurrency is stored by the owner. A cryptocurrency application or software may reside on a computer or laptop. A mobile device, such as a cell phone, may have the application or software. Web-based wallets may be maintained by a third party, such as a VCE, where the owner accesses the cryptocurrency online. Cryptocurrency can also be retained on a "cold storage wallet"[2] such a USB drive or printed on a piece of paper.

The digital wallet contains two long computer-generated alpha-numeric addresses: a "public key," which is given to others, and a "private key," which is only known to the owner and allows him or her to access the funds. Since there is no central authority involved, a debtor who loses the private key has no ability to recover it[3] (or the value of the currency). The public address is similar to a bank account and routing number, and the private key is similar to the account password or PIN.

To illustrate, a hypothetical Bitcoin owner named Bob has a wallet on Kraken, a VCE. He logs into the VCE's website and, using his private key, authenticates his ownership of the Bitcoin. Since Bob is going through extensive medical treatment, he wants to send his Bitcoin to a relative named Mary for safekeeping. Mary, who doesn't have a Kraken account but does have a

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[2] "Cold storage" refers to the fact that the private key is not connected to the Internet, and thus cannot be easily stolen online.

[3] An owner may, however, retain a "recovery seed," which is a random group of 12 to 16 words that enable him or her to recreate the private key.

virtual currency wallet on her computer (having downloaded the free Bitcoin Core software), is able to give Bob her wallet public key (i.e., the wallet address). This enables Bob to tell Kraken to send the Bitcoin to Mary's virtual currency wallet. Mary uses her own private key to access the funds and authenticate her custody of the transferred funds, once the transaction has been posted to the Blockchain (the public ledger).

How many types of cryptocurrency are there?

As of March 6, 2019, there were over 2,100 active cryptocurrencies listed on coinmarketcap.com. Bitcoin is one of the most commonly seen cryptocurrencies among trustees who have administered cases where the debtor has or had cryptocurrency. Other common cryptocurrencies include Bitcoin Cash, Litecoin, Ethereum and Monero. Each cryptocurrency is unique in how it is stored, traded, purchased and sold. Many of these cryptocurrencies are traded on the largest U.S.-based cryptocurrency exchanges, which are listed below. With over 100 VCEs, only a handful of exchanges have a presence in the United States. Among the ten largest VCEs, only two are U.S.-based.

Identifying and Investigating Cryptocurrency

Often a trustee's biggest challenge is identifying cases where a debtor has or had cryptocurrency in the first place. In many cases, cryptocurrency is not listed in the Schedules or Statement of Financial Affairs. Cases involving cryptocurrency are often identified through reviewing the debtor's bank statements, PayPal transactions and credit card statements.

When reviewing a debtor's financial transactions, trustees should look for payments to or from a VCE using the list provided below as a reference tool. The lengthy computer-generated alpha-numeric address that may appear on these statements is often the sign of a cryptocurrency transaction because the sequence of numbers is too long to be an account number.

Coinbase is one of the largest VCEs and is based in San Francisco. Reviewing bank statements that show a "Coinbase/BTC" or similar entry is often how bankruptcy cases involving cryptocurrency assets or potentially avoidable transfers are found. Other, larger U.S. VCEs are Bittrex, Kraken, and GEMINI. There are also numerous VCEs located in foreign jurisdictions, which pose additional challenges for the trustee. U.S.-based VCEs are regulated by state and federal authorities and must comply by maintaining key financial and customer records. These records are often critical to the investigation of the debtor's financial affairs and should be obtained by the trustee.

Another way to identify a possible cryptocurrency asset is by simply asking the debtor at the section 341 meeting of creditors. A trustee may want to start off with a general question, such as "Within the last 12 months, have you held or used any Bitcoin or other virtual currency?" If the debtor answers yes, then appropriate follow-up questions should come next, such as:

- *When and why did you start using the virtual currency*?
- *What was the purpose of your initial and your subsequent transactions*?

- *In the last 12 months, what was the highest amount of virtual currency that you held*?

