

Virtual Currency and Avoidance Actions: The Million Dollar Question Involving Bitcoin

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Every creditor loathes being served with an avoidance action where a debtor or bankruptcy trustee is seeking the return of a payment made by the debtor – whether through a preference action, fraudulent transfer claim, or other use of the trustee’s avoidance powers. Now imagine being asked to return \$1 million more than what was paid by the debtor. Sounds extreme, but it is a possible result when the payment was made with a virtual currency such as Bitcoin, and the issue is currently being considered by a bankruptcy court in California.

The clawback action involves a trustee attempting to avoid and recover the transfer of bitcoins as a fraudulent conveyance.¹ Assuming that the trustee is successful, the key question is whether the trustee is entitled to recover the value of the bitcoins as of the date of the transfer or as of the date of recovery. Given the rise in the value of bitcoins since the alleged fraudulent transfer was made in September 2013, the difference in the recovery is approximately \$1 million. Even for creditors that do not deal with virtual currency, the case is a good reminder of possible consequences related to avoidance actions when a creditor accepts anything other than standard currency in exchange for goods or services. It is also worth keeping in mind for a situation where a debtor returns goods that subsequently increase or decrease in value.

What is Bitcoin?

Bitcoin is a form of digital currency that is created and held electronically. It has been described as the first decentralized peer-to-peer payment network that is powered by its users with no central authority.² Unlike Dollars, Euros, or other traditional currency that is printed by a governmental agency, bitcoins do not exist physically. Instead, a mobile application or computer program can provide a personal Bitcoin digital wallet that allows a user to send and receive bitcoins.

There is a relatively small universe of vendors, suppliers, and service providers that accept payment from their customers in the form of virtual or digital currency such as Bitcoin. However, the number of businesses and individuals using Bitcoin is growing and the rise is expected to continue. It has been reported that over 100,000 merchants currently accept Bitcoin and that millions of dollars worth of Bitcoin are exchanged daily.³

Hashfast Technologies and the Disputed Transfers

Hashfast Technologies LLC (“Hashfast”) was in the business of designing, manufacturing, and selling computer chips and equipment for the purpose of auditing transaction data for the Bitcoin networks, also known as “Bitcoin mining.”⁴ In July 2013, Hashfast began marketing a Bitcoin mining computer system known as the BabyJet. Pursuant to an agreement with Hashfast, Dr. Mark A. Lowe was entitled to receive commissions in exchange for his endorsement of the BabyJet or other Hashfast products on message boards and other forms of social media. Dr. Lowe had the option of receiving the commissions in cash or bitcoins. In September 2013, Hashfast paid Dr. Lowe 3,000 bitcoins which had a value of \$363,861 at that time.

Hashfast entered Chapter 11 bankruptcy proceedings in June 2014. Hashfast filed a complaint against Dr. Lowe seeking to avoid and recover the Bitcoin transfers as a fraudulent conveyance. The Trustee alleged that Hashfast received less than reasonably equivalent value in exchange for Dr. Lowe’s services, which consisted of posting 160 comments on Bitcoin-related forums over a period of approximately one month. The action was transferred to a liquidating trustee (the “Trustee”) and a dispute arose regarding the maximum recovery available if the Trustee was successful in proving the fraudulent transfer claims. The Trustee alleged that he was entitled to recover the 3,000 bitcoins that were transferred or the value of the bitcoins on the date of recovery, whichever is greater. The value of the bitcoins was approximately \$1.3 million in January 2016 when the Trustee brought a motion requesting the bankruptcy court to rule on this issue. Dr. Lowe asserted that the most that the Trustee could recover is \$363,861, which was the value of the bitcoins on the date that they were received by Dr. Lowe.

An Issue of First Impression

Section 550(a) is the provision of the Bankruptcy Code that governs the recovery of property that has been the subject of a successful avoidance action. It provides that “the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property.” Section 550(a) does not specify the timing for the value of the property, but the Trustee relied on case law that interpreted the provision to mean that the Trustee is entitled to recover the greater of the value of the property at the transfer date or the value at the time of recovery. Therefore, the Trustee asserted that it was entitled to recover either

¹ Kasolas v. Lowe (In re Hashfast Technologies LLC), Adv. Pro. 15-03011 (Bankr. N.D. Cal).

² <https://bitcoin.org/en/faq>

³ <https://bitcoin.org/en/faq>

⁴ Bitcoin mining is the use of computing power and specialized hardware to process Bitcoin transactions. Bitcoin miners can earn a reward in bitcoins for providing this service.

the 3,000 bitcoins or the value of the bitcoins on the date of recovery.

Dr. Lowe took the position that Bitcoin was the equivalent of U.S. dollars. This allowed Dr. Lowe to argue that he should be treated as if he received U.S. currency and would only have to turn over \$363,861 if the Trustee's clawback action is successful. With Bitcoin being a new technology and medium of exchange, no prior bankruptcy court had considered this issue so the Hashfast bankruptcy court was presented with a question of first impression.

