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Blockchain Law

The British are coming — to the aid of crypto scam victims

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The English courts have been applauded for the "flexible approach" they generally have taken to enable victims of digital asset frauds and thefts to obtain effective relief.

Owners of digital assets too often have fallen victim to thefts and scams, and then are left struggling to find ways to recover what was taken from them. In recent months, the English courts have seen a flurry of rulings in such litigations, particularly when it comes to issuing injunctive relief, as injured plaintiffs explore various tactics for making themselves whole. These rulings are helping to write a playbook about which litigation approaches and tactics may be successful for such digital asset holders and which may not.

A Fiduciary Duty to Patch Code?

A ruling of the England and Wales Court of Appeal issued on February 3, 2023 addressed the question of "whether the developers who look after bitcoin may arguably owe fiduciary duties or duties in tort to an owner of that cryptocurrency." *Tulip Trading Ltd. v. van der Laan*, [2023] EWCA Civ 83 (Feb. 3, 2023). Reversing an earlier ruling of the High Court which had rejected any possibility of such a claim, the Court of Appeal held that the facts presented raised at least a triable issue whether those developers might owe fiduciary or tort duties to bitcoin owners.

The plaintiff bitcoin owner alleged that "the private keys" to its bitcoin were "lost in a hack, likely stolen," leaving plaintiff unable to access or transfer its bitcoin. Plaintiff alleged that the developer defendants control and run the relevant bitcoin networks, and "it would be a simple matter" for them to secure plaintiff's stolen bitcoins "by moving them to another address which [plaintiff] can control."

Plaintiff argued that "the role the developers have undertaken" in relation to the bitcoin and "the power this role gives them" requires that they "ow[e] fiduciary duties to the true owners of bitcoin cryptocurrency," which duties "should extend to implementing the necessary software patch to solve [plaintiff's] problem and safeguard [plaintiff's] assets from the thieves." The defendants, however, denied they had "the power or control" plaintiff ascribed to them and argued that imposing such fiduciary duties "would be highly onerous and unworkable."

The Court of Appeal, noting that a fiduciary role "involves acting for or on behalf of another person in a particular matter and also that there is a relationship of trust and confidence between the putative fiduciary and the other person,"

Robert A. Schwinger is a partner in the commercial litigation group at Norton Rose Fulbright US LLP.

identified bitcoin software developers as "people who it is clearly arguable have undertaken a role which at least bears some relationship to the interests of other people, that is to the owners of bitcoins."

Further, it was alleged that "it is the developers who control this software." While these claims were "heavily contested by the developers in this case, who advance their case on decentralisation," i.e., that the blockchain mechanism was governed by consensus protocols among a "large and shifting class" of tokenholders, the court concluded that this was a fact issue that could not be resolved on appeal.

The court in its ruling had taken note of the parties' competing factual submissions on this issue and the conflicting views expressed in academic literature.

The court noted that if a third party identified a software bug and the developers agree it should be fixed, "then the developers will no doubt act to introduce a change in the source code," and "computers on the network will update the software they are running (absent a fork, which again can only be a matter for trial)." Or the developers could decide not to implement such a change at all. "These features, of authority and of discretionary decision making, are common to fiduciary duties."

The court also concluded that the developers "arguably" have "a fiduciary duty" not to "introduce a feature for their own advantage that compromised owners' security." They thus had "a duty which involves abnegation of the developer's self-interest. It arises from their role as developers and shows that the role involves acting on behalf of bitcoin owners to maintain the bitcoin software."

While the lower court had held "that there is no entrustment by owners because the developers are a fluctuating and unidentified body," the court of appeal concluded that this was merely "part of the developers' case on decentralisation," i.e., a fact issue. Thus, it was "a significant flaw in [the lower court's] reasoning" to treat this "highly contested fact" as if it were an incontestable premise.

The Court of Appeal conceded that it would be "a significant step to define a fiduciary duty [to "fix bugs in the code"], but since the developers do have the practical ability to prevent anyone else from doing this, one can see why a concomitant duty to act in that way is properly arguable." Thus, "[i]n a very real sense the owners of bitcoin, because they cannot avoid doing so, have placed their property into the care of the developers." This, said the court is "arguably an 'entrustment'" that could support the existence of a fiduciary duty.

