How Arbitration May Need To Adapt To Blockchain Disputes

By **Peter Kamminga** (January 9, 2023, 8:21 PM GMT)

Blockchain, cryptocurrency, non-fungible tokens and smart contracts can't seem to escape the headlines. As the fallout from the recent FTX Trading Ltd. bankruptcy ensnares individuals and organizations, it is unclear how this will all play out.

With the rise and fall of these new tools, enveloped in complex technology and terminology, comes a steady flow of disputes — from U.S. Securities and Exchange Commission enforcement litigation to class actions to the matters resulting from the Celsius Network LLC, Voyager Digital Holdings and FTX bankruptcies.

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Parties are seeking cryptocurrency recovery after fraud or theft, as well as filing claims unrelated to fraud against crypto platforms or exchanges, or bringing other blockchain-related matters. While most of these matters end up in litigation, some defendants have recently argued that certain matters, such as those resulting from hackers stealing crypto, are in fact contractual disputes that belong in arbitration.

As this tidal wave of legal disputes is upon us and parties are determining how to argue and resolve these matters, a few questions emerge: What makes these disputes new and different? What circumstances make them unique and challenging? What should arbitrators consider in order to successfully navigate the novel landscape?

What's new and what's not?

Despite the novel nature of these disputes, there is some familiar ground. Even with the complex underlying tech, the legal questions raised in these cases are often not new, and the answers are not always technical in nature. The investor claims, shareholder disputes, IP violations related to NFTs, disruption of supply of services, fraud claims, misrepresentation matters and bankruptcy proceedings that arise usually follow existing applications of law.

But in several cases, previously answered questions require new answers. Crypto, NFTs and smart contracts present unique circumstances and issues, sometimes requiring a novel application of existing laws or regulations. Ordinary matters, such as identifying and suing defendants on the blockchain or obtaining judgments, spawn multiple challenges and confront practitioners with unanswered legal questions.

In disputes relating to entitlement to tokens, control over project wallets and misrepresentation claims

in the context of crypto funds, there is ambiguity. Agencies and industry participants still <u>grapple</u> with the status of NFTs and crypto coins, or digital tokens. Are they securities not unlike stocks and bonds, or ordinary assets with their own intrinsic value?

Not only are the technologies and their applications new, but a combination of factors also put crypto, NFTs and smart contracts in the rare category of things that create unique and conflict-prone circumstances, as well as challenges resulting from them.

Rapidly Developing Technological and Business Environment

The adoption of new technologies involves a period of pioneering. It can create gold-rush type circumstances, with growth spurts, down cycles and new players constantly entering the market.

In addition to the steep learning curve that comes with familiarizing oneself with a new tech language and having to navigate the evolving business environment, the focus is on claiming a sizable market share and rapidly expanding one's footprint. Sometimes there is little time for careful reflection and the papering of transactions.

Add to that the danger posed by bad actors, outages and technical glitches, which can lead to problems with blockchain, smart contracts and the assets traded using them — cryptocurrency and NFTs.

Finally, typical to evolving fields, there is little regulation and there are few seasoned players. The stream of news coming from the FTX bankruptcy, for instance, <u>reveals</u> a lack of oversight and the type of checks and balances present in more established industries and institutions.

Size and Volatility of Market and Potential for Many Claimants

The current dynamic of the market creates a breeding ground for disputes. The scale of the market — in terms of users and amounts traded — and its volatility are unique. This is illustrated by crypto and NFTs suddenly creating a multitrillion-dollar market and their steep fall in terms of financial value and deal volume. Due to this market's size, the decline is affecting many professional and individual investors.

FTX is one example. As the smoke begins to clear following its collapse, the extent of the financial fallout is slowly being revealed, and the scale and impact may rival the <u>Lehman Brothers</u> bankruptcy.

The quickly changing values of companies and currencies are also unprecedented. These market fluctuations make it challenging to value companies and establish and quantify loss. As a result, traditional approaches to valuation are reshaped to meet the automation and transaction speed native to this technology.

Decentralized, Cross-Border Character and Anonymity of Transactions

Other aspects of the technology raise unique legal challenges. Traditional legal questions that are easily answered in an offline, non-blockchain world become challenging. Where is an entity based? Where are its assets? Who is the counterparty?

Determinations are much harder to make when the flow of funds is not dependent on central banks, assets are not located in a certain jurisdiction and transactions can be anonymous. With a few keystrokes, money can be transferred to the other side of the world, leaving attorneys and neutrals

scratching their heads over questions of ownership.

These conditions raise questions regarding the jurisdiction of courts and lead to discussions of, for instance, whether the so-called minimum contact test is met.[1]

If a party wishes to contest certain activity on the blockchain, such as making a claim of patent infringement, there is frequently no obvious party to sue. The ability to use anonymous accounts makes it tricky to identify parties to transactions made on the blockchain.

Evolving Regulatory Landscape

The regulatory landscape is currently in flux. In this new and still largely unregulated field, various federal agencies and state actors are determining their jurisdiction and figuring out their approaches. In the meantime, there are applicable rules, but it is uncertain how they are currently interpreted by courts and arbitrators.

Internationally, the different stances that countries take on crypto and blockchain and the use of smart contracts creates a patchwork of rules. Some see growth opportunities and do not want to hinder the crypto rush, while countries such as Algeria and China currently prohibit cryptocurrency trading, and others fall somewhere between these extremes.

