



**WSSFC 2022**

**Substantive Track – Session 1**

# **Real Facts on Virtual Assets**

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## About the Presenters...

**Jeffrey M. Glazer** is a partner at Ogden Glazer + Schaefer where he manages the firm's food and beverage practice. He has worked with alcohol beverage companies for the past 15+ years and his practice encompasses all 4 tiers of the 3-tier system (don't forget the farmers that make the ingredients!!); OG+S represents a wide array of (farmers), manufacturers, wholesalers, and retailers. He has spoken at numerous events across the country on food and beverage issues and published frequently on topics relevant to the industry. Jeff was the founder of Madison Beer Review and Madison Craft Beer Week.

**Virginia E. George** is a partner in the firm of Steinhilber Swanson LLP. She primarily concentrates her practice in bankruptcy and insolvency matters. Virginia graduated from the University of Wisconsin – Milwaukee in 1985, with a Bachelor of Arts in Journalism. Following college, she attended law school in Marquette University Law School, where she received The America Jurisprudence Award and earned her J.D. in 1988. She is currently serving as a board member for IWIRC Wisconsin Network and is a past two-term board member of the Bankruptcy Insolvency and Creditor's Rights Section of the State Bar of Wisconsin. She is also an active member of NABT, ABT, IWIRC and TMA, MBA, and EDWBA. She regularly presents at conferences on various bankruptcy topics.

**Catherine La Fleur** is a 1988 graduate of Marquette University Law School and has been an adjunct professor of law there since 2001, teaching courses in trial advocacy, pretrial practice, and depositions. She received her mediation training from Harvard Law School's Program of Instruction for Lawyers. Ms. La Fleur spent her initial years in insurance defense and coverage litigation and subrogation work. She specializes in civil litigation, family law, alternative dispute resolution and appellate law. She has tried numerous jury trials involving personal injury, automobile liability defense, slip and fall liability defense, product liability, fire subrogation, piercing the corporate veil, eminent domain, abuse of process, legal negligence, probate, real estate misrepresentation and insurance coverage litigation. She is an appointed Court Commissioner by the Hon. Janet Protasiewicz. She was the Wisconsin Bar's Chair of the Litigation Board, served two terms on the Bar's Board of Governors, and was an elected member of Wisconsin Judicial Council for six years. In 2014, Ms. La Fleur participated in the Joint Legislative Council's Study Committee on the Transfer of Structured Settlements. She spent six years on the Special Preliminary Review Committee of the Office of Lawyer Regulation. In 2016, she was appointed by Justice Roggensack to a committee formed to study the Office of Lawyer Regulation. Catherine has graded bar exams for the Board of Bar Examiners for over a decade.

*Virtual Asset Issues Arising in Bankruptcy*

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**I. Definitions and Basic Concepts**

**A. What is a Virtual Asset?**

**Virtual Assets** are digital representations of value that can be digitally traded, or transferred, and can be used for payment or investment purpose.

- Common examples of virtual assets are virtual currency like Bitcoin, Litecoin, Ethereum or Dogecoin.
- Gaming tokens, non-fungible tokens (NFTs) and governance tokens might also be considered virtual assets, depending on the circumstances and the context in which the assets exist and are used.

**B. What is Virtual Currency?**

**Virtual currency** as defined by the Internal Revenue Service is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.

In some environments, it operates like “real” currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S.

**Cryptocurrency** as defined by the Internal Revenue Service is a type of virtual currency that utilizes cryptography to validate and secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.

**Virtual Currency Exchanges (VCEs)** are the platforms through which cryptocurrency is acquired, transferred, traded, and stored. There are over 500 VCEs in the U.S. as of 2022. [www.forbes.com/advisor/investing/cryptocurrency/best-crypto-exchanges/](https://www.forbes.com/advisor/investing/cryptocurrency/best-crypto-exchanges/)

- **Centralized exchanges (CEX)** are the most common and traditional and are similar to a brokerage account. They are owned by private

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<sup>1</sup> Co-authored by Beth M. Brockmeyer, Steinhilber Swanson LLP.

companies and offer investors a platform to trade cryptocurrencies. Examples: Binance, Coinbase, Kraken, Gemini

- **Decentralized exchanges (DEX)** operate with no central point of control and are more like a marketplace that facilitates peer-to-peer trading. Servers for this type of exchange are spread throughout computers located across the world. Examples: Bisq, Uniswap, PancakeSwap, Tokenlon, dYdX
- **Hybrid exchanges** attempt to provide the best of both CEX and DEX. They offer the greater functionality and liquidity of centralized exchanges together with the security advantages of decentralized exchanges. Examples: Nash, Qurrex, Eidoo, Legolas

### C. What are Non-Fungible Tokens (NFTs)?

**Non-Fungible Tokens (NFTs)** are tokens that represent ownership of unique digital items like artwork or music, but not limited to those items.

