ANDERSON KILL
ATTORNEYS AND COUNSELORS AT LAW

Raytheon

CLWG Working Group

Location: Tewksbury, MA
Date: March 20, 2018
Time: 8:15am - 9:00 am

Blockchain Technology and Risk: When Good Ledgers Go Bad

SPEAKER:

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Stephen D. Palley is a partner in the Washington D.C. office of Anderson Kill. He is a member of the firm's insurance recovery, construction and cyber insurance recovery group. He also co-chairs the firm's Blockchain and Virtual Currencies practice group.

In 20 years of litigation experience, Mr. Palley has handled a wide range of commercial disputes in state and federal courts across the United States. Mr. Palley is a fellow of both the American College of Coverage and Extra Contractual Counsel and the Construction Lawyers Society of America, and has also been recognized as Washington, D.C. "Super Lawyer" in Construction Litigation. A frequent and sought after speaker and writer on technology and construction insurance-related topics, Mr. Palley is regularly quoted by national news outlets on blockchain and virtual currency issues and has appeared on Bloomberg Television's "What Did You Miss?" He is the lead editor and contributing author of "Construction Insurance" and contributing author to Fundamentals of Construction Law, treatises published by the ABA Forum on the Construction Industry.

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Daniel J. Healy is a partner in Anderson Kill's Washington, D.C. office. After starting his career with Anderson Kill, he spent over five years serving as a Trial Attorney with the U.S. Department of Justice, Tax Division. He served as lead trial counsel in cases involving tax shelters, fraud and substantive tax disputes. He regularly appeared in federal and state courts across the country. While doing so, received numerous Outstanding Attorney awards and served as the E-Discovery Coordinator for the Tax Division.

Mr. Healy represents policyholders seeking insurance coverage, is Deputy Co-Chair of the Cyber Insurance Recovery Practice Group and is a member of the firm's Regulated Products Group. He has experience obtaining coverage relating to D&O liabilities, business interruption, environmental liabilities, health benefits, property damage, asbestos products, and intellectual property disputes. He was selected for inclusion in the Best Lawyers in America in the category insurance litigation.

Disclaimer

The views expressed by the participants in this program are not those of the participants' employers, their clients, or any other organization. The opinions expressed do not constitute legal advice, or risk management advice. The views discussed are for educational purposes only, and provided only for use during this session.

Introduction

Ecclesiastes 1:9

Thomas v. Mayville Gas Co. 108 Ky. 224 (1900)

- Street car company operated electric car line.
- Mayville Gas supplied street car co with electricity.
- Wire broke loose, wasn't insulated, killed child.
- Verdict to plaintiff as to street car co. Mayville Gas gets a defense verdict. Appeal follows.
- Street car co owned the wires; gas co supplied the electricity for a fee.
- "Did the fact that the gas company supplied the harmless wires with the force that converted them into a death-dealing agency make it responsible for the injury which resulted in the death of the intestate? The exact question submitted has not, so far as we are aware, been answered by any court of last resort."

The Basics

BASIC VOCABULARY

- Blockchain
- Bitcoin
- Ethereum
- “Altcoin”
- Distributed ledger
- Consensus
- Cryptocurrency
- Token Sales (ICOs)
- “Smart contracts”

