

BY MARISSA LEE

Stablecoin: Yet Another Layer of Cryptocurrency Complexity

Stablecoin — a new class of cryptocurrencies pegged to another, more “stable” asset — is gaining traction following bitcoin. Corporations and financial institutions increasingly regard stablecoin as both an attractive investment vehicle and a convenient medium of exchange,¹ while certain regulators and courts have addressed how to define cryptocurrencies, bankruptcy courts have not yet done so.

The classification and valuation of stablecoin and other cryptocurrencies will decide how certain collateral is affected in bankruptcy proceedings. This article takes the position that given stablecoin’s price volatility, bankruptcy courts should treat it as a commodity in a § 550 recovery.



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Despite Its Peg, Stablecoin Remains Volatile

Stablecoin and bitcoin are the two main types of cryptocurrency actively traded in a market that includes more than 2,600 different cryptocurrencies and a total capitalization of more than \$300 billion.² Cryptocurrencies are encrypted digital assets that can be purchased, transferred or sold using blockchain technology enabled by a network of computers and algorithms.³ However, bitcoin’s popularity has recently been undermined due to very high price volatility.⁴

Deemed the new and improved bitcoin, stablecoin contains an additional feature: It is pegged in value to another asset. Stablecoin comes in three types: fiat- or commodity-backed, cryptocurrency-backed and algorithmic-backed.⁵

The first type is backed by an asset such as a fiat currency, gold or other commodity. The second type is backed by another cryptocurrency, usually a top-ranked one with large market capitalization such as bitcoin or ether, or a blended portfolio of multiple cryptocurrencies. The third type relies on

algorithms that expand and contract the supply of stablecoins in a way that is similar to how central banks stabilize prices. Stablecoin purports to be the best of both worlds by combining the advantages of cryptocurrencies (speed) with the advantages of traditional currencies (stability).

But stablecoin is pegged to other assets; it is not collateralized.⁶ Holders do not have an actual legal claim to the underlying assets.⁷ Stablecoin companies are not bound to maintain their peg when the Federal Reserve has deliberately stayed out of the cryptocurrency space. The Federal Reserve has stated that it does not have authority to regulate bitcoin and other cryptocurrencies.⁸ For example, the most well-known stablecoin, Tether, is designed always to be worth \$1, yet it fell to \$0.91 in October 2018.⁹ Tether is facing criticism of its poor accounting and audit practices¹⁰ for alleged market manipulation and potentially holding insufficient U.S. dollar reserves.¹¹ Tether has also been accused of improperly issuing more coins than those actually backed by U.S. dollars.¹² Without federal oversight, such an arrangement lacks reliability when holders must rely on stablecoin companies’ self-regulation and reserve reporting.

Intuitively speaking, pegging is not sustainable when it is preferable to own a U.S. dollar, supported by the full faith and credit of the U.S. government, over a cryptocurrency with questionable backing.¹³ Existing stablecoins issued by start-ups lack any performance track records.¹⁴ It is doubtful

1 JPMorgan and Facebook are developing their own stablecoins for instantaneous money transfers with and between their customers. See, e.g., Eleni Digalaki, “JPMorgan Is Launching the First U.S. Bank-Backed Digital Token,” *Bus. Insider* (Feb. 19, 2019), available at [businessinsider.com/jpmorgan-launching-jpm-coin-cryptocurrency-2019-2](https://www.businessinsider.com/jpmorgan-launching-jpm-coin-cryptocurrency-2019-2); Nathaniel Popper and Mike Isaac, “Facebook and Telegram Are Hoping to Succeed Where Bitcoin Failed,” *N.Y. Times* (Feb. 28, 2019), available at [nytimes.com/2019/02/28/technology/cryptocurrency-facebook-telegram.html](https://www.nytimes.com/2019/02/28/technology/cryptocurrency-facebook-telegram.html) (unless otherwise specified, all links in this article were last visited on June 26, 2019).

2 “All Cryptocurrencies,” Investing.com, available at [investing.com/crypto/currencies](https://www.investing.com/crypto/currencies).

3 See Yilu Zhang, “The Incompatibility of Bitcoin’s ‘Strong’ Decentralization Ideology and Its Growth as a Scalable Currency,” 11 *N.Y.U. J. L. & Liberty* 1, 560-62 (2017).

4 Paul Krugman, “Bubble, Bubble, Fraud and Trouble,” *N.Y. Times* (Jan. 29, 2018), available at [nytimes.com/2018/01/29/opinion/bitcoin-bubble-fraud.html](https://www.nytimes.com/2018/01/29/opinion/bitcoin-bubble-fraud.html).

