

Cryptocurrencies in Insolvency: Evasive Reality

By POLINA LYADNOVA, EKATERINA DOROKHOVA and HANNAH WHITNEY



Heated debates on the legal nature and preferred regulatory regime for cryptocurrencies have been continuing for years now. The legal status and treatment of cryptocurrencies varies across different jurisdictions, from categorisation as a means of payment (Japan and Sweden) or asset (Canada and Israel), to a complete ban (Iceland and Nigeria). In this article inspired by a recent Russian court case (later appealed and effectively reversed), we consider the current legal situation and outlook for cryptocurrencies in both Russia and the UK, which, more broadly, may reveal interesting and important differences between the approaches towards cryptocurrencies in civil law and common law jurisdictions.

Russia

Despite a positive outlook, the formal legal status of cryptocurrencies in Russia is at present uncertain, with no legislative guidance and little settled case law on the matter (except for case law on the treatment of internet resources disseminating information on cryptocurrencies, its purchase and possible use). Against this backdrop, a recent bankruptcy case before by the Moscow Arbitrazh Court¹ (*Tsarkov's case*) captured plenty of attention in the legal community. In this case, an insolvency officer argued that the contents of Mr. Tsarkov's (the debtor's) cryptocurrency wallet should be included in the insolvency estate as an asset, and suggested that exclusion of cryptocurrencies from the insolvency estate would infringe creditors' rights, as it would decrease the size of the insolvency estate.

The court dismissed the insolvency officer's claim, stressing that the legal status of cryptocurrency in Russia remained unclear, pending the relevant changes to legislation expected by July 1, 2018.² Although the court acknowledged that operations with cryptocurrencies by Russian persons are not prohibited under Russian law, it concluded that cryptocurrencies do not have the legal status of an asset and that transactions involving cryptocurrencies are unenforceable in Russia.

One line of the court's argumentation related to the anonymity of cryptocurrencies. As a practical matter, it is hard (not to say impossible) to identify the owner of a cryptocurrency. Even though, in the case at hand, it should not have raised any concerns,³ the discussion indeed highlighted a potential problem where the debtor does not voluntarily provide this information and question arises as to how this information in practice could be traced.

The court took note of the core features of a cryptocurrency: the absence of a "controlling centre" for the issue and circulation of cryptocurrencies, as well as the anonymous nature of issuance and circulation of cryptocurrencies, which prevents identification of the owner. The court noted that the absence of a "controlling centre" results in an inability to contest or cancel an unauthorised transaction. The court further explained that lack of centralisation means that no person guarantees the purchasing capacity of the cryptocurrency. Furthermore, as a consequence of the anonymous nature of the issuance and circulation of cryptocurrencies, holders of cryptocurrencies may get involved, either intentionally or unintentionally, with illegal activities (in particular, money laundering and financing of terrorism).⁴ None of these features, however, necessarily mean that a cryptocurrency cannot be recognised as an asset.

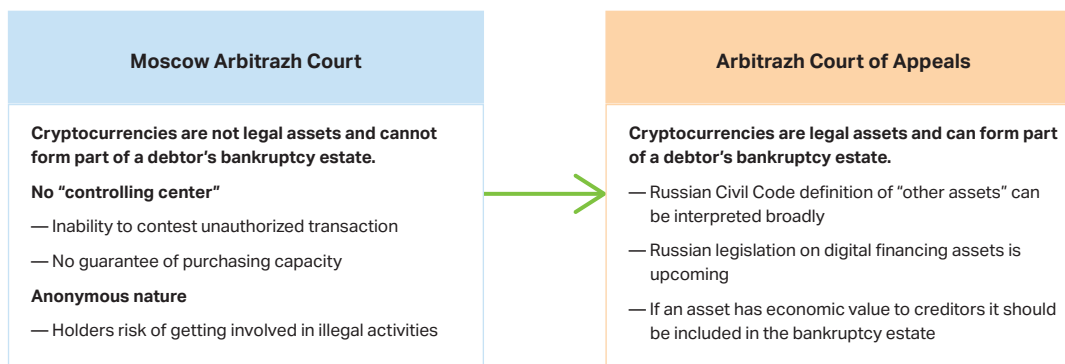
The decision of the court of first instance in Tsarkov's case was heavily criticised in the legal community for a number of reasons, above all for the court's failure to draw any analogy between cryptocurrencies and assets. Indeed, it seemed that