BITCOIN

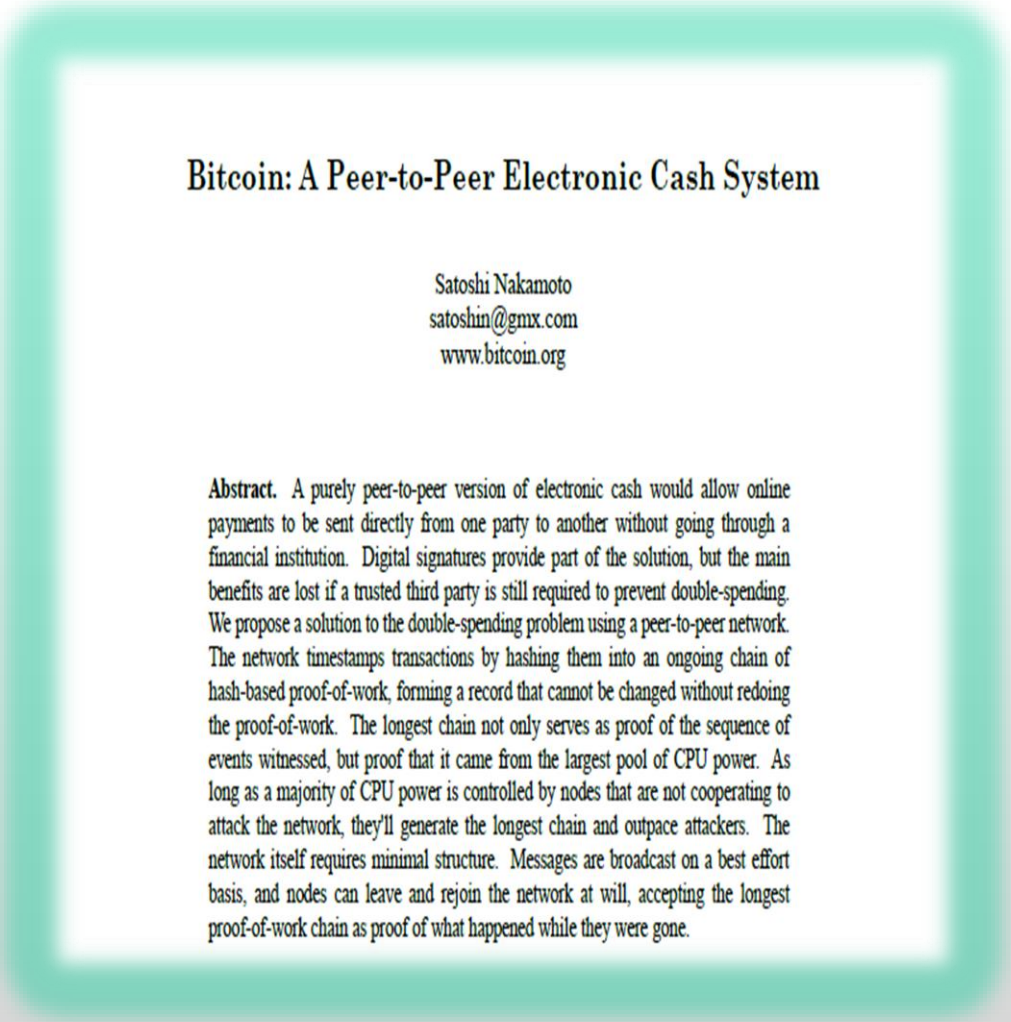
Blockchain based digital cash

From 2009 has grown in value to nearly $7,000 per BTC (as of 11/2/07)

Can be exchanged using private wallets

Significant volume through centralized exchanges (which allow buy/sell in fiat currency)

- e.g., Coinbase, Gemini in the U.S.
- Full AML/KYC
- Can buy/sell using cash from U.S. bank accounts



Bitcoin: A Peer-to-Peer Electronic Cash System

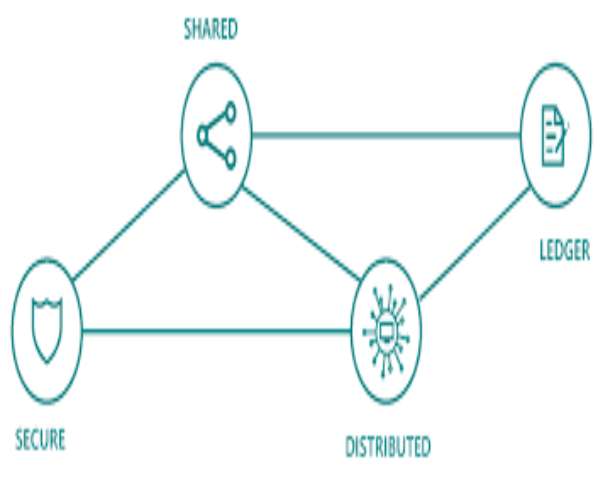
Satoshi Nakamoto
satoshin@gmx.com
www.bitcoin.org

Abstract. A purely peer-to-peer version of electronic cash would allow online payments to be sent directly from one party to another without going through a financial institution. Digital signatures provide part of the solution, but the main benefits are lost if a trusted third party is still required to prevent double-spending. We propose a solution to the double-spending problem using a peer-to-peer network. The network timestamps transactions by hashing them into an ongoing chain of hash-based proof-of-work, forming a record that cannot be changed without redoing the proof-of-work. The longest chain not only serves as proof of the sequence of events witnessed, but proof that it came from the largest pool of CPU power. As long as a majority of CPU power is controlled by nodes that are not cooperating to attack the network, they'll generate the longest chain and outpace attackers. The network itself requires minimal structure. Messages are broadcast on a best effort basis, and nodes can leave and rejoin the network at will, accepting the longest proof-of-work chain as proof of what happened while they were gone.

BLOCKCHAIN CHARACTERISTICS

Distributed

- Nodes vs. client-server
- No central point of failure
- The same ledger is everywhere



Decentralized

- “Peer-to-peer”
- Transactions don’t require an intermediary

BLOCKCHAIN CHARACTERISTICS (CONT'D)

Tamper-resistant/proof ("immutable")

- Cryptographically secured
- No super-user/root
- Once block added it can't be removed without detection
  - Unless the chain is "forked"
- Private vs. Public

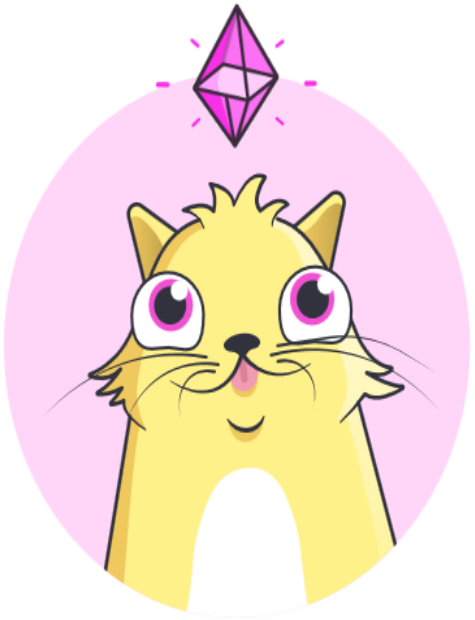
PRIVATE BLOCKCHAINS

Hyperledger (Linux Foundation)

Corda (R3)

Use Cases

IMMUTABLE CATS …



What is CryptoKitties?

