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Cryptocurrencies and Unclaimed Property: Potential Implications of State Escheat Laws for the Blockchain Technology Industry

The use of blockchain technology and the issuance of cryptocurrencies have grown considerably in recent years, inviting heightened scrutiny and regulation. While federal securities, tax, and other financial services regulatory agencies, such as the SEC, the IRS, state securities commissioners and others, have begun applying their rules and regulations to cryptocurrency businesses, the cryptocurrency industry has not yet faced significant enforcement from state unclaimed property administrators. This GT Advisory considers the application of state unclaimed property laws to cryptocurrencies, and the potential implications and challenges of such application for both industry participants and state unclaimed property administrators.

Overview of Unclaimed Property Laws

Each state has adopted its own unclaimed property laws. These laws require a “holder” to report and remit, or “escheat,” unclaimed property to the state. Unclaimed property consists of a wide range of tangible and intangible property (defined differently by the states) due or owing to another person, in the possession of a holder. State unclaimed property laws generally define “holder” as any person in possession of property belonging to another person, which is subject to the state’s unclaimed property laws. Typical examples of types of property subject to state unclaimed property laws include uncashed money orders and travelers checks, uncashed rebate checks, customer overpayments or credits,

unclaimed royalty payments, unused gift certificates and gift cards, uncashed employee payroll checks, uncashed vendor or accounts payable checks, uncashed dividend checks, amounts due and payable under insurance policies or annuities, unclaimed bank account balances, contents of safe deposit boxes, securities, amounts distributable from employee benefit plans, and certain pre-payments, deposits, and layaway items. A holder is required to report and remit unclaimed property to the appropriate state when the property has been unclaimed by the owner for the applicable statutorily mandated holding period, or “dormancy” period, set by the jurisdiction (typically three to five years, depending on the type of property). General priority rules require a holder to report and remit the property to the state of the owner’s last known address, as shown on the holder’s records, or, if the holder does not have a last known address for the owner in its records, then to the state of the holder’s domicile or incorporation. Generally, a lawful owner can later contact the state seeking return of escheated property.

Can Cryptocurrencies Constitute Unclaimed Property Subject to Escheat?

Unclaimed property laws vary by state, but generally apply to a wide range of intangible assets, including money, financial accounts, and securities. The 2016 Revised Uniform Unclaimed Property Act (the Uniform Act) specifically includes “virtual currency” in its definition of “property” subject to escheat. Under the Uniform Act, “virtual currency” is defined as a “digital representation of value used as a medium of exchange, unit of account, or store of value, which does not have legal tender status recognized by the United States,” but specifically excludes the software or protocols governing the transfer of the digital representation of value, game-related digital content, or a loyalty card or gift card. To date, five states, including Illinois, Colorado, Kentucky, Tennessee and Utah, have adopted the Uniform Act’s definition of “virtual currency” as property subject to escheat in their unclaimed property laws. It is expected that more states will follow in adopting the same or similar provisions. In addition, most states have a catchall provision for miscellaneous intangible personal property that may make an intangible asset subject to escheat. Accordingly, even if a state does not have a specific statutory provision covering the escheat of virtual currencies, the state may take the position that cryptocurrencies fall within the catchall provision for miscellaneous intangible property subject to escheat.

Potential Implications and Considerations

In analyzing the applicability of unclaimed property laws to cryptocurrencies, it will first be necessary to determine what type of property the cryptocurrency is under applicable state law. Is the cryptocurrency comparable to money? Is it a commodity or security? Is it redeemable for cash? This is an important consideration because different dormancy periods may apply depending on the characterization of the property.

One factor that may become increasingly complicated is whether there is even a “holder” of some cryptocurrencies. While certain types of cryptocurrencies classified as “tokens” may have a specific party controlling the token (such as a token issued for the purchase of specific goods or services), in a classic blockchain structure, the existence of a cryptocurrency may be validated by a network of otherwise unrelated computers located in multiple and unknown state or national jurisdictions. A further complication is that the existence of a cryptocurrency may be governed by contractual terms established at the creation of the cryptocurrency (and those terms can vary), with set terms and conditions affecting both the nature and location of the asset, including who can control the asset.