5 Bilal Memon, “Guide to Stablecoins: Types of Stablecoins and Its Importance,” Master the Crypto, available at masterthecrypto.com/guide-to-stablecoin-types-of-stablecoins.

6 Chrisjan Pauw, “Important Aspects of Stablecoins: The Difference Between Pegging, Collateralization and Redeemability,” Cointelegraph (Oct. 19, 2018), available at cointelegraph.com/news/important-aspects-of-stablecoins-the-difference-between-pegging-collateralization-and-redeemability.

7 Shaya Rochester and Lindsay Lersner, “What Happens When Crypto Meets Insolvency,” *Law360* (Feb. 7, 2019), available at [law360.com/articles/1116999/what-happens-when-crypto-meets-insolvency](https://www.law360.com/articles/1116999/what-happens-when-crypto-meets-insolvency) (subscription required to view article).

8 Ryan Tracy, “Yellen: Bitcoin ‘Doesn’t Touch’ Banks the Fed Oversees,” *Wall St. J.* (Feb. 27, 2014), available at [wsj.com/articles/no-headline-available-1393521584](https://www.wsj.com/articles/no-headline-available-1393521584) (subscription required to view article).

9 Sarah Wurfel, “(Un)stable Coin Tether Troubles Could Rash the Whole Ecosystem Right Now but End Up Being Good Long-Term,” *Crypto J.* (Oct. 15, 2018), available at captainaltcoin.com/unstable-coin-tether-troubles-could-crash-the-whole-ecosystem-right-now-but-end-up-being-good-long-term.

10 Sam Town, “Tether Audit: FSS Report States All USDT Is Fully Backed, but Can’t Prove It,” *CryptoSlate* (June 21, 2018), available at cryptoslate.com/tether-audit-fss-report-states-all-usdt-is-fully-backed-but-cant-prove-it.

11 Joseph Young, “Tether Spotlight Once Again: Controversy Over 100% Peg to USD,” *NewsBTC* (March 19, 2019), available at [newsbtc.com/2019/03/14/tether-spotlight-once-again-controversy-over-100-peg-to-usd](https://www.newsbtc.com/2019/03/14/tether-spotlight-once-again-controversy-over-100-peg-to-usd).

12 Matthew Leising, “U.S. Regulators Subpoena Crypto Exchange Bitfinex, Tether,” *Bloomberg* (Jan. 30, 2018), available at [bloomberg.com/news/articles/2018-01-30/crypto-exchange-bitfinex-tether-said-to-get-subpoenaed-by-cftc](https://www.bloomberg.com/news/articles/2018-01-30/crypto-exchange-bitfinex-tether-said-to-get-subpoenaed-by-cftc).

13 Barry Eichengreen, “Why ‘Stable Coins’ Are No Answer to Bitcoin’s Instability,” *The Guardian* (Sept. 11, 2018), available at [theguardian.com/technology/2018/sep/11/stable-coins-bitcoin-cryptocurrencies-tether](https://www.theguardian.com/technology/2018/sep/11/stable-coins-bitcoin-cryptocurrencies-tether).

14 See generally “Blockchain,” State of Stablecoins (2019), available at blockchain.com/research (containing comprehensive list of stablecoin companies and models).

that these profit-driven companies can maintain stablecoin's peg to the more valuable U.S. dollar on a one-to-one basis when the central banks in countries like Argentina, Mexico, Greece and Thailand failed to do so in the past.¹⁵ To induce holders to own stablecoins, these companies are effectively required to have U.S. dollars in reserves that, at the very least, equal or exceed the coin value.¹⁶ In addition, unlike cash in a bank account, stablecoin has no federal insurance to protect against fraud or theft.¹⁷ The non-central bank involvement — the very characteristic that makes stablecoin and other cryptocurrencies attractive and distinctive in the first place — renders them inherently risky.

