

What Lawyers Need to Know About Bitcoins

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What are Bitcoins?

Bitcoins are digital currency – and yes, lawyers are beginning to accept them from clients. They are also known as virtual currency or cryptocurrency since cryptography is used to control the creation and transfer of bitcoins. They use peer-to-peer technology with no central authority or banks. The issuance of bitcoins and the managing of transactions are carried out collectively by the network. The system was introduced as open source software in 2009 by Satoshi Nakamoto. For you trivia buffs, the capitalized Bitcoin refers to the technology and network and the lower case “bitcoin” refers to the actual digital currency.

Bitcoins are created by a process called mining. We won't go into all of the technology that is used to create and verify the bitcoin transactions since it will probably make your head hurt. Suffice it to say that those users who provide computing power for Bitcoin get newly minted bitcoins in exchange for transaction fees to verify and record payments into a public ledger. All bitcoin transfers are recorded in a computer file called a block chain, which is synonymous to a ledger that deals with conventional money. Users send and receive bitcoins from their mobile device, computer or web application by using wallet software.

Legality of bitcoins

There is nothing illegal about bitcoins or the ability to trade or exchange them for services or real currency. However, bitcoins tend to be used to support criminal activities such as illegal drug sales since Bitcoin users are anonymous. In fact, in October last year the FBI shut down “Silk Road,” an anonymous Internet marketplace for illegal drugs like heroin and cocaine and criminal activities such as murder for hire according to an article posted on *Reuters*. They also arrested Ross Ulbrich, the alleged founder of Silk Road and seized 144,000 bitcoins from him, ironically making the FBI the holder of the world's

Usage rules

Even though bitcoins are virtual currency, there are still specific rules for this new payment method. Bitcoins have different recognition and status, depending on the jurisdiction. As an example, Germany does not classify bitcoins as a foreign currency, but rather a financial instrument under German banking rules. It is considered “private money” and can be used for tax and trading purposes. At the other side of the spectrum, bitcoins are banned in Thailand and are illegal. But what about in the United States? The IRS finally answered that question in March of this year. They said that bitcoins are considered property, not money, for tax purposes. This means that gains will be taxed the same way as investing in other property when you buy low and sell high.

How are bitcoins used- and the lawyers that use them

Bitcoins are used as a replacement for traditional credit card, cash, check or electronic funds transfers. They are a quick and cheap alternative form of payment. Patrick Murck, general counsel for the Bitcoin Foundation said that he accepted bitcoins from clients when he was in private practice. With credit cards you get hit with a processing fee. With bitcoins, he was paid within minutes in an irreversible manner without fees. Jay Cohen, a criminal defense lawyer in Houston, was one of the first attorneys in Texas to accept bitcoins for payment. He said that it helps preserve client privacy, since payment is made without using a bank.

Apparently, anonymous transactions are very attractive to particular clients and several attorneys are taking advantage of the technology. Noted criminal defense attorney Arkay Bukh specializes in cybercriminal cases. He has begun accepting bitcoins as payment, which helps ensure the privacy that his clients demand. Bitcoins eliminate the audit trail that accompanies checks or credit cards. Bukh, attorney for alleged Boston Marathon conspirator, Azamat Tazhayakov, has also represented several well-known cybercriminals over the years.

Not all law firms are criminal defense firms. Law 4 Small business has clients all over the country and accepts bitcoins to avoid credit card transaction and wire transfer fees. Texas business law firm Ram Law Firm PLLC accepts them. Top tier English entertainment and media law firm Sheridans has begun accepting them – big news across the pond. By the time this gets to print, you can bet that more law firms will be accepting them – some are actually using the fact that they accept bitcoins as a marketing strategy.

How long do they last?

Lost or stolen bitcoins are gone forever. If you buy bitcoins or use them as payment, the transaction is transmitted via code using a private key. If you lose the private key then access to the bitcoins in your wallet goes up in virtual smoke. No key – no access. There is no person or central bank to reclaim your key. What does this mean for the common user? Certainly, make sure you protect your key and wallet. You should also consider encrypting your wallet to protect it from being stolen by hackers. According to Digital Forensic Investigator News, for just \$35 you can buy a specialized malware tool designed to steal bitcoins. They also report that the detection rate of such malware by the antivirus tools is below fifty percent. Even more reason to protect your electronic currency. Finally, make sure you back up your encrypted wallet. Without a backup, if you lose your computer or hard disk that holds your wallet, your bitcoins are lost forever.

