Hunton & Williams

Client Alert

February 2018

Despite Growing Value of Bitcoin, Retailers and Merchants Take a Cautious Approach

Bitcoin has received considerable media attention in recent months as its value soared to $20,000 in December 2017, then retreated to around $9,000 in February 2018, fueling growing speculation regarding its future. While some investors embrace bitcoin, many members of the general public struggle to understand it. And despite the interest in cryptocurrency by investors, as evidenced by the high market value of bitcoin (even after the recent drop in value), very few retailers and merchants accept cryptocurrency as a form of payment. Retailers and merchants appear to (wisely) be taking a cautious approach. This article considers the reasons why.

Bitcoin is a peer-to-peer digital currency created in 2009. Peers consist of interlinked computer systems that communicate via the internet. All transactions are conducted by the users of the systems "peer-to-peer" without involvement or intervention of any third-party intermediary. Unlike commodities such as precious minerals, bitcoin has no intrinsic value and no physical form. Bitcoin is not issued, backed or regulated by any government, central bank or other legal entity. It is a private, decentralized system that is not tied to traditional financial institutions.

Bitcoin is known as a cryptocurrency because it relies on cryptography to authenticate transactions. Cryptography involves the storage and transmission of data in a form that permits only certain, intended individuals to read and process the data. More specifically, bitcoin uses block chain technology to authenticate each bitcoin. Block chain is essentially a database or ledger to which changes can be made only when there is a consensus among the parties to a transaction. The database or ledger is maintained by the peer-to-peer network. Entities and individuals who provide the hardware and software required to host the database or ledger and independently authenticate transactions are referred to as "miners." In exchange for their services the "miners" bring new units of the virtual currency into existence, for which they receive compensation in the form of a portion of the newly mined bitcoin. Rather than being denoted by bank accounts and other personal, identifying information, bitcoin users are identified by public and private keys, which are large sequences of alphanumeric characters. Transactions are recorded in a publicly accessible block chain and are associated with a public key. The private key is only known to a specific user and serves as a digital credential. The public and private keys work in tandem to authenticate the transactions.

Bitcoin has not been embraced by retailers or merchants in the United States as an accepted currency. At present, only a few companies are known to accept bitcoin (or any other cryptocurrency) as a form of payment. A recent report by a large financial institution indicated that just 3 of the 500 leading online sellers accept bitcoin. Notably, Overstock.com and Expedia accept bitcoin. That a limited number of retailers and merchants have embraced the currency is unsurprising considering that bitcoin is relatively new, only recently began receiving significant public interest and is not well understood by most people. Nevertheless, bitcoin warrants the attention of the business community and at some point may appeal to retailers and merchants who regularly engage in consumer transactions.

One potential advantage of cryptocurrency transactions is that they do not involve an exchange of personal, identifying information such as credit card numbers, bank account and routing numbers, social security numbers or personal addresses. Bitcoin users rely on public and private keys to make and

© 2018 Hunton & Williams LLP

authenticate transactions. Some view bitcoin technology as a means of reducing the risk of identity theft. With retailers and merchants receiving and retaining significant amounts of personal, identifying information, the constant threats to data privacy, and the ongoing risk of class action lawsuits related to identity theft, bitcoin may warrant consideration as a way to decrease or limit a growing source of liability. On the other hand criminal schemes, including hacking of cryptocurrency accounts and scams, are on the rise. Several large-scale hacks of cryptocurrency exchanges have occurred within the past few months. An increase in criminal schemes may indicate that cryptocurrencies are not as secure as once thought, thereby defeating one of its potential selling points.

Other aspects of bitcoin that may appeal to retailers and merchants are reduced transaction costs and finality of the transactions. Because bitcoin is a peer-to-peer digital currency and transactions are performed by users, no intermediary charges a fee for processing payments, as is the case with credit card transactions. In addition, transactions using bitcoin are irreversible, which eliminates credit card reverse charges. The potential savings to retailers and merchants could be significant if bitcoin were to comprise a large share of a company's payments.

Despite the appeal of certain bitcoin features there are several reasons why retailers and merchants remain cautious. First, as noted earlier, only a few companies accept bitcoin and it is not regulated by any government, central bank or other legal entities or tied to any traditional financial institutions. Starting in 2018 people are able to trade bitcoin futures on the Nasdaq Stock Market, but the overall exchange market is not well developed. Limited ability to transfer bitcoin limits its value to retailers and merchants for whom liquidity is important. Second, bitcoin's value has proved to be highly speculative and volatile. The continuing likelihood of drastic price fluctuation may create too much risk and uncertainty for most retailers and merchants to bear. Unlike with the US dollar, a regulated, legal tender, there are no institutions in place to guard against or respond to fluctuations in the value of private, digital currencies. Third, companies cannot process a high volume of cryptocurrency transactions. That will likely need to change before retailers and merchants accept cryptocurrencies on a significant basis, but there has yet to be sufficient demand to spur development in this area. Finally, the anonymity associated with cryptocurrencies is a double-edged sword. Although anonymity may help protect against identity theft, it may create an additional source of liability by allowing individuals to use bitcoin for nefarious or criminal purposes, such as money laundering. Perception matters and no company wants to be associated with nefarious or criminal activity.

In addition to the issues noted above, a company's decision to accept bitcoin would raise several legal considerations, including licensing/regulation requirements and tax implications. For example, bitcoin has been deemed an asset or property for tax purposes and exchanges are considered money services businesses. Insufficient regulatory guidance on these (and other) legal issues does not help matters. A wait-and-see approach remains the proper course of action at this point in time. But bitcoin, and cryptocurrencies in general, should garner the attention of merchants and retailers. If consumers embrace cryptocurrency on a large-scale level, then consumers will likely expect (or demand) that retailers and merchants follow suit. Companies that remain abreast of developments in this field may be best positioned to realize potential benefits, and limit or avoid potential shortcomings, should consumer demand increase and the risks, stability and uncertainty of such currencies be reduced as they mature..

Authors

Andrew S. Koelz
akoelz@hunton.com

Matthew J. Calvert
mcalvert@hunton.com

© 2018 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.