Bankruptcy Courts' Position on Stablecoin Remains Elusive

Despite stablecoin's growing visibility and discourse among various investors, economists, regulators and courts alike, bankruptcy courts have not addressed how stablecoin and other cryptocurrencies should be treated. The only written decision on the topic, *In re HashFast Technologies LLC*, explicitly declined to resolve the issue.¹⁸ There, the trustee sought the return of 3,000 bitcoins or the cash-equivalent value paid by the company to a former employee, Mark Lowe, in return for Lowe promoting the company's bitcoin-mining hardware. The trustee argued that this payment qualified as a preferential transfer under § 547 or a fraudulent transfer under § 548 of the Bankruptcy Code.¹⁹ The trustee added that he was entitled to a recovery under § 550 that permits clawing back the compensation already made to Lowe.²⁰

While bitcoin's price appreciated substantially in the course of the bankruptcy proceedings, the court had to determine whether bitcoin was a currency or a commodity, and the answer would dictate the amount that would be recoverable by the trustee. If bitcoin was a currency, the trustee would be entitled to the value on the date of transfer (*i.e.*, the date on which Lowe received the coins for his service). If bitcoin was a commodity, the court would determine the appropriate arrangement per § 550(a) where the trustee "may recover, for the benefit of the estate, the property transferred, or, *if the court so orders*, the value of such property."²¹ The options included giving back the coins themselves, or paying out cash in value as of the date of transfer, filing or recovery. Since this case was settled between the parties, the court ultimately declined to resolve these issues.²²

Bankruptcy Courts Should Adopt Solution to Treat Stablecoin as a Commodity

The simplest solution may be for bankruptcy courts to grant stablecoins to creditors and not invoke the currency

vs. commodity debate.²³ While this solution is easier to administer and imposes uniformity, it is ineffective in at least two situations.

Similar to other cryptocurrencies, stablecoin relies on blockchain technology and public and private key encryption. Stablecoins are rendered worthless if an owner does not know the access information because without the access information, the coins are not retrievable. This solution becomes impossible when stablecoins are lost or stolen.

Likewise, stablecoins are vulnerable to hacking.²⁴ In November 2017, Tether reported that it lost stablecoins worth \$30 million when its system was hacked.²⁵ Moreover, § 550 requires bankruptcy courts to resolve transfer liability "to the extent that a transfer is avoided."²⁶ When the "extent" of the "transfer" depends on price fluctuations, courts cannot fulfill the statutory mandate. What creditors get is a different "extent" of the "transfer" from what a debtor purchased in terms of monetary value.

In the upside case, the creditors now own the very same stablecoins transferred from the debtor, but these coins are worth more. The creditors are enriched while the debtor is denied that opportunity of tapping into this windfall. Especially in the reorganization context, the debtor should partake in these upside returns. The debtor can be incentivized to earn money, and the creditors can be paid out sooner at the same time.²⁷ Conversely, in the downside case, the creditors are harmed because they cannot fully recover. Therefore, returning stablecoins themselves is neither desirable nor straightforward when the implications include limited application and unfairness.

The second solution — classifying stablecoin as a currency — should be rejected because it goes against the congressional intent to require any recovery under § 550 to be "for the benefit of the estate."²⁸ This currency approach values stablecoins on the date of transfer, but it can be problematic on two grounds.

First, creditors cannot capture the value of appreciation. Section 541 defines "property of the estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case."²⁹ Bankruptcy courts interpret this to be a "very broad and all-encompassing definition intended to bring all the debtor's property, in any form, into the bankruptcy estate upon the commencement of the case."³⁰ Once a debtor has filed for bankruptcy, the debtor effectively relinquishes ownership of stablecoins to the estate, and the creditors should benefit from the upside.

Second, the currency approach adversely incentivizes the debtor to strategize the bankruptcy filing timing around when one expects stablecoin's price to appreciate. Recognizing that

23 Mary Maginnis, "Money for Nothing: The Treatment of Bitcoin in Section 550 Recovery Actions," 20 *J. Bus. L.* 485, 517 (2017).

24 Tim Johnson, "The Trouble with Bitcoin: Keeping It from Getting Hacked, Lost or Stolen," *McClatchy DC Bureau* (May 10, 2018), available at mcclatchydc.com/news/nation-world/national/national-security/article210865704.html.

25 Stan Higgins, "Tether Claims \$30 Million in U.S. Dollar Token Stolen," *CoinDesk* (Nov. 21, 2017), available at coindesk.com/tether-claims-30-million-stable-token-stolen-attacker.

26 11 U.S.C. § 550(a).

27 Harley Hahn, "Liquidation or Reorganization?," *Santa Barbara Independent* (May 5, 2013), available at independent.com/2013/05/05/liquidation-or-reorganization.

28 11 U.S.C. § 550(a).

29 11 U.S.C. § 541(a)(1).

30 *In re Denton*, 169 B.R. 608, 611 (Bankr. W.D. Tex. 1994).