CryptoKitties is a game centered around breedable, collectible, and oh-so-adorable creatures we call CryptoKitties! Each cat is one-of-a-kind and 100% owned by you; it cannot be replicated, taken away, or destroyed.

… OR DECENTRALIZED INSURANCE?

2 Why is insurance a candidate for decentralization?

The multi-trillion dollar insurance industry is dominated by huge corporations, weighed down by heavy regulation and plagued by misalignments of company and consumer incentives. The insurance world has devolved into an inefficient, expensive and ultimately frustrating industry. When customers most need help, they can end up fighting in vain for reimbursement from companies whose profits too often depend on avoiding paying out.

Etherisc is building a platform for decentralized insurance applications. With visionaries like you, we can create a platform full of opportunities across the industry's value chain. Corporates, large and small, not-for-profit groups and insurtech startups can all come together to provide better products and services. We aim to use blockchain technology to help make the purchase and sale of insurance more efficient, enable lower operational costs, provide greater transparency into the industry and democratize access to reinsurance.

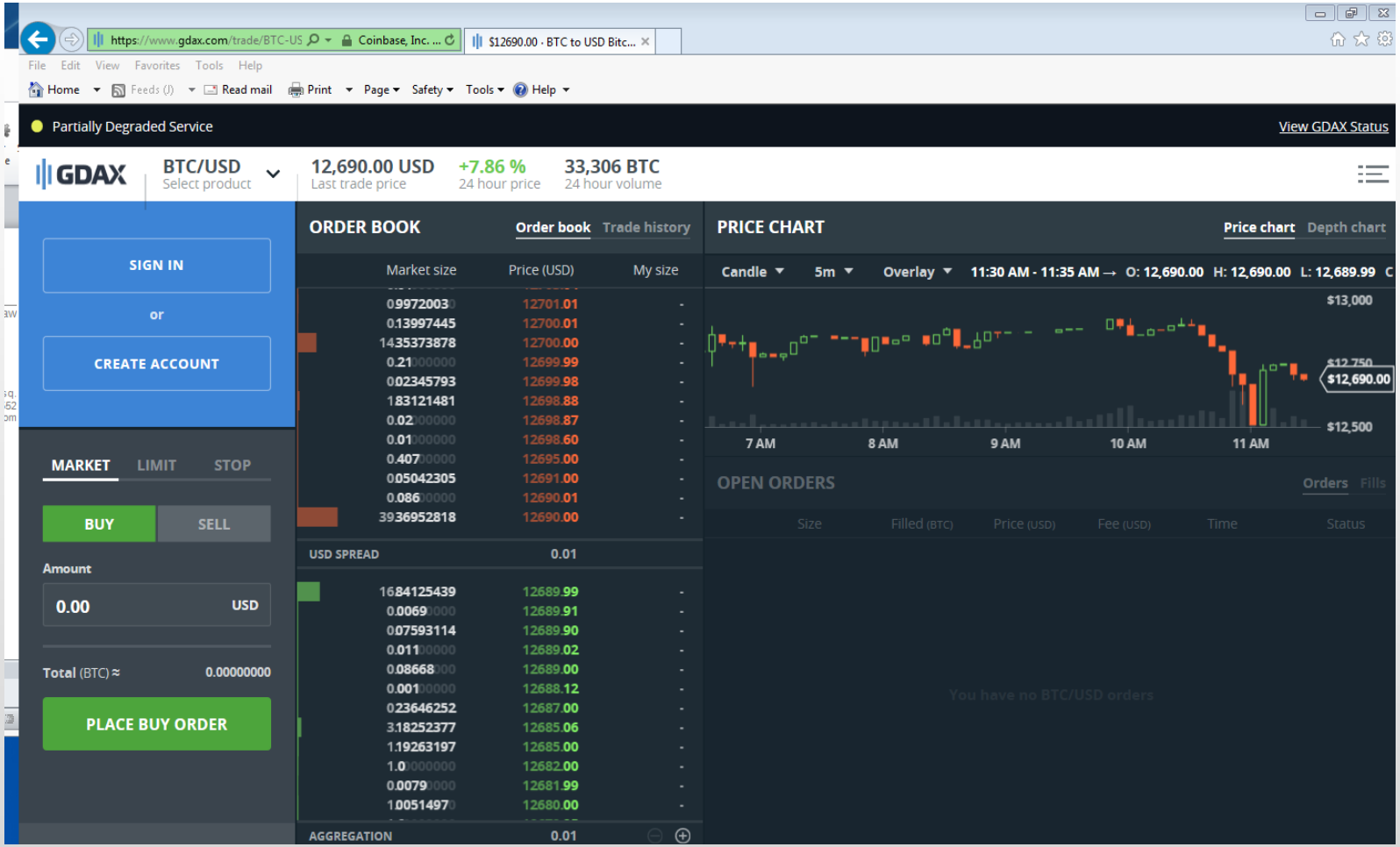
Blockchain can provide the means to disintermediate the market with a peer-to-peer risk platform that helps insurance return to its roots as society's safety net. We even envisage new groups building their own bespoke insurance risk pools and services on the platform. And Etherisc will be a fully-compliant, fully licensed insurance platform for the emerging blockchain economy.

