FinTech Update: Emerging Legal Trends Regarding Blockchain Technology

USA | January 17 2018

Over the course of the past few years, Blockchain technology – a platform that acts as a digital ledger for assets – has rapidly grown in prominence. While it is perhaps most well-known for its connection to Bitcoin, the potential applications for Blockchain's technology go far beyond cryptocurrencies. Blockchain provides a peer-to-peer tool for sharing information about assets and transactions, such as digital goods, money, medical records, company records, intellectual property, contracts, and other types of data. This article seeks to provide a brief overview of Blockchain technology and to explore early trends in how Blockchain's technology may come into play in legal disputes.

Overview – What is Blockchain?

Quite simply, Blockchain technology is a sequential chain of blocks containing information. Like a hardcopy ledger or record book, Blockchain is a record of chronological transactions. However, Blockchain departs from the traditional ledger because the ledger is electronic and, more significantly, it is distributed and decentralized. In addition, when a transaction (a "block") is recorded, each transaction is linked chronologically to the prior block and shared across a network of computers. Each computer ("node") on the Blockchain has the entire ledger and no single node has unilateral authority over the Blockchain. Instead, the nodes collectively verify the data in each transaction before the related block is created.

The Anatomy of a Block

Each block in the chain contains three key components. First, the block contains the stored data. For example, the blocks used in Bitcoin contain data regarding Bitcoin transactions, including the identification of the payor's electronic wallet, the payee's electronic wallet and the amount of the transfer. Second, each block contains a hash, a code which acts like a unique fingerprint for each block, and is based on the data in the block. Third, each block contains a reference to the hash of the previous block to which it was connected. The references to the prior hashes are the links, or chains, that connect the blocks to each other. Each new block in the chain is confirmed by the consensus of computers on the ledger before a transaction is finalized.

The reference hash also protects against alterations of the block. If a computer on the ledger alters the data in an already-created block, then the block's hash also changes. As such, the altered block's new hash will not match the reference hash in the subsequent block. To use an example, Block 50 and Block 51 are chronological blocks in a one hundred block ledger. Block 50 has a hash of "xyz" and Block 51 has a hash of "a1a" and a reference hash of "xyz." If a participant on the Blockchain alters the data in Block 50, it will receive a new hash "abc." However, because Block 51's reference hash still identifies the old hash of Block 50, "xyz" Block 51's reference hash is now incongruent with Block 50's hash and thus signals that the chain has been altered.

Benefits of Blockchain

Blockchain technology contains several key benefits. The first benefit of Blockchain is transparency. Because Blockchain is a distributed ledger system, all participants receive a copy of the entire Blockchain. This means that Blockchain is not reliant on a centralized authority to maintain its records; instead, all participants have access to all of the blocks, and each new block is sent to each participant to verify the block. This transparency and completeness should be particularly helpful for companies that store records using Blockchain technology, as they should be able to efficiently present records for audit with limited risk that the records have been altered. Second, the use of a decentralized and peer-to-peer network increases the speed of transactions, as the transaction is verified quickly by a consensus of participants on the ledger, rather than being routed through a single intermediary for verification. Third, the blocks of data on the chain make tampering more difficult, due to the fact that a modified block receives a new hash and further because a new block is not added to the chain until the other nodes on the peer-to-peer system have reached a consensus regarding the new block. There is an additional layer of protection due to the use of cryptography (mathematical coding of the data) to protect the data in the blocks.

Litigation Concerning the Use of Blockchain

While Blockchain technology is still relatively new, a handful of recent lawsuits give clues to the paths Blockchain-related litigation may take.

The first involves a recently-filed class action, which raises questions about whether and how U.S. securities laws should be applied to Blockchain currencies. In *GGCC, LLC v. Dynamic Ledger Solutions, et al.*, No. 3:17-cv-06779 (N.D. Cal.), a putative class of investors sued the creators of a new Blockchain cryptocurrency—"Tezos." This suit arose from an initial coin offering ("ICO") that Tezos conducted in July 2017. As explained in the complaint, "[a]n ICO is a fundraising mechanism through which the founders of a Blockchain project sell crypto tokens in exchange for the cryptocurrencies bitcoin and ethereum (ether). An ICO is similar to an Initial Public Offering, but instead of purchasing shares of a company, investors purchase crypto-tokens that can later be traded for other tokens or for cash."

The complaint alleges that the Defendants raised $232 million in Bitcoin and Ethereum at July 2017 prices, which has appreciated to over $600 million based on November 2017 prices. But, due to alleged internal conflicts among the defendants, the Tezos cryptocurrency is still not operational. According to the plaintiffs, the Tezos founders are claiming that the funds raised in the ICO were mere "donations" and that they have "the right to abandon the project at will and without recourse." Plaintiffs allege that the Tezos tokens are, in reality, securities which are subject to U.S. securities laws. They further assert that the defendants failed to file a registration statement with the Securities and Exchange Commission ("SEC") prior to selling the Tezos tokens. Accordingly, the plaintiffs claim that the ICO was an illegal sale of unregistered securities and that they are entitled to rescission of their purchases. This case is still in its infancy, but it is the first major class action involving a Blockchain cryptocurrency. The case may set precedent on whether and how cryptocurrencies are regulated by U.S. securities laws. We will therefore continue to monitor the progress of this case.

The SEC has also recently increased its attention on Blockchain cryptocurrencies. For example, on December 1, 2017, the SEC's new cyber unit sued PlexCorps and its founders for alleged sales of unregistered securities through an ICO of "PlexCoin Tokens." *See SEC v. PlexCorps, et al.*, No. CV 17-7007 (E.D.N.Y.). According to the SEC, PlexCorps and its founders made fraudulent misrepresentations in connection with the ICO, conducted the ICO without filing a registration statement, and have misappropriated funds raised through the ICO. The SEC is seeking permanent injunctions, a release of all funds collected so far, as well as interest and penalties.

The SEC also recently announced a consent agreement with Munchee, Inc. regarding the alleged sale of unregistered securities in the form of "MUN" tokens. *See In re Munchee Inc.*, Admin Proceeding No. 3-18304. Unlike Tezos and PlexCoin, Munchee was not formed primarily to create a cryptocurrency. Instead, Munchee maintained an iPhone application for restaurant reviews. It launched the sale of MUN tokens as a way to raise revenue and improve its application. Before the sale of the tokens was complete, however, the SEC intervened. Munchee and the SEC reached an agreement under which Munchee was required to refund the proceeds raised from the sale of MUN tokens.

The Tezos, PlexCorps, and Munchee cases show that, thus far, the bulk of litigation related to Blockchain has been in the securities arena. But as Blockchain technology improves and becomes more commonplace, we can expect to see an increase in the volume and variety of Blockchain-related litigation.

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