- An NFT certifies that the holder owns the underlying digital asset and can sell, trade, or redeem it.
- By way of example, the digital image CryptoPunk #5822 sold for \$23.7 million.



[hypebeast.com/2022/2/cryptopunk-5822-record-breaking-8000-eth-23-7-million-usd-sale-info](https://hypebeast.com/2022/2/cryptopunk-5822-record-breaking-8000-eth-23-7-million-usd-sale-info)

### D. What is a Blockchain and how does it work?

**Blockchains** are a type of distributed database or ledger system that publicly records transactions between participants within the system in such a way that transactions are verifiable and immutable.

- Transactions are recorded forever in a continuously growing ledger of activity.

- The innovation is that it guarantees the fidelity and security of the record of data and generates trust without the need for a trusted third party.

E. **Digital Wallets** allow users to receive, send, and otherwise control digital assets. Digital Wallets are accessed by both *public* and *private* keys. There are various types of digital wallets.

- **Hot wallets** are used with cryptocurrency applications or software found on a computer or cell phone or on a web-based wallets maintained by third parties and accessed through a VCE online. Connected to the internet so easier to use but more vulnerable to unauthorized use or cyberattacks.
- **Cold wallets** are kept on USB drives, an offline computer or paper. Not connected to the internet so more cumbersome to use, but offer more security.
- **Public Keys** are computer generated alphanumeric addresses that are shared, not unlike a bank account and routing number.
- **Private Keys** are computer generated alpha numeric addresses only known to owner of wallet, not unlike a PIN or password that are used to receive, send, and otherwise control the assets in the wallet.

## II. Are virtual assets property of the bankruptcy estate? Yes

### A. Property of the Estate under 11 U.S. C. § 541

1. The commencement of a case under section 301, 302, or 303 creates an estate.
2. Pursuant to subsection 541 (a)(1), the estate includes all legal or equitable interests of the debtor in property, wherever located or by whomever held, as of the commencement of the case.
3. In 2014, the Internal Revenue Service stated that for federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency. Notice 2014-21, 2014-16 I.R.B. 938.
4. In Stern v. Marshall, the U. S. Supreme Court held that property interests are created and defined by state law and that unless some federal interest requires a different result, there is no reason why such interests should be analyzed

differently simply because an interested party is involved in a bankruptcy proceeding, 564 U.S. 462, 495, 131 S. Ct. 2594, 2616 (2011).

**B. What characteristics make virtual assets different than other property in bankruptcy proceedings?**

1. **Ownership and transfers:** opportunity for transactions to be made with pseudonymous
2. **Timing of transactions:** difficulty in determining when transfers occurred
3. **Value:** highly volatile
4. **Lack of physical form:** complicates jurisdictional characterizations
5. **Complexity in oversight:** locating, liquidating, selling

**C. Are Debtors required to disclose virtual assets on their bankruptcy schedules? Yes**

1. There is no specific question on Schedule A/B that asks about virtual assets.
2. Debtors could disclose virtual assets at the following questions on Schedule A/B:
  - a. **Question 16 Cash** *Examples:* Money you have in your wallet, in your home, in a safe deposit box, and on hand when you file your petition
  - b. **Question 17 Deposits of money** *Examples:* Checking, savings, or other financial accounts; certificates of deposit; shares in credit unions, brokerage houses, and other similar institutions.
  - c. **Question 35 Any financial asset you did not already list**
  - d. **Question 53 Do you have any other property of any kind you did not already list?**

**D. Are virtual assets exempt assets in a bankruptcy proceeding?**

1. **Federal exemptions:** 11 U.S.C. § 522(d)(5) “wildcard”
2. **Under Wisconsin law:** Debtors may attempt to use:
  - a. Depository account exemption under Wis. Stats. 815.18(3)(k):

*Depository accounts.* Depository accounts in the aggregate value of \$5,000, but only to the extent that the account is for the debtor's personal use and is not used as a business account.

b. Net income exemption under Wis. Stats. § 815.18(3)(h):

*Net income.* Seventy-five percent of the debtor's net income for each one week pay period. The benefits of this exemption are limited to the extent reasonably necessary for the support of the debtor and the debtor's dependents, but to not less than 30 times the greater of the state or federal minimum wage.

**Wis Stats. § 815.18(2)(n):**

“Net income” means gross receipts paid or payable for personal services or derived from rents, dividends or interest less federal and state tax deductions required by law to be withheld.