Even when a cryptocurrency is deposited into an online entity, that does not necessarily resolve the issue of who the holder is with respect to the cryptocurrency. Is the holder the cryptocurrency exchange, the online wallet provider, or another form of financial intermediary? In general, a holder is defined as an entity in possession of unclaimed property belonging to another person or entity. In the context of

cryptocurrencies, whether a business will be deemed a holder may depend on the business's ability to access and transfer the cryptocurrency to a third party. What happens when the holder's ability to access and/or transfer the cryptocurrency is restricted? More often than not, the owner has a private key or password needed to transfer the cryptocurrency, in which case a cryptocurrency exchange or wallet provider likely would not be able to transfer the property to the state, and the state likely could not assert the right to take custody of the property. In such cases, the exchange or wallet provider may be deemed not to have possession and control of the property, and thus not be subject to reporting obligations under state unclaimed property laws.

Another complicating factor is the states' ability or inability to accept and hold escheated cryptocurrencies. Even if a cryptocurrency exchange or wallet provider has the technological ability to transfer a customer's cryptocurrency to a third party, state unclaimed property administrators may not be technologically equipped to accept and hold cryptocurrencies on behalf of owners, which could make an in-kind transfer impossible. Additionally, states do not typically hold non-cash assets reported and remitted pursuant to unclaimed property laws; rather, commodities and tangible items (e.g., jewelry, stock, art, etc.) are generally liquidated upon receipt. Importantly, should the owner later contact the state to recover such property, the owner will receive only the liquidated value of the asset, not its potential appreciated value. If the state were to require the holder to liquidate the cryptocurrency and remit cash to the state, or if the state were to accept the cryptocurrency and liquidate the property upon receipt, any subsequent appreciation value to the owner could be lost. This liquidation process could harm the cryptocurrency industry and market participants, and would arguably fail to serve the legislative purpose of state unclaimed property laws (which is to return unclaimed property to its rightful owner). Liquidation may also invite litigation against holders for negligent escheat, or against the states for unlawful takings.

In many instances it also may be hard to track ownership of a liquidated cryptocurrency. For example, when a state does not take in the escheated cryptocurrency, but requires the holder to liquidate it and deposit the resulting funds, how would a claimant later prove ownership to the state when claiming the proceeds? Ownership is generally validated by the network on which the cryptocurrency resides, and the liquidated cryptocurrency would no longer reside on the network.

Industry participants should be aware of the potential for regulatory enforcement actions, audits, or litigation based on purported violations of state unclaimed property laws. In March 2018, a class action was filed in California by cryptocurrency owners against Coinbase, a popular cryptocurrency exchange, alleging Coinbase unlawfully retained cryptocurrencies that were not delivered to or claimed by the owners/plaintiffs. The plaintiffs claimed, among other things, that Coinbase violated California's Unclaimed Property Law by failing to report and remit the unclaimed cryptocurrencies to the state of California. The complaint alleged that Coinbase is a banking organization, business association, and/or financial organization subject to California's Unclaimed Property Law, that the plaintiffs are the "owners" of the cryptocurrencies, that the cryptocurrencies are "property" subject to escheat under the Unclaimed Property Law, and that Coinbase, as the holder of the cryptocurrencies, failed to satisfy its notice and reporting obligations under the Unclaimed Property Law. Coinbase filed a motion to dismiss, arguing California's Unclaimed Property Law does not create a private right of action. The plaintiffs subsequently amended their complaint, removing their claim based on violation of the Unclaimed Property Law but retaining their claim that Coinbase engaged in unfair and unlawful business practices under California's Unfair Competition Law. The case was dismissed upon the filing of a Joint Stipulation of Voluntary Dismissal on May 30, 2019. While this case sets no precedent with respect to the treatment of cryptocurrencies under state unclaimed property laws, it highlights the fact that market participants may be subject to administrative and legal proceedings brought by both public authorities and private parties.

As cryptocurrency use and acceptance continues to grow, industry participants, including cryptocurrency exchanges, online wallet providers, and others, should be aware of their potential reporting obligations under state unclaimed property laws. Businesses can take proactive steps to determine their rights and obligations, minimize their liabilities, and streamline their accounting and reporting processes with respect to unclaimed property. It also will be important for users of cryptocurrencies to remain alert as to their obligations to protect their assets from escheat, not only in the jurisdiction where the owner is located, but in other jurisdictions that may claim dominion over the assets. Counsel can assist in determining your respective rights, obligations, and potential liabilities, and in navigating the holder reporting requirements and procedures in each state where you maintain business operations or otherwise may be required to report unclaimed property.

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