In short, Etherisc can deliver the insurance industry the modernization customers are crying out for.

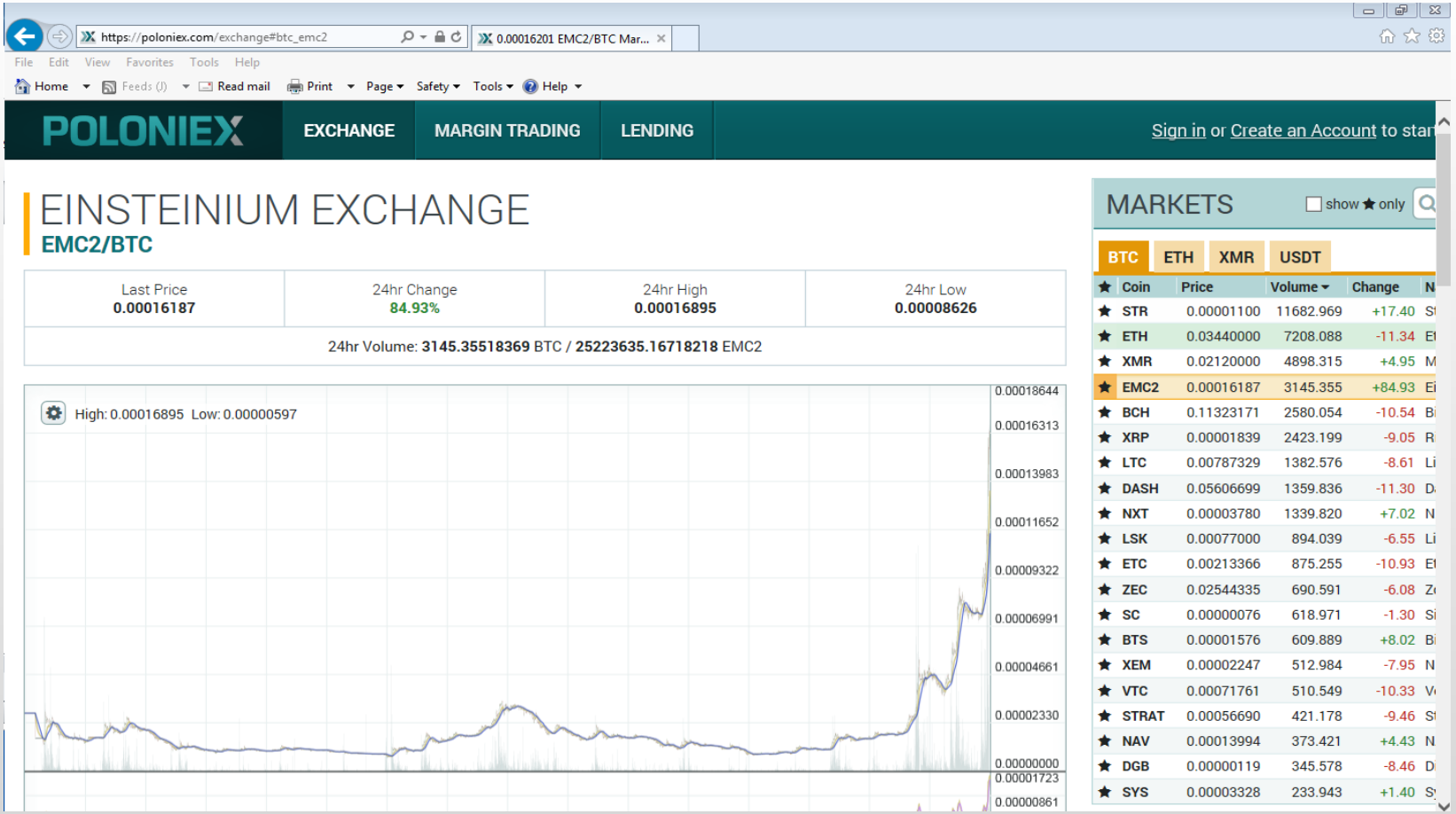
We have assembled an award-winning team of experts, experienced in delivering innovative products. We have already demonstrated the use-case for decentralized insurance applications with a successful flight-delay DApp that debuted at one of blockchain's biggest international conferences. This was the first insurance product live on a public blockchain. With your support, we can now build out our open-access platform and help make one of the globe's biggest industries finally work the way it should – for everyone, everywhere.

https://etherisc.com/#downloads

… OR THE NEW GOLD?



… OR A DEN OF THIEVES?