Further, "it is realistic to say that bitcoin owners have a legitimate expectation that the developers will not exercise their authority in their own self-interest to the detriment of owners, and that they will act in good faith to use their skills to fix bugs in the software drawn to their attention."

Lastly, the court concluded that the fact that "there may not be a consensus amongst [the bitcoin] owners does not of itself undermine the conclusion that the duty of developers is fiduciary in nature. If anything it serves to underline the fact that the owners really do place trust in the developers to make good decisions on their behalf."

The court acknowledged that imposing such a duty was not without its difficulties. Recognizing such a claim "would involve a significant development of the common law on fiduciary duties," and it could not be said "that every step along the way is simple or easy." For example, the court noted the question of what should happen if rulings in different cases were to impose conflicting directives upon developers.

Nevertheless, the Court of Appeal concluded that plaintiff's fiduciary duty claim against the developers could not be rejected outright before trial:

> [T]o rule out [plaintiff's] case as unarguable would require one to assume facts in the defendant developers' favour which are disputed and which cannot be resolved this way. If the decentralised governance of bitcoin really is a myth, then in my judgment there is much to be said for the submission that bitcoin developers, while acting as developers, owe fiduciary duties to the true owners of that property.

While it may prove an ambitious undertaking for the plaintiff to prove that "the decentralised governance of bitcoin really is a myth," for now plaintiff's fiduciary duty claim against the developers will have an opportunity to proceed to trial.

Treating NFTs as Property

February also saw the latest installment in a long-running English court saga about NFT theft and ownership, with a third decision in the High Court in the same case from a third judge in less than 12 months. In *Osbourne v. Persons Unknown*, [2023] EWHC 340 (KB) (Feb. 22, 2023) (Healy-Pratt, J.), the court reconfirmed what prior judges in the litigation had held: that non-fungible tokens or "NFTs" were legally cognizable as a form of property under English law, and that in appropriate circumstances it could be appropriate to effect service of process solely by means of airdropping "service NFTs" of the papers into wallets apparently controlled by the wrongdoers. See also the prior rulings at [2023] EWHC 39 (KB) (Jan. 13, 2023) (Lavender, J.); [2022] EWHC 1021 (Comm) (Mar. 10, 2022) (Pelling, H.H.J.).

The plaintiff in *Osbourne* was a self-described "Blockchain, Fintech and Welltech specialist consultant and thought leader, whose work entails speaking, training and consulting internationally." She purchased from online marketplaces and placed into a wallets she owned two NFTs that "were part of a set of 10,000 NFTs representing unique digital works of art depicting inspirational women, each of which also entitles its holder to attend exclusive virtual events and confers other benefits on its holder."

These NFTs were later transferred out of her wallet without her knowledge or consent by an unidentified person or persons. There was a suggestion this unauthorized transaction may have been "enabled" by "a failure in the system architecture."

The stolen NFTs were traced to other wallets, whose owners appeared to be trying to sell them. In deciding whether it was appropriate to enjoin any transfer or disposal of the stolen NFTs, the court explained that "NFTs are a type of cryptoasset that represent an underlying asset, whether tangible or intangible. In that sense, they are digital representations of value. The value of an NFT is, in large part, governed by the provisions of the underlying smart contract that conveys rights to, and in some instances, imposes obligations on the holder."

The court stated that "there is at least a realistically arguable case that NFTs are to be treated as property as a matter of English law." The court cited the similar conclusions "in relation to cryptoassets such as Bitcoin" that were made in High Court cases such as *AA v. Persons Unknown*, [2019] EWHC 3556 (Comm) (Dec. 13, 2019) (Bryan, J.) (discussed in R. Schwinger, "Property and Contract in the Digital World", N.Y.L.J. (Mar. 16, 2020)), and in *Fetch.ai Ltd. V. Persons Unknown*, [2021] EWHC 2254 (Comm) (July 15, 2021) (Pelling, H.H.J.), which addressed the perhaps awkward fit between intangible digital assets and the somewhat rigid categories typically used under English law for defining "property."