Country	Treatment of Cryptocurrencies
Japan	Means of payment
Philippines	Means of payment
Sweden	Means of payment
New Zealand	Payment system
Argentina	Money (but not legal currency)
Australia	Money
Germany	Unit of account and private money
Brazil	Asset
Canada	Asset
Finland	Asset
Israel	Asset
Mexico	Asset
The Netherlands	Asset
Norway	Asset
Pakistan	Commodity
The United States	Commodity, security, currency/form of money, asset (depending on the regulator, legal regime and particular crypto)
The United Kingdom	No settled approach
Bolivia	Banned
Ecuador	Banned
Iceland	Banned
Nigeria	Banned
Romania	Banned
Vietnam	Banned

the court was unwilling to take any responsibility for giving legal status to cryptocurrencies before the amendments to the Civil Code of the Russian Federation⁵ (the "Amendments") and/or the draft law "On Digital Financial Assets"⁶ (the "Draft Law"), both of which were approved in the first reading on 22 May 2018, have been adopted by the State Duma.

The Amendments and the Draft Law were introduced pursuant to President Putin's instructions of 21 October 2017 No. Pr-2132.⁷ The Amendments specifically provide that cryptocurrencies will be recognised as "other assets", thus officially granting tokens and cryptocurrencies the status of objects of civil rights and confirming their negotiability and enforceability. Furthermore, the Amendments introduce the terms "digital money" and "digital rights," which refer to cryptocurrencies and tokens, respectively. Although digital money is not, in general, recognised as a legal means of payment, it was suggested that, in certain cases and circumstances "determined by the law," they could be, assuming the relevant legislation is adopted in the future. Under the Draft Law, it will also become possible to exchange cryptocurrencies into roubles or a foreign currency through an exchange, broker, dealer or person providing securities' management services.

Tsarkov Case



Thus, if the Amendments and/or the Draft Law are adopted (which, as noted above, was expected to happen by July 1, 2018), the question whether cryptocurrencies can be included in an insolvency estate should finally be resolved (although this would of course only be possible where there is a technical possibility of identifying the owner and making a compulsory record of change of ownership). In Tsarkov's case, the court of first instance, however, did not take any account of the intended status of cryptocurrencies under the legislative changes discussed above in reaching its decision.

The court's decision appeared to go against the main objective of the last stage in an insolvency process, which is to increase the insolvency estate and maximise recovery by the creditors. Therefore, the decision, if it had not been successfully appealed, could have created a dangerous precedent, opening up possibilities for unscrupulous debtors to keep potentially significant assets in cryptocurrencies out of the creditors' reach.

Two months later, the court of appeals reversed the decision of the court of first instance in Tsarkov's case⁸ and ordered the debtor to make the password for the cryptocurrency wallet available to the insolvency officer. The court of appeals disagreed with virtually every aspect of the initial decision, including the status of cryptocurrencies, the economic effect of the decision and evidence of ownership of the cryptocurrency wallet by the debtor, in particular noting the following:

1. the term "other assets" used in the Civil Code to define the objects of civil rights should be interpreted broadly given current developments in the economy and information technology. The court of appeals thus concluded that cryptocurrencies should be qualified as "other assets";
2. legal analogy and principles of fairness, reasonableness and equity should have been applied by the court of first instance in determining the legal status of cryptocurrencies;
3. the Amendments (which, if adopted, will grant cryptocurrencies the status of assets) are currently under review by the Russian parliament;

4. no assets that have economic value to the creditors should be excluded from the insolvency estate, unless such possibility is expressly indicated in the law. In the event that such assets are excluded from the insolvency estate otherwise than as provided for by the law, creditors are deprived of their right to receive maximum recovery in the course of the insolvency process; and
5. the fact that the debtor was the legal owner of the cryptocurrency wallet was confirmed by the record of website inspection executed by a notary, as well as the debtor's own statements.