SUPPLY CHAIN USES

- Tracking global shipments
- Meat sourcing and tracking
- Temperature tracking
  - Pharmaceuticals and Medical
- Reducing fraud in trucking
- Smart contracting to normalize terms

“Crypto Law”

WHAT IS "CRYPTOCURRENCY"? WHY DOES IT MATTER?

- Why does it matter?
  - What it is determines the laws that apply.
  - Is it software? Electronic data? Money? A tangible thing? An intangible thing?
  - Where is crypto-currency located for purposes of determining where a loss has taken place?

WHAT IS "CRYPTO-CURRENCY"? WHY DOES IT MATTER? (CONT'D)

- It depends! Choice of law is complicated with distributed systems
- Is it a software "token", an API key, a license agreement?
- Is it the equivalent of ledger entry?
- A commodity, according to the CFTC. "Virtual currencies can be regulated by CFTC as a commodity. Virtual currencies are 'goods' exchanged in a market for a uniform quality and value." *CFTC v. Patrick K. McDonnell*, 2018 U.S. Dist. LEXIS 36854 (E.D. NY, March 6, 2018); (*See, also*., *In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (9/17/2015) ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.") (citing 7 U.S.C. § 1a(9)).

Federal and State Level

Tax (IRS)

- March 25, 2014, "This notice describes how existing general tax principles apply to transactions using virtual currency." (Notice 2014-21, available at https://www.irs.gov/pub/irs-drop/n-14-21.pdf)
- "In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability."

Commodity (CFTC)

- Since 2015 , treats bitcoin and other virtual currencies as "commodities" for enforcement purposes, providing jurisdiction under the Commodities Exchange Act,

Securities (SEC)

- SEC v. Shavers, (EDTX 8/6/13): "Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money"
- July 25, 2017, the SEC issues the DAO Report (Howey Test – investment of money in a common enterprise with the expectations of profits solely from the efforts of others. money transmission.
- Significant state level securities enforcement in Texas, South Carolina, New Jersey.

Consumer Protection (FTC)

- Enforcement actions in consumer fraud context against companies promoting questionable crypto-currency ventures.

State Law in all states other than Montana and South Carolina

18 U.S.C. § 1960 ("Bank Secrecy Act")

1960 provides, in pertinent part:

- Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business, shall be fined in accordance with this title or imprisoned not more than 5 years, or both.
  - (A) As used in this section— (1) the term "unlicensed money transmitting business" means a money transmitting business which affects interstate or foreign commerce in any manner or degree and— (A) is operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law, whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable;
  - (B) fails to comply with the money transmitting business registration requirements under section 5330 of title 31, United States Code, or regulations prescribed under such section; or
  - (C) otherwise involves the transportation or transmission of funds that are known to the defendant to have been derived from a criminal offense or are intended to be used to promote or support unlawful activity;
- Proof of intent **not** required

FINCEN GUIDANCE RE ICOS

"Generally, a developer that sells convertible virtual currency, including in the form of ICO coins or tokens, in exchange for another type of value that substitutes for currency is a money transmitter and must comply with AML/CFT requirements that apply to this type of [money services business]. An exchange that sells ICO coins or tokens, or exchanges them for other virtual currency, fiat currency, or other value that substitutes for currency, would typically also be a money transmitter."

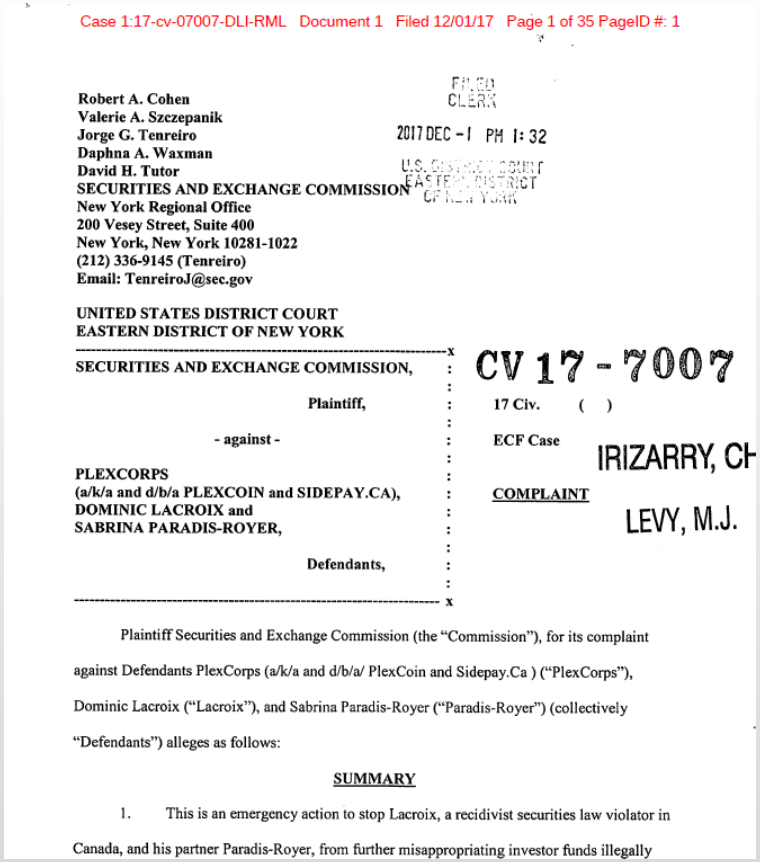
FinCen letter to Senator Wyden, dated Feb. 13, 2018