The court also agreed with the prior rulings in the case that it was appropriate to issue injunctive relief against the alleged thieves barring them from dealing with or disposing of the NFTs at issue, and not simply to relegate the plaintiff to a possible damages award. In addition to uncertainty over whether the defendants could "meet even the relatively modest damages claim that is likely to arise in the circumstances of this case," the nature of the stolen assets here as artwork NFTs meant that damages would not furnish an adequate remedy. While the NFTs were worth "about £4,000, give or take," the evidence showed that these NFTs were "assets which have a particular, personal and unique value to the claimant which extends beyond their mere 'fiat' currency value." The Court held it appropriate to grant an injunction "to protect assets in such circumstances."

Increasing the Availability of Making Service Through NFTs

On a separate procedural note, this most recent *Osbourne* ruling also approved making freer use of "alternative means" in order to make service upon defendants accused of NFT theft who cannot be found or identified. The court approved making service solely by the alternative means of airdropping service NFTs of the papers into the wallets where those defendants had moved the NFTs they took from the plaintiff, without requiring any additional steps or alternatives.

Because the evidence showed that the plaintiff "had no other available method of conventional service on the defendants… except service by NFT sent to the relevant wallets," service

"was proposed by way of non-fungible token airdrop." This previously had been approved by one of the earlier judges in the case, and was extended to additional papers in the case later on.

The court noted that the prior judge "was made aware" at the time of his ruling that "the present case was the first occasion on which service by NFT had been approved as the sole method of service of documents." This was in contrast to an earlier English case which had authorized such service only in conjunction with additional forms of alternative service. See *D'Aloia v. Person Unknown,* [2022] EWHC 1723 (Ch) (June 24, 2022) (Trower, J.) (discussed in R. Schwinger, "Serving Process by Airdropping NFTs: The Next Frontier?", N.Y.L.J. (Sept. 26, 2022)).

The court also noted that service in this manner "is a rapidly developing area of legal specialism." In particular, the court noted that because a "specific feature" of NFT service tokens "was their ability to be open to the public and viewed through the hyperlinks contained within them," the court needed to implement "a protocol . . . for certain redactions relating to personal data" that were "naturally conditional upon the Defendants being offered access to unredacted versions of the documents."

Tactics To Recover Crypto Assets

Osbourne upheld the issuance of injunctive relief when dealing with the theft of NFTs, which are "non-fungible" tokens. But is similar injunctive relief equally available when the assets sought to be recovered are just ordinary fungible stablecoins? The recent High Court case of *Piroozzadeh v. Persons Unknown*, [2023] EWHC 1024 (Ch) (Mar. 2, 2023) (Trower, J.), held it was not, and raised a number of issues about attempting to freeze fungible crypto assets held by an exchange.

In *Piroozzadeh*, the plaintiff claimed to have been scammed by fraud out of a substantial amount of both fiat currency and stablecoins by a group of defendants. Plaintiff's investigator claimed to have traced the lost stablecoins to wallets held with the cryptocurrency exchange Binance. Plaintiff sought *ex parte* injunctive relief against Binance seeking to require it to preserve plaintiff's stablecoins or their "traceable proceeds," on the theory that Binance in this situation should be deemed to hold these assets as a constructive trustee for plaintiff.

The *ex parte* injunctive relief was granted but at a later hearing with a fuller evidentiary presentation the High Court determined that it was not proper for the injunction to have been granted, and ordered it dissolved, for several reasons.

First, the court noted there was no good reason for the injunctive relief application to have been made against Binance *ex parte.* Binance "was not alleged to be guilty of wrongdoing." Plaintiff argued that Binance was not given notice of the application "because there might have been an inadvertent tipping off" of the actual wrongdoers. But the court rejected this, noting that "there is no specific evidence that might have caused the court to conclude that tipping off was a material risk." The fact that Binance was "not a regulated entity" like a bank did not alter the conclusion that notice of the application for injunctive relief should have been given to it.