Therefore, although Russian case law on cryptocurrencies is scarce, these recent developments may indicate that the Russian courts (at least higher instances) are willing to align their practices with the Amendments and/or the Draft Law. If these drafts are adopted, cryptocurrencies will finally gain a footing in the Russian legal framework with the status of an asset, which will allow insolvency officers to include the contents of the cryptocurrency wallet in the insolvency estate. The Amendments also made clear that the legislators may in the foreseeable future even go so far as to provide for instances where cryptocurrencies may be used as a means of exchange.

The United Kingdom

In the UK, there is, at present, no case law on the legal status of cryptocurrencies; given the nature of the common law legal system, the courts may, in any event, be reluctant to set precedent before the legislative intervention of Parliament on this issue. To that end, in February 2018, the UK Parliamentary Treasury Committee launched an inquiry into cryptocurrencies to consider how they should be classified and regulated. Meanwhile, the Governor of the Bank of England, Mark Carney, has expressed the view that cryptocurrencies do not currently meet any of the usual definitions of a currency, and it is not clear the extent to which they will ever become effective media of exchange.



In the legal academic community, there has been some debate on whether cryptocurrencies should be treated as assets or currencies, although it is noted that this may depend on the specifics of the cryptocurrency in question. For instance, while cryptocurrencies that have economic value and can be freely traded and transferred are arguably likely to be treated as property at common law,⁹ it has been argued that virtual currencies that have become a medium of exchange and are commonly accepted as payment for goods could, from a legal perspective, be viewed as money.¹⁰

There is also no consistent, settled approach to the treatment of cryptocurrencies across the different areas of law. For capital gains tax purposes, there is a two-part test to determine whether a cryptocurrency is an asset, which may or may not be applicable in a particular context. The European Court of Justice, in the case of *Skatteverket v Hedqvist* (2015), which concerned the VAT treatment of Bitcoin for the purposes of the Principal VAT Directive,¹¹ held that Bitcoin could not be characterised as “tangible property” within the meaning of Article 14 of the Directive, given that the virtual currency had no purpose other than to be a means of payment, just like traditional currencies. In a probate context, cryptocurrencies are defined as (digital) ‘property interests’ and are considered part of a deceased person’s estate. In divorce cases, despite the absence of case law on digital assets, it is becoming commonplace to inquire about digital assets as part of the discovery process.

While there is not (yet) any formal framework in the UK for the treatment of cryptocurrencies in the insolvency context specifically, it is apparent that there are a number of important

practical challenges facing insolvency practitioners, such as recoverability (given the supranational and anonymised nature of cryptocurrencies) or valuation (given the potential volatility in price).¹²

The European Union is also grappling with this question and has announced that it will decide how to address the issue of cryptocurrencies later this year or in early 2019.¹³ A recent ESMA report acknowledged that this area contained many uncertainties, not least in the field of insolvency law, which will need to be addressed in due course.¹⁴

In conclusion, as the use of cryptocurrencies in a variety of business (and other) contexts becomes more widespread, it is clear that legislators and regulators will play a crucial role in the months and years ahead, and countries face very real challenges and questions on how to categorise and regulate cryptocurrencies against the backdrop of a globalised world in which restrictions on the issue and circulation of cryptocurrencies in certain jurisdictions could simply result in the transfer of projects and investments into more favourable jurisdictions. ■

1. Decision of the Moscow Arbitrazh Court in case No. A40-124668/17-71-160 F dated March 5, 2018.
2. As of publication of this article, the Draft Law and Amendment have not been adopted yet.
3. Though, in the case at hand, the cryptocurrency wallet did not require any identification of the wallet owner, as the debtor specifically acknowledged ownership of the wallet and even provided the court with notarised screenshots of the wallet with a balance (in practice, ownership of an email box would be proven in the same manner—that is, by submitting notarised screenshots to the court—and the Russian courts are known to have accepted such evidence in the past).