In this varied landscape, it's tough to determine if rules have been broken, potentially leading to challenges with enforcement of awards related to crypto-assets. The regulatory choices made in the coming months, both in the U.S. and internationally, will help determine the outcomes of cases.

What does this mean for the arbitration of these disputes?

Arbitration is a preferred forum for international matters and seems on the surface to be a good fit for these disputes given the borderless nature of blockchain technology. Yet it will need to take this new and unique landscape into account to remain a relevant dispute resolution mechanism.

While there is discussion about how arbitration stacks up against litigation, it is still attractive.[2]

It allows for the selection of an expert arbitrator with relevant technical expertise in settings where such familiarity can hold considerable sway. It offers the benefit of keeping the dispute out of the media, and given the international nature of crypto, NFT and smart contract transactions, it can provide jurisdictional certainty and enforceability.

All this seems to make it a good match, as customers frequently engage in transactions across multiple borders and jurisdictions, suppliers and investors may be headquartered or branched overseas, and the prospect of litigation in foreign courts may be unappealing.

Therefore, many contract models stipulate arbitration as the dispute resolution method for disputes between investors and platforms, issuers and investors, trading platforms and other participants. It has been used in breach of contract, misrepresentation and claims for losses resulting from technical issues at trading platforms.

For instance, some token listing agreements are issued by exchanges that designate arbitration as the means of dispute resolution. It can also be built into initial coin offerings and agreements between

platforms and users. Claims by investors against crypto exchange <u>Binance</u> went to arbitration,[3] and parties involved in crypto investments, related loans and loans used to purchase NFTs may use arbitration agreements.

Even so, in order to be and remain an effective forum, arbitration may need to adapt to fit the reality of the novel landscape. New resolution techniques may be necessary in international arbitration.

How may arbitrators need to adapt?

For arbitration to adapt to blockchain disputes, there is certainly a need for speed. The velocity of blockchain transactions may inspire parties to opt for a faster and more flexible process for resolving disputes.

Special or modified rules may also be necessary. By their nature, crypto, NFT and smart contract cases may demand a more streamlined process and set of allowances than traditional arbitration.

As the business landscape is volatile, plaintiffs may be motivated to embrace efficient, expeditious processes. Parties may seek the ability to craft customized, abbreviated and accelerated procedures. Rules[4] may also have to reflect the fact that smart contracts are likely to be written in code and provide that the code will govern the interpretation of the smart contract.

Some familiarity with the nature of the blockchain may also be beneficial to arbitrators. A working knowledge or certain level of comfort with the technology, its concepts and language may figure significantly in the legal cases related to crypto, NFTs, smart contracts and other blockchain tech.

Arbitrators may be faced with situations where parties do not disclose their identities to each other. A tribunal may be empowered to operate, modify, sign or cancel any digital asset relevant to a dispute, and may have to determine governing law on on-chain activities. On the other hand, arbitrators may not need to be tech experts; tribunals, like courts, can always fill in any knowledge gaps by appointing crypto specialists.

There is possible competition to arbitration from on-chain artificial intelligence resolution. Some new developments provide for resolving disputes on-chain using blockchain technology.[5]

Some observers anticipate that the elimination of direct human involvement in smart contracts — executing without human involvement — and the transparency of blockchain will absolve smart contracts from contractual disputes altogether. Examples are platforms like Aragon and Kleros. They rely on game theory and financially rewarding jurists.

The tool may even directly modify the blockchain, enabling automatic transfers of assets and amending of the relevant coding, all without needing to engage with the offline world. It remains unclear whether the awards resulting from these processes would meet the requirements of an award under the New York Convention. Questions also remain in situations where an offline intervention is needed after all.

Finally, there is the question whether bilateral treaties may be used to protect crypto investments in situations where a state seeks to ban certain crypto-assets. Investment treaties often have a broad definition of what a protected investment is, and one could contend that cryptocurrencies, NFTs and other digital assets fall within the applicable definition, making them candidates for investor-state arbitration.

The circumstances of blockchain disputes are in some ways unprecedented, but as with any new development, we will eventually find our way. This applies to both parties arbitrating these matters and neutrals resolving them.

The landscape will evolve and shift. It will not look the same, even in a few months, as regulations get implemented, we learn more about these new technologies, and legal questions and solutions emerge.

As we cycle through their development, some technologies will become established while others will wither. Projecting and piecing together a legal landscape, along with the outcomes of rulings, will set our course. In adapting to this new reality, arbitration will likely play a major role in the years to come.

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[1] Minimum contact requirements for personal jurisdiction: https://constitution.congress.gov/browse/essay/amdt5-4-7-1-4/ALDE_00013035/.

[2] U.S. Supreme Court agrees to hear Coinbase arbitration dispute: https://www.reuters.com/legal/us-supreme-court-agrees-hear-coinbase-arbitration-dispute-2022-12-09/.

[3] The Impending Binance Arbitration: a Primer on the World of Cryptocurrencies, Derivatives Trading and Decentralised Finance on the Blockchain: http://arbitrationblog.kluwerarbitration.com/2021/10/13/the-impending-binance-arbitration-a-primer-on-the-world-of-cryptocurrencies-derivatives-trading-and-decentralised-finance-on-the-blockchain/.

[4] JAMS Smart Contract Clause and Rules (DRAFT): https://www.jamsadr.com/rules-smart-contracts.

[5] Bridging the Governance Gap: Dispute resolution for blockchain-based transactions: https://www3.weforum.org/docs/WEF_WP_Dispute_Resolution_for_Blockchain_2020.pdf