15 Berry McKenna, "Why Fixed Exchange Rates Don't Work," *The Globe and Mail* (April 30, 2018), available at theglobeandmail.com/report-on-business/economy/economy-lab/why-fixed-exchange-rates-dont-work/article617163.

16 Eichengreen, *supra* n.13.

17 John Wasik, "How You Could Get Crushed by Bitcoin, Cryptos," *Forbes* (Jan. 10, 2018), available at forbes.com/sites/johnwasik/2018/01/10/how-you-could-get-crushed-by-bitcoin-cryptos/#792ff8b952d0.

18 Ordering on Motion for Partial Summary Judgment, *In re HashFast Technologies LLC* (HashFast), No. 14-30725DM (Bankr. N.D. Cal. Feb. 19, 2016) (stating that court "does not need to decide whether bitcoin [is a] currency or commodity[y]").

19 See 11 U.S.C. §§ 547, 548.

20 See 11 U.S.C. § 550.

21 11 U.S.C. § 550(a) (emphasis added).

22 *HashFast*, *supra* n.18 at 1.

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“a transferee has an opportunity to benefit by delay, and there are possibilities for abuse where the transferred property is appreciating substantially in value,” Congress drafted § 550 to deter such behavior on the debtor’s part.³¹ Accordingly, courts have held that creditors should claim the value appreciation because such a result “serves the equitable underpinnings of restorative justice by discouraging a ‘wait-and-see’ approach by [debtors] holding property, such as stock, that [might] be subject to wide, rapid swings in value on account of volatile markets.”³²

Stablecoin is designed in a way in which an issuing company basically attempts to act like a central bank, adjusting the coin supply and price by means of using a peg, cross-collateralization of different cryptocurrencies, and algorithms. This worry might be justified, because a sophisticated debtor who has control of these pricing mechanisms or access to the related information might be capable of such manipulation. Even with the Bankruptcy Code specifically accounting for the debtor’s misrepresentation and fraud in § 523(a),³³ creditors have the burden to prove all elements showing that the debtor acted fraudulently and thus should not be granted a discharge.³⁴

The third solution — treating stablecoin as a commodity — should be preferred, because it accounts for this inherent price volatility by permitting bankruptcy courts to select the appropriate date on which to value stablecoin. Courts

recognize that § 550(a) “provides the bankruptcy court with flexibility to fashion a remedy so as to return the estate to its pre-transfer position.”³⁵ Creditors enter into an agreement with a debtor with the mutual understanding that the debtor will repay the credit and interest to compensate for the creditors’ opportunity cost and receipt of that credit at a later time. When the debtor files for bankruptcy relief, the creditors might not get the payment back in full or, at the very least, experience delay and inconvenience in payment.

In this regard, the creditors are already held to these concessions regardless of their intentions.³⁶ Accordingly, bankruptcy courts should seek a remedy optimizing recovery to the creditors and retaining the ability to assign greater sums to them. The commodity approach permits courts to decide whether to value stablecoin as of transfer, filing or recovery date, whereas the currency approach restricts doing so to the transfer date only.

Conclusion

Bankruptcy courts should classify stablecoin as a commodity because this approach best serves the policy underlying § 550 of the Bankruptcy Code. The commodity classification and the following ability for courts to decide the time of stablecoin’s valuation constitute a more pragmatic and adjustable approach, especially when stablecoin remains an untested and volatile asset. This flexibility leads to courts making a more reasonable and equitable determination that balances debtor and creditor interests. **abi**

31 5 *Collier on Bankruptcy* ¶ 550.02[3] (16th ed. 2011).

32 *Id.* See also *In re Brun*, 360 B.R. 669, 674 n.6 (Bankr. C.D. Cal. 2007).

33 Michael Medved, “The Bitcoin Problem: An Impending Dilemma for Bankruptcy Courts,” *Timely Tech @ The University of Illinois* (Nov. 16, 2018), available at illinoisjltip.com/timelytech/the-bitcoin-problem-an-impending-dilemma-for-bankruptcy-courts.

34 *Grogan v. Garner*, 498 U.S. 279, 287-88 (1991) (imposing preponderance-of-burden standard on creditors invoking fraud-discharge exception).

35 *In re Trout*, 609 F.3d 1106, 1111 (10th Cir. 2010).

36 Frances F. Gecker, “The Recovery of Opportunity Costs as Just Compensation: A Takings Analysis of Adequate Protection,” 81 *N.W.U.L. Rev.* 953-92 (1987).

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