CRYPTOCURRENCY LITIGATION

Tezos Class Actions

- Tezos = a new blockchain
- US based founders raise capital through Swiss Foundation that they create
- They call the payments “contributions”
- Foundation is independent!
- Approx. $1 Billion in crypto-currency & fiat controlled by foundation
- Founders got into fight with board of foundation they created (since resolved)
- Founders sued in 6 class actions for securities fraud b/c no tokens issued

SEC ENFORCEMENT ACTIONS



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U.S. DISTRICT COURT
EASTERN DISTRICT
OF NEW YORK

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UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

- against -

PLEXCORPS
(a/k/a and d/b/a PLEXCOIN and SIDEPAY.CA),
DOMINIC LACROIX and
SABRINA PARADIS-ROYER,

Defendants,

CV 17 - 7007

17 Civ. ( )

ECF Case

IRIZARRY, CH

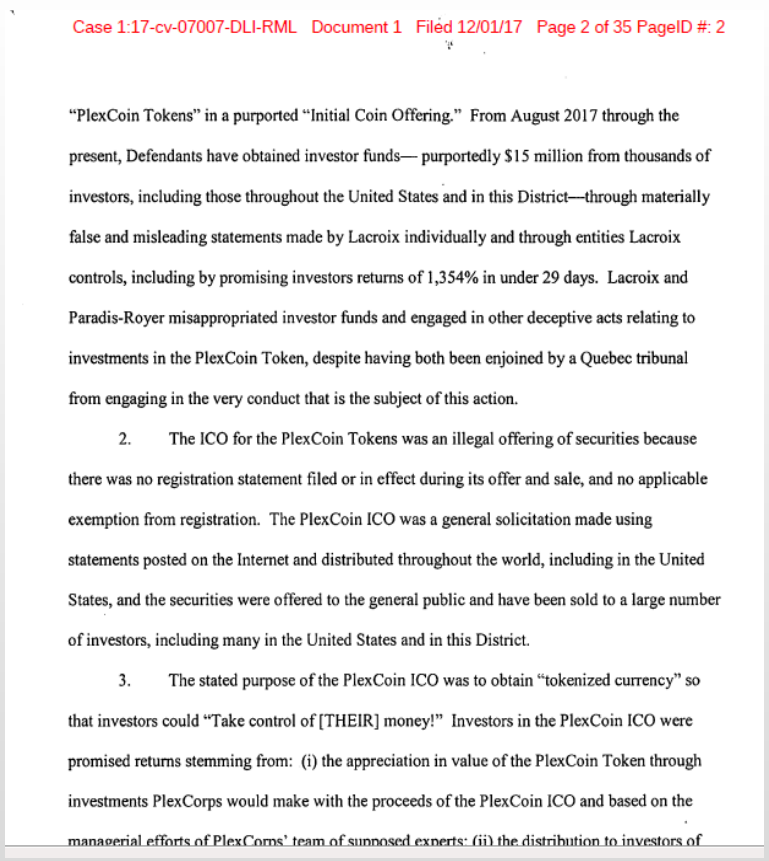
COMPLAINT

LEVY, M.J.

Plaintiff Securities and Exchange Commission (the "Commission"), for its complaint against Defendants PlexCorps (a/k/a and d/b/a/ PlexCoin and Sidepay.Ca) ("PlexCorps"), Dominic Lacroix ("Lacroix"), and Sabrina Paradis-Royer ("Paradis-Royer") (collectively "Defendants") alleges as follows:

SUMMARY

1. This is an emergency action to stop Lacroix, a recidivist securities law violator in Canada, and his partner Paradis-Royer, from further misappropriating investor funds illegally



Case 1:17-cv-07007-DLI-RML Document 1 Filed 12/01/17 Page 2 of 35 PageID #: 2

"PlexCoin Tokens" in a purported "Initial Coin Offering." From August 2017 through the present, Defendants have obtained investor funds— purportedly $15 million from thousands of investors, including those throughout the United States and in this District—through materially false and misleading statements made by Lacroix individually and through entities Lacroix controls, including by promising investors returns of 1,354% in under 29 days. Lacroix and Paradis-Royer misappropriated investor funds and engaged in other deceptive acts relating to investments in the PlexCoin Token, despite having both been enjoined by a Quebec tribunal from engaging in the very conduct that is the subject of this action.

2. The ICO for the PlexCoin Tokens was an illegal offering of securities because there was no registration statement filed or in effect during its offer and sale, and no applicable exemption from registration. The PlexCoin ICO was a general solicitation made using statements posted on the Internet and distributed throughout the world, including in the United States, and the securities were offered to the general public and have been sold to a large number of investors, including many in the United States and in this District.