Although there was no prior bankruptcy law authority, both parties presented other rules and regulations related to Bitcoin to support their positions. Dr. Lowe cited to federal guidelines from the Department of Treasury and Securities Exchange Commission where the government had taken the position that virtual currencies, such as Bitcoin, should be treated the same as U.S. currency. The Trustee presented a notice issued by the IRS that concluded, for federal tax purposes, virtual currency is treated as property and, therefore, gains realized through sale or exchange of bitcoins are taxable events. The dispute as presented by the parties to the bankruptcy court was whether Bitcoin was currency or a commodity.

Limited Ruling by the Hashfast Court

At a hearing on the Trustee's motion, the Court expressed the view that it was unnecessary to rule on the question of whether Bitcoin was currency or a commodity. Instead, in a two-page order, the Court simply ruled that bitcoins are not U.S. dollars for purposes of the fraudulent transfer provisions of the Bankruptcy Code. The order further stated: "if and when the Liquidating Trustee prevails and avoids the subject transfer of bitcoin to the defendant, the court will decide whether . . . he may recover the bitcoin (property) transferred or their value, and if the latter, valued as of what date."

Although the Court refused to answer the valuation issue at this time, the Court engaged with counsel on the topic during the hearing. There were analogies drawn to various items that had the potential to fluctuate in value such as Golden State Warriors tickets, Euros, Ferraris, and Apple stock. The Court noted an additional complication occurs if the recipient had disposed of the property and then the property continues to fluctuate in value. The Court challenged the parties to identify the factors that should be considered when determining the value to be returned to the bankruptcy estate and concluded that those issues should be reserved for another day.

The Court's reluctance to rule on this issue is not surprising since the issue would become moot if the Trustee does not succeed in proving the underlying merits of the fraudulent transfer case. It was the Court's view that a decision on the timing and valuation issues required a full factual record that did not exist and, therefore, the Court limited its ruling to stating that bitcoins are not the equivalent of U.S. dollars.

Which Party Should Prevail?

The question that the Hashfast case highlights is who is entitled to the benefit when there is a substantial increase

in the value of the property transferred in an avoidable transaction: the bankruptcy estate or the recipient of the transfer? The Trustee argued that the estate is entitled to the recovery date value because the estate should be returned to the same position it occupied prior to the transfer. The case law cited by the Trustee, however, dealt with situations where the value of the property had decreased in value since the time of the transfer. When property decreases in value, it is logical to conclude that the value as of the transfer date (rather than the recovery date) should be returned to the estate to make it whole again. Dr. Lowe argued that the Trustee's position was akin to a "heads I win, tails you lose" argument because the Trustee would be taking the opposite position if the value of the bitcoins had declined.

If one of the purposes of clawback actions is to "undo" the result when a creditor receives an avoidable transfer, then it should be sufficient for the estate to receive the value of the property as of the transfer date. From a valuation perspective, that would put the estate into the same position it held prior to the transfer. It is only when the property has decreased in value that the estate would be harmed if the estate received the recovery date value rather than the transfer date value. In addition, under fraudulent transfer law, the measuring date for determining reasonably equivalent value and whether the debtor was insolvent – both required elements of a fraudulent transfer claim – is the transfer date. Dr. Lowe raises a legitimate question: why use a different date if the transfer date accomplishes the goal of returning the estate to its pre-transfer position?

On the other hand, there may be nothing inequitable about the Trustee's position that, by using the recovery date, the bankruptcy estate is entitled to the windfall, which would be shared among all creditors. Avoidance actions attempt to redistribute the debtor's assets according to bankruptcy priorities and are often only pursued when recoveries to unsecured creditors are extremely low or nonexistent. In most instances, the recipient of a preference or fraudulent transfer engaged in no wrongdoing, but still must return the payment or property received. Why should the defendant be the sole recipient of the upside value of the debtor's assets when all other creditors are taking significant losses? Avoidance actions and the bankruptcy priorities would serve to allocate the upside proportionately among all creditors.

In fact, the Bankruptcy Code recognizes that certain avoidance action defendants have received property in good faith and the Bankruptcy Code addresses potential unfairness that may result if appreciated property has to be returned. Section 550(e) of the Bankruptcy Code grants a good faith transferee a lien on the property to the extent of any increase in the value of such property as a result of improvements made to the property. Improvements would include, for example, taxes paid on account of the gains associated with the increase of value. Some courts have interpreted Section 550(e) to mean that any increase in value that is not attributable to the transferee, such as market conditions, is a benefit to be recovered by the bankruptcy estate.

It will be interesting to see whether this matter is litigated to a conclusion or if the parties settle. Each party is bearing

the risk and uncertainty of the Bitcoin market in addition to the risk and uncertainty of litigation. In fact, the value of the 3,000 bitcoins at issue has fluctuated between approximately \$1.1 million and \$1.32 million during the time between the Trustee's motion and this writing. A ruling on this issue could set an important precedent and its impact could be significant if the use of Bitcoin in commercial transactions continues to increase.

About the Author:

Kevin Zuzolo is an associate in Otterbourg's Bankruptcy Department. Mr. Zuzolo also has experience representing banks and financial institutions in connection with secured transactions.