- *What exchanges/payment processors do you use?*

- *What e-mail address did you use to create the digital wallets?* (E-mail addresses are how most VCEs track their customer accounts.)

- *Where do you retain your digital wallet?*(See the four types noted above; if on a USB drive or on a piece of paper, ask where the cold storage wallet is located and request immediate turnover.)

- *Where is your private key stored right now*? (Ask the debtor to write it down; if the debtor does not know the private key, ask appropriate follow-up questions.)

- *Did you ever buy virtual currencies for anyone else, sell virtual currencies to anyone else, or conduct any virtual currency transactions on anyone else's behalf?* (This is a possible crime.)

When debtors can't explain financial transactions to the trustee and break them down, they may be trying to hide something. Whether a trustee's case involves undisclosed or undervalued cryptocurrency, or the debtor made false statements about his ownership of and interest in cryptocurrency, it is essential for trustees to report these cases to the Office of the U.S. Trustee, in accordance with the *Handbook for Chapter 7 Panel Trustees* (Section 4.N.7 and 4.N.9).

Safeguarding the Assets

Cryptocurrency transactions are fast and can disappear through a virtually anonymous transaction in an instant. Indeed, the perceived anonymity[4] and speed are major factors that have drawn people to the technology. This ability to conceal the assets or deplete them makes it critical for a trustee to move quickly to safeguard them. Trustees have multiple ways to protect the assets depending on the unique facts and circumstances of each case and the debtor's cooperation. It is essential that the trustee control a debtor's digital wallet and private key to preserve or administer a cryptocurrency asset. Obtaining possession of both is critical.

As with other assets that might not be immediately turned over and that may no longer exist for the trustee to administer when not immediately turned over, a trustee should develop a plan for how cryptocurrency assets will be addressed when they are a part of a debtor's estate. One measure a trustee can take is to reach out to the largest U.S.-based VCEs to determine their procedures for identifying a customer account for cryptocurrency they have exchanged; the information they will need from a trustee to locate a transaction and obtain records; and, perhaps

[4] There are ways to "de-anonymize" and trace transactions through the Blockchain, but they are very technical and involve reviewing layers of transactions and analyzing the patterns.

most importantly, what a trustee would need to do to request that the VCE "freeze" the digital wallet and prohibit any sales, exchanges, transfers or trades of cryptocurrency by the debtor or from the debtor's account.

The chart at the end of this article also contains the website addresses for the listed VCEs for your reference. Remember, records are generally maintained by VCEs based upon the e-mail address or addresses the debtor used when creating his or her account with the exchange. In addition to taking measures to preserve the cryptocurrency asset, it is equally important that a trustee determine what each VCE will need in order for the trustee to obtain turnover of the value of the cryptocurrency in the debtor's account for deposit into the estate's bank account.

Policies and procedures of the VCEs are evolving with the rapid acceptance and use of cryptocurrency. It is very likely that information regarding policies and procedures obtained from an exchange today may be different than the policies and procedures that a trustee may need to follow in the future when cryptocurrency is found to be an asset in a case being administered. The key is to have a plan for how these unique assets will be dealt with and periodically update your plan.

Conclusion

The important work that trustees perform in effectively and efficiently administering their assigned cases while helping the U.S. Trustee Program preserve the integrity of the bankruptcy system can sometimes be challenging, yet very rewarding. We hope this brief discussion of some basic concepts and characteristics of cryptocurrency, along with strategies that trustees can use to identify, safeguard and investigate the financial affairs of a debtor who has or had cryptocurrency, will facilitate overcoming the challenge of this relatively new technological advancement.

LARGEST U.S.-BASED CRYPTOCURRENCY EXCHANGES

BITTREX (Bittrex Inc.) bittrex.com	**BITPAY** (Bitpay Inc.) bitpay.com	**COINBASE** (Coinbase Inc.) www.coinbase.com	**GEMINI** (Gemini Trust Co. LLC) gemini.com
ITBIT (Paxos Trust Co. LLC) www.itbit.com	**KRAKEN** (Payward Ventures Inc.) www.kraken.com	**POLONIEX** (Poloniex LLC) www.poloniex.com	