3. The stated purpose of the PlexCoin ICO was to obtain "tokenized currency" so that investors could "Take control of [THEIR] money!" Investors in the PlexCoin ICO were promised returns stemming from: (i) the appreciation in value of the PlexCoin Token through investments PlexCorps would make with the proceeds of the PlexCoin ICO and based on the managerial efforts of PlexCorps' team of supposed experts; (ii) the distribution to investors of

IRS ENFORCEMENT

Potentially Taxable Transactions

- Sales or exchanges of cryptocurrency for government-backed currency
  - Another virtual currency?
  - Tax Cuts and Jobs Act in December of 2017
- Token sales, such as in an ICO
- Expenditures, such as to purchase goods or services

Potentially Taxable Transactions

- Payment, e.g., mined or received during a hard fork
- Compensation, such as when paid for services
- Donations

FMV

- IRS Guidance Publication 561
- Determined as of the date of donation
  - Closing price?
  - Exchange?
- Private vs. Public coins or tokens

New Risks/Novel Issues

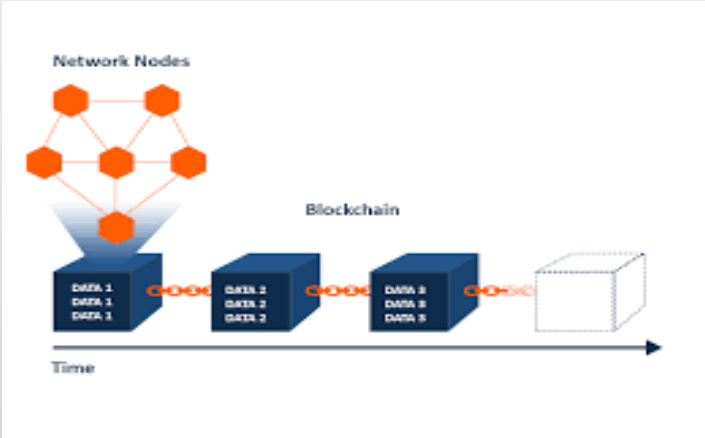
NEW RISKS?

- Forks (Ethereum/Ethereum Classic)
- Frozen wallets (Parity)
- Automated distributed governance (The DAO)
- There's no help desk

LEGAL STATUS OF NODES/VALIDATORS?

What is a collection of nodes exactly?

- A general partnership?
- An unincorporated association?
- Subject to implied governance rules of … which jurisdiction?



But it's different this time

Distributed records

Append only ("immutable(ish))

"Consensus"

Private keys

Distributed Presence = Distributed Jurisdiction

Jurisdiction

- Subject matter jurisdiction
- Personal jurisdiction
  - *In personam*
  - *In rem*

Venue

Forum non convenience

New Tech/Same Old Law

CFTC v. Patrick K. McDonnell, 2018 U.S. Dist. LEXIS 36854

- CFTC sued the defendants, alleging that they "operated a deceptive and fraudulent virtual currency scheme" and "simply misappropriated customer funds." CFTC sought a preliminary injunction, damages and restitution.
- The Court began its opinion by describing the two questions presented as follows: "(1) whether virtual currency may be regulated by the CFTC as a commodity; and (2) whether the amendments to the CEA under the Dodd-Frank Act permit the CFTC to exercise its jurisdiction over fraud that does not directly involve the sale of futures or derivative contracts."
- It answered both questions "yes" and granted the request for injunctive relief.

New Tech/Same Old Law

***FTC v. Patrick K. McDonnell*, 2018 U.S. Dist. LEXIS 36854**

- While CFTC jurisdiction is typically applied to futures contracts, the Court also noted that "The CFTC has recently expanded its enforcement to fraud related to spot markets underlying the (already regulated) derivative markets." (Id. at * 28) (citing cases).
- "Where a futures market exists for a good, service, right, or interest, it may be regulated by CFTC, as a commodity, without regard to whether the dispute involves futures contracts." (Id. at * 30).
- Other federal agencies could have jurisdiction over the virtual currencies – this in and of itself is not a limitation on CFTC's authority. Thus, injunction entered and fairly onerous order entered.

New Tech/Same Old Law

Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996)

- Trademark infringement and unfair competition case
- Defendant moved to dismiss for lack of personal jurisdiction
- Does court have pj? Two part test: (1) long arm statute, (2) is exercise of pj consistent with due process
- Defendant had an "internet site on the World Wide Web"

New Tech/Same Old Law

Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996)

- "The server for the website is presumably in Berkeley, California. The website is at present continually accessible to every internet-connected computer in Missouri and the world. CyberGold's website can be accessed at "www.cybergold.com" by any internet user."
- Court says 20-30 mm internet users: "The "internet" is essentially a term that describes the interconnection of all of these computers to each other. It is also referred to as "the information superhighway."
- At least 12,000 in Missouri have access. Evidence showed 311 times accessed.
- Plaintiff argued that the website "acts as a state-wide advertisement for CyberGold's forthcoming internet service.""

