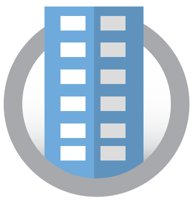
Blockchain's Awareness Problem—and How to Solve It

Corporate



It seems impossible not to hear about blockchain these days. Best known for its role as the technology behind cryptocurrencies, blockchain has many other potential uses, and its development is driving frenzied business activity worldwide. In fact, its explosive growth is expected to maintain its hockey-stick trajectory well into the future. Market research firm International Data Corp. expects global spending on blockchain to have reached $2.7 billion in 2019, an 80 percent leap from $1.5 billion in 2018. By 2023, spending should rocket to $15.9 billion, nearly a 1,000 percent gain from 2018, equating to a sizzling 60.2 percent five-year annualized growth rate.

Despite such popularity and commercial investment, many in-house counsel know little about blockchain and even less about how to deal with it from a legal perspective. Crowell & Moring partner Michelle Ann Gitlitz, who is global head of the firm's Blockchain and Digital Assets practice, has observed this firsthand and sees a pressing need to remediate the problem.

"There's often a disconnect between companies' efforts from a product development standpoint to harness blockchain and their in-house counsel's knowledge of the technology and how to address nuanced legal issues," she says. "It's especially glaring when companies are close to introducing a blockchain- or digital asset-based product or service and ask the general counsel for legal review and approval, yet the GC hasn't heard about it. GCs can't protect their companies from blockchain- and digital asset-related risks—let alone understand the technology and relevant laws—if their companies aren't keeping them in the loop."

A Quick Look at Blockchain

Blockchain is a type of ledger, or register, composed of digitally recorded and encrypted data stored in strung-together chunks (i.e., blocks). The blocks are distributed across a network of internet-connected devices that, when connected, form a chain. Because of how the technology works and its decentralized nature—no single party is responsible for a chain's maintenance or integrity—blockchain offers much greater privacy protection and security than traditional IT systems.

Blockchain's capabilities are such that it can significantly raise the bar for data management in multiple areas. These notably include documentation, speed, efficiency, productivity, auditability, compliance, process automation, standard setting, sharing, and authentication as well as privacy and security.

As S. Starling Marshall, a partner in Crowell & Moring's Tax and Litigation groups, explains, "The question not so long ago was, What is this stuff and what can we do with it? Now it's, This is going to disrupt our industry and ensure our future. How soon can we go to market?"

It's no wonder, then, that businesses across a wide range of industries are creating blockchain applications to help open up opportunities, improve execution, and disrupt the marketplace. These are among the industries most frequently cited for their adoption of blockchain:

Energy: To track production and for peer-to-peer energy trading.

Financial services: Think trading, payments, insurance, and transaction processing.

Health care: Management and privacy of medical records are the subjects of intense blockchain development programs.

Music: Blockchain can enhance the creation and digital distribution of music and address issues of copyright, piracy, and monetization.

> "GCs can't protect their companies from blockchain risks or understand the technology and relevant laws if the companies don't keep them in the loop." **Michelle Ann Gitlitz**

> “It’s easy to forget that there were no laws or regulations specific to the internet for at least five years after it became part of daily life.” **S. Starling Marshall**

Real estate: With its huge volume of paperwork, lack of transparency, potential for inaccurate recordkeeping, and need for clear ownership records, real estate is ripe for blockchain solutions.

Perhaps the most common application of blockchain among lawyers is the “smart contract,” which is a blockchain-based contract that automatically enforces itself when specific conditions are satisfied. The smart contract’s future is bright: According to Deloitte’s 2019 Global Blockchain Survey, nearly all of the 1,300-plus companies surveyed—95 percent—said that it was an important blockchain capability.

At the same time, however, more than one-third of respondents cited seven blockchain-related regulatory issues that were of great concern going forward: privacy, money transmission, know your customer/anti-money laundering, informational reporting, securities law, financial reporting, and tax.

In the Beginning, There Was No Law

The legal paradigm for blockchain is nascent and unformed. There are just a handful of federal or state laws on the books specifically directed at blockchain and its uses or consequences.

That will change as blockchain becomes more common and business practices evolve, says Marshall. “It’s easy to forget that there were no laws or regulations specific to the internet for at least five years after the internet became part of daily life for people and businesses,” she notes. “Lawmakers, regulators, and lawyers had to rely on telecom regulation for guidance at first. That’s where blockchain is now, but the law will catch up.”

Marshall adds that there are a handful of areas where blockchain issues can fall under existing laws governing the digital world. Data privacy, for example, is addressed by a number of regulations, such as the Health Information Portability and Accountability Act and the California Online Privacy Protection Act. Securities and commodities regulations partially cover oversight of digital assets, while the IRS has begun to address the taxation of these assets. And anti-money laundering and know-your-customer laws govern payments and banking transactions.

Activity among states is much greater than on the federal level thus far. States that have passed legislation to address the validity and admissibility of blockchain evidence include Arizona, Tennessee, Vermont, and, most important, Delaware. Several other states—California, Florida, Hawaii, Illinois, Maine, and North Dakota—have formed working groups to explore the use of blockchain by state agencies for recordkeeping purposes.

Fundamental Recommendations

Gitlitz and Marshall have three key recommendations for in-house counsel who need to get smart fast about blockchain and the law.

Communicate. Above all, lawyers should be aware of their companies’ involvement with blockchain at all times. “Start by asking what you do and don’t need to know about blockchain in your company. Then proactively communicate with your business partners to encourage them to keep you in the loop from the outset and include you in the conversations and decisions as they normally would about any business matter,” says Gitlitz.

Consult outside counsel. When blockchain is unfamiliar territory, reach out to lawyers who specialize in it and can provide education about both the technology and the legal considerations that surround it. They can help spot the risks and compliance issues that blockchain poses and offer insights into how other companies and industries are handling them.

Outside counsel can provide added value concerning an underappreciated blockchain reality: Regulators aren’t always as up to speed on the legal issues as might be expected. The education and regulatory experience outside counsel can impart can yield big dividends for in-house lawyers when dealing with regulators.

Ask the right questions. To identify the key legal challenges that blockchain may present, GCs and their staffs should ask and answer these essential questions:

- What are the enforcement risks of smart contracts?
- What are our obligations regarding data privacy and dissemination in the jurisdictions in which we do business?
- What are our blockchain or digital asset reporting obligations?
- What are our blockchain or digital asset regulatory obligations?
- What are the implications of blockchain concerning taxation? Trade? Product liability? Supply chains?

In these early days for blockchain law, says Gitlitz, there are—and will likely be for some time—more questions than answers. “But that’s OK,” she says. “Lawyers will continue to ask questions. It’s just that with blockchain and digital assets, there are fewer answers at the moment.”