The court found the failure to have given Binance notice of the application for injunctive relief was especially serious because in the court's view plaintiff's counsel did not present various information in the *ex parte* proceedings that would have called into question the propriety of enjoining Binance on a constructive trustee basis, as English procedure required counsel to do. Most significant among these facts was that a Binance user "does not retain any property in the [cryptocurrency] deposited with the exchange." Rather:

> the user's account is credited with the amount of the deposit and they are then permitted to draw against any credit balance as in a conventional banking arrangement. The [deposited] assets are then swept into a central unsegregated pool [and] treated as part of [Binance's] general assets. They are not specifically segregated to be held for the sole benefit of the user from whose account they have been transferred.

Because of these circumstances, the court concluded, any attempt months later when the injunction was sought "to trace the [assets] swept into the pool from the three user accounts at [Binance] would have been . . . an essentially futile and close to impossible and possibly impossible exercise."

Moreover, "it should have been apparent that the consequence of pooling was that the users' right to receive substitute assets from the exchange was at the very least likely to constitute [Binance] a purchaser for value of anything that was transferred into the account in the first place," which means that Binance was "no longer susceptible to any remedy at the suit of the claimant so long as it acted *bona fide*."

The court characterized plaintiff's counsel as "adopting an overenthusiastic approach" by not having raised or addressed these issues at *ex parte* hearing, despite it being known from previously litigated cases that Binance "was likely to assert a *bona fide* purchaser defence" based on the pooling. Thus, the High Court declined to continue the injunction and ordered it dissolved.

Innovative Judgment Enforcement Tools

A recently-released judgment in *Law v. Persons Unknown,* 2023 WL 03483927 (London Cir. Comm. Ct. Jan. 26, 2023) (Pelling, J.), featured a more cooperative cryptocurrency exchange than in *Piroozzadeh* and an interesting use of an extraterritorial order to secure meaningful relief for the plaintiff.

The plaintiff in *Law* had been fraudulently induced to transfer crypto assets to wallets controlled by certain of the defendants. The plaintiff had succeeded in obtaining default judgments against those defendants for his losses, and the English court had then issued a worldwide freezing order. The cryptocurrency exchange where the wallets holding the improperly obtained assets were hosted, which was based overseas, agreed "to cooperate with any order the English court might make."

The court noted "the extraterritorial aspects of the case" that would be raised by requiring that money be transferred back to the plaintiff, particularly in a situation where the wrongdoer defendants "have not participated in any aspect of this litigation and filed no defence or responded materially in any way at all." But the court noted that "[t]he account is plainly controlled by the defendants responsible for the fraud and in those circumstances, in the normal way, there would be an ability to enforce a monetary order if the accounts were maintained in England."

While the exchange was currently not permitting the wrongdoer defendants access to the account, the court noted concerns about whether this would necessarily continue to remain the case indefinitely into the future, when the court had no power over the wrongdoers as they were outside the court's jurisdiction.

Thus, it said, "it is appropriate that the funds within the account be transferred into England and Wales" after "first of all converting the cryptocurrency held in the relevant account to fiat currency." The court further directed that the funds be "either paid directly into the court funds office or paid to the claimant's solicitors on the understanding that it will be then paid by them to the court funds office."

Conclusion

The English courts have been applauded for the flexible approach they generally have taken to enable victims of digital asset frauds and thefts to obtain effective relief. These recent cases show their willingness to adapt legal concepts and practices in very novel settings so that persons investing and transacting in digital assets can expect largely the same protection from the courts that holders of more traditional assets have long enjoyed. They are willing to entertain ambitious claims like the challenge to the notion of decentralization being attempted in *Tulip Trading*, while at the same time not flinching from examining the nuts and bolts of crypto operations and what their legal implications might be, as shown in *Piroozzadeh*.

Innovation in digital assets cannot flourish unless the holders of those assets can be confident that the law will provide them relief when they have been victimized and suffer losses. The receptive approach to such claims seen in these recent English cases help inspire such confidence and thus ultimately provide the foundation needed for vibrant digital asset marketplaces to develop and grow.