Volatility

Make no mistake about it; bitcoin valuation is a very volatile market. The value of a bitcoin has soared to huge heights and then rapidly turned around to nearly crash to nothing. As an example, in January of 2013 the value of a bitcoin was \$15.68. On April 3, 2013 the value went from \$106 to \$147 and then down to \$125 in a single day. In December of 2013 the market value of bitcoin shot past \$1,000 and approached \$1,200. Today the market value is around \$480, quite a drop from the highs of just four months ago. As you can see, the value of bitcoins is all over the place. Some people count on the

volatility to make some big money very quickly, but you can also lose in fast fashion too. Investing in bitcoins seems more like gambling to us than a solid financial strategy.

Technology hiccups

Let's face it. At some point technology will fail. In the case of Bitcoin, high volume traffic can cause a temporary shutdown. As we've mentioned before, a hard disk failure could cause you to lose your entire wallet. That's one of the reasons why the really serious Bitcoin users have multiple wallets in multiple locations.

In March 2013, a technical glitch caused a fork in the block chain (ledger for bitcoins). Half of the network added blocks to one version of the chain and the other half added to another chain. This meant that there were two Bitcoin networks operating at the same time (version 0.8 and version 0.7). In order to fix the problem there was a temporary halt of all transactions, which caused a sharp sell-off. In layman's terms, there was a failure of the database upgrade used in version 0.8, which caused the fork to occur. The major Bitcoin developers and miners spent several hours switching the network back to version 0.7 to ultimately have a single network. The incident marked the closest moment to complete failure of the Bitcoin protocol.

Ethical issues

We are not aware of any states issuing an ethical opinion specifically for Bitcoin usage. However, it is well known that an attorney can't access client funds until they are earned, hence the existence of trust accounts. Also, an attorney can accept property as payment, but there must be a valuation for the property. This is where accepting bitcoins could get a little muddy. The Model Rules note that a fee for legal services must be "reasonable." If an attorney receives bitcoins they should immediately convert and exchange those bitcoins to actual currency AND put it in their escrow account. This effectively (and actually) puts a value on the bitcoins. As part of the reconciliation and billing process, the lawyer would just note wording stating the number of bitcoins and the market value at conversion. Obviously, it would be wise to check with your state bar ethics counsel prior to accepting bitcoins for payment.

Criminal defense lawyers, of course, can face potential ethical and even criminal issues if clients pay them with assets they are determined to have acquired through illegal conduct. And yet, almost invariably, when we hear about lawyers accepting bitcoins as payment, the lawyers involved are criminal defense attorneys. For all the talk of "privacy" and the frequent inability to prove the connection between illegal conduct and bitcoins, it is clear that federal authorities believe the bitcoins are used to keep criminal activities financially untraceable.

The future

We're pretty good at predicting some things and lousy at others. Some have predicted the end of the line for Bitcoin, especially when the busiest online exchange, Mt. Gox, was frozen for days following rumors that hackers had stolen \$350 million of Bitcoin wealth. They shut down for several days. Supposedly, there is an internal memo circulating that says 744,408 bitcoins have disappeared in a "theft which went unnoticed for several years." Mt. Gox is back, but not letting customers trade or make any withdrawals. It is unknown if customers will be able to recover any of the lost funds during the

coming bankruptcy proceedings. Bottom line ... your digital money can be hacked and stolen just like your identity or other digital property.

Unless some serious security measures are built into Bitcoin, we wouldn't recommend that you invest any serious wealth with the virtual currency. And you still might want to think about accepting bitcoins as lawyers. The bulk of people we know regard bitcoins as "shady money" and they may well regard lawyers accepting bitcoins as "shady lawyers." Will bitcoins be legitimized one day in the eyes of average Joes and Janes? Maybe – but not soon.

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