**E. How are virtual assets valued in a bankruptcy?**

1. There is no generally accepted framework or methodology for classification or valuation. Holding that Bitcoin was not the equivalent of U.S. currency and deferring further consideration of the nature of Bitcoin. *In re Hashfast Technologies LLC*, Ch. 11 No.14-30725 (N.D. Cal. 2014).
2. There is not a clear market for virtual assets.
3. Values of virtual assets tend to fluctuate dramatically.
4. Until Congress acts or there is governing case law Debtors, Trustees and Creditors will need to find a path forward.

**F. How will turnover of virtual assets to the trustee be effectuated in compliance with 11 U.S.C. § 542?**

1. § 542(a) requires an entity in possession, custody, or control of property that the trustee may use, sell, or lease under section 363 to deliver to the trustee all estate property that the trustee does not already possess.
2. Entities like VCEs and Debtors should be prepared to cooperate with trustees to effectuate turnover to be in compliance with § 542.
3. Mechanics of Turnover for Debtors

- a. Cold Wallet turnover by Debtors of paper records, hard drives, and USB drives to trustees;
- b. Hot Wallet turnover by Debtors of public and private keys to trustees.

4. Mechanics of turnover for VCEs

- a. Freezing or suspending accounts to prevent transfers;
- b. Provide account information to show balances and transactions;
- c. Create trustee VCE accounts;
- d. Transfer assets controlled by a trustee into trustee's VCE account;
- e. Convert cryptocurrency to fiat currency for deposit into a trustee VCE account;
- f. Transfer digital assets from the trustee VCE account to a wallet controlled by a judgment creditor;
- g. The VCE Coinbase provides an online Bankruptcy trustee guide. [help.coinbase.com/en/coinbase/other-topics/other/bankruptcy-trustee-guide](https://help.coinbase.com/en/coinbase/other-topics/other/bankruptcy-trustee-guide)

**G. What virtual asset disclosures are required in the Statement of Financial Affairs?**

1. **Question 18.** Property transfers outside the ordinary course of business (2 years) Within 2 years before you filed for bankruptcy, did you sell, trade, or otherwise transfer any property to anyone, other than property transferred in the ordinary course of your business or financial affairs?
  - a. Under 11 U.S.C. § 548, the trustee may avoid any transfer of an interest of the debtor in property that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily-
    - (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted;
    - or;

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and;

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

- b. Debtors should be prepared for creditor and trustee inquiries, including failures to disclose virtual assets on financial statements and credit applications;
- c. Valuation and timing of valuation of virtual assets will be key to determining whether an avoidance action will be brought.

2. **Question 20.** List of Certain Financial Accounts, Instruments, Safe Deposit Boxes, and Storage Units.

Within 1 year before you filed for bankruptcy, were any financial accounts or instruments held in your name, or for your benefit, closed, sold, moved, or transferred?

Include checking, savings, money market, or other financial accounts, certificates of deposit; shares in banks, credit union, brokerage houses, pension funds, cooperatives, associations, and other financial institutions.

- a. Did the Debtor close a cryptocurrency account on a VCE in the 12 months before filing bankruptcy?
- b. Are the virtual assets from the closed VCE account traceable?

3. **Question 6.** During the 90 days before you filed bankruptcy, did you pay any creditor a total of \$600 or more?

- a. Holders of cryptocurrency on VCE beware as withdrawals within 90 days from a VCE account may be considered a preference under 11 U.S.C. § 547 if the VCE files bankruptcy.
- b. A holder of cryptocurrency on an exchange, could be considered a creditor of the exchange for the amount of crypto held and subject to clawback by the trustee.

**H. What are some best practice suggestions to help neutralize the uncertainties of virtual currency in bankruptcy?**

- a. Ask your clients the same questions that trustees will be asking about virtual assets;

- b. Collect and review the records bankruptcy trustees will be requesting;
  - (1) Review bank statements and credit card statements;
  - (2) Review Paypal transactions;
  - (3) Be on the lookout for the names of VCEs;
  - (4) Pay attention to lengthy computer generated alpha numeric addresses; that are longer than an ordinary account number;
  - (5) Verifying the value of the virtual asset just prior to the filing of the bankruptcy petition for accuracy due to volatility.
- c. Discuss the importance of full disclosure of all assets and Denial of Discharge under 11 U.S.C. § 727(a) prior to filing
  - (1) Be mindful of clients who gamble as they may be more susceptible to the speculative nature of virtual assets;
  - (2) Be mindful that the nature of virtual assets is inherently ripe for shielding assets from creditors and may increase the risk for opportunistic behavior.

Steinhilber Swanson LLP is a statewide law firm helping businesses and individuals facing financial distress. A successful workout or reorganization requires attorneys with knowledge and expertise. We have a depth of both. We believe in working closely with the client and their current advisors to achieve results. We serve clients in workouts, restructurings, bankruptcy and non-bankruptcy reorganizations and receiverships throughout Wisconsin and in Courts across the country from our offices in Milwaukee, Madison, and Oshkosh.

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