New Tech/Same Old Law

Maritz, Inc. v. Cybergold, Inc., 947 F. Supp. 1328 (E.D. Mo. 1996)

- "CyberGold's posting of information about its new, up-coming service through a website seeks to develop a mailing list of internet users, as such users are essential to the success of its service. Clearly, CyberGold has obtained the website for the purpose of, and in anticipation that, internet users, searching the internet for websites, will access CyberGold's website and eventually sign up on CyberGold's mailing list. Although CyberGold characterizes its activity as merely maintaining a "passive website," its intent is to reach all internet users, regardless of geographic location. Defendant's characterization of its activity as passive is not completely accurate. By analogy, if a Missouri resident would mail a letter to CyberGold in California requesting information from CyberGold regarding its service, CyberGold would have the option as to whether to mail information to the Missouri resident and would have to take some active measures to respond to the mail. With CyberGold's website, CyberGold automatically and indiscriminately responds to each and every internet user who accesses its website. Through its website, CyberGold has consciously decided to transmit advertising information to all internet users, knowing that such information will be transmitted globally. Thus, CyberGold's contacts are of such a quality and nature, albeit a very new quality and nature for personal jurisdiction jurisprudence, that they favor the exercise of personal jurisdiction over defendant."

Risk Management 101

INSURANCE COVERAGE FOR CRYPTO LOSSES

- D & O
- E & O
- Crime/Fraud policies?
- CGL, Property
- Cyber
- Manuscripted crypto policies?
  - Cf. Bitfinex

Wallets & Keys

Key management

Private wallet

INDEMNITY AGREEMENTS

- Who else is involved in the decentralized information
  - Where is the information you are concerned about?
- Standard Terms in a New Light
  - Contractual liability exclusions
  - Limitations of liability
  - Additional insured provisions
  - Contractual liability exclusions
  - "Other insurance" or "primary, non-contributory"

RISK MANAGEMENT/INSURANCE QUESTIONS FOR NEW BLOCKCHAIN VENTURES

- Where is data located?
- Can system be switched off?
- What policies (if any) cover risks associated with the system?
- Who owns it?
- If your blockchain uses a token, are you now a money servicing business under the Bank Secrecy Act?

Managing Distributed Presence

Forum selection clauses

Arbitration waivers

Geo-fencing

- By contract (customer affirmation)
- With tech (e.g., geo-IP blocking)

CONCLUSION

Traditional risk management concepts need to evolve and that will not happen until someone gets badly burned.

QUESTIONS

THANK YOU.

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ADDENDUM ON INSURANCE

D&O AND E&O

- What is a “Claim”?
  - Director or Officer: “A written demand for monetary damages or nonmonetary relief.”
  - Private company: “A written demand for monetary, nonmonetary or injunctive relief.”
  - Public company: securities law violations and derivative suits
  - Regulatory investigations

D&O AND E&O (CONT'D)

- What is a "Wrongful Act"?
  - D&O: "Any error, misstatement, misleading statement, act, omission, neglect, or breach of duty…by an Insured Person or an Organization in his or her Insured Capacity"
  - E&O: "Any actual or alleged negligent act, negligent error or negligent omission committed by the Insured solely in the performance of or failure to perform professional services for others in the Insured's Profession . . ."

D&O AND E&O (CONT'D)

- Potential Limits to Coverage
  - Who is an "Insured"?
  - Exclusions (electronic data/cyber loss)

ALL RISK POLICIES

- Care, custody and control … ownership
- Tangible vs. intangible
- Exclusions for computers and data
- Sublimits

NMA 2914

This Policy does not insure loss, damage, destruction, distortion, erasure, corruption or alteration of ELECTRONIC DATA from any cause whatsoever (including but not limited to COMPUTER VIRUS) or loss of use, reduction in functionality, cost, expense of whatsoever nature resulting therefrom, regardless of any other cause or event.

CGL POLICIES

- Define the liability
- Property damage (to what?)
- PIA Coverage
- Suit
- Exclusions for computer-related issues

CL 380

1.1 Subject only to Clause 1.2 below, in no case shall this insurance cover loss, damage, liability or expense directly caused by or contributed to by or arising from the use or operation, as a means for inflicting harm, of any computer, computer system, computer software programme, malicious code, computer virus or process or any electronic system.

1.2 Where this Clause is endorsed on policies covering risks of war, civil war, revolution, rebellion, insurrection, or civil strife arising therefrom, or any hostile act by or against a belligerent power, or terrorism or any person acting from a political motive, Clause 1.1. Shall not operate to exclude losses (which would otherwise be covered) arising from the use of any computer, computer system computer software programme, or any electronic system in the launch and/o guidance system and/or firing mechanism of any weapon or missile.

FIB/FIDELITY BOND

Financial Institution Bond

- Standard Insuring Agreements.
  - Fidelity, On Premises, In Transit, Securities, Counterfeit Currency.
- Some Available Endorsements for Electronic Loss.
  - Computer Systems Fraud Insuring Agreement.
  - Telefax Transfer Fraud Insuring Agreement.
  - Voice Initiated Transfer Fraud.
  - Hacker and Virus Malicious Destruction.
- Definitions – Money, Property
  - "racketeering acts" exclusion; requirement of "finally adjudicated"

CYBER

- 1st and 3rd party coverage
- Specific coverages
- Network and data as property
- Exclusions for cloud and third parties
- Applications