4. The court pointed out that Article 27 of Federal Law No. 86-FZ "On the Central Bank of the Russian Federation" imposes a ban on issuing any currency other than Russian rouble or equivalent thereof on the territory of the Russian Federation, and cited some of the positions of the Central Bank suggesting, in particular, that operations with cryptocurrencies are of speculative nature and bear a significant risk of loss of value, as well as other risks associated with cryptocurrency fluctuation and the maintenance of records of rights attached to cryptocurrency.
5. Draft law on amendments to part one, two and three of the Civil Code of the Russian Federation, <http://sozd.parliament.gov.ru/bill/424632-7>.
6. Draft law "On Digital Financial Assets", <http://sozd.parliament.gov.ru/bill/419059-7>.
7. List of instructions given by President Putin as a result of the meeting on 10 October 2017 on the use of the digital technologies in the financial sector, <http://kremlin.ru/acts/assignments/orders/55899>.
8. Decision of the Ninth Arbitrazh Court of Appeals No. 9AP-16416/18 in case No. A40-124668/17, dated May 15, 2018.
9. *Journal of International Banking & Financial Law*, 2016, Volume 31, Issue 10, November, "The legal aspect of virtual currencies" – (2016) 10 JIBFL 569.
10. *Financial Markets Law Committee*, July 2016, "Discussion paper on Issues of Legal Uncertainty Arising in the Context of Virtual Currencies", http://www.fmlc.org/uploads/2/6/5/8/26584807/virtual_currencies_paper_-_edited_january_2017.pdf.
11. EU Directive 2006/112.
12. Several of these issues are well illustrated by the ongoing liquidation proceedings of the Mt. Gox Bitcoin exchange in Japan.
13. "EU says stands ready to regulate crypto-currencies" (February 2018), <https://www.reuters.com/article/us-crypto-currencies-eu/eu-says-stands-ready-to-regulate-crypto-currencies-idUSKCN1GA1Q3>.
14. ESMA Report, February 2018, "The Distributed Ledger Technology Applied to Securities Markets", <https://www.esma.europa.eu/press-news/esma-news/esma-assesses-dlt%E2%80%99s-potential-and-interactions-eu-rules>.



▼ **Polina Lyadnova** is a partner at Cleary Gottlieb's London office. Polina's practice focuses on financial transactions, including debt capital markets and debt restructuring, particularly in Russia and the CIS. Polina also has experience in other cross-border transactions involving Russian businesses. Recent representations include Rosneft, Rusal, Iberian Minerals, TPG, FESCO and

Sistema. Polina received a law degree with highest honours from the Moscow State Institute of International Relations (MGIMO) in 2003 and LL.M. in Banking and Finance degree with merits from King's College, University of London in 2007.



▼ **Ekaterina Dorokhova** is an associate at Cleary Gottlieb's Moscow office. Ekaterina's practice focuses on financial transactions, including debt capital markets, debt restructuring and insolvency. Ekaterina also has experience in mergers and acquisitions, joint ventures, and other corporate and regulatory matters, including antitrust and foreign investments law matters. Ekaterina received

an LL.B. and an LL.M., both with highest honours, from the Moscow State Institute of International Relations (MGIMO) in 2011 and 2013, respectively.



▼ **Hannah Whitney** is a trainee at Cleary Gottlieb's London office. Hannah is currently working in the finance team, having completed six months in the capital markets team. Hannah graduated with first-class honours from Oxford University in 2014 and spent a year studying at Harvard University, before completing her legal studies at University of Law, London in 2017.