

THE LIABILITY MAZE



KATY MICALLEF SITS DOWN WITH **DR. MAX GANADO** FOR AN IN-DEPTH LOOK AT THE RECENT GOVERNMENT PROPOSAL TO GRANT LEGAL PERSONALITY TO TECHNOLOGY ARRANGEMENTS SUCH AS DLT AND SMART CONTRACTS.

As I make my way through GANADO Advocates' offices, I can't help but be struck by how neatly old complements new. The recently renovated buildings are a convergence of pristine glass and 300-year-old stone, a seamless transition between tradition and modern architecture. This juxtaposition is mirrored in Dr. Max Ganado, a man with a seemingly bottomless pit of knowledge, who has applied his vast experience in the application of law to the emerging technology of the blockchain and A.I. sphere.

Following the success of the three pieces of blockchain legislation launched last November, the Government of Malta has been mindful of the need to pick up the pace, now that the eyes of the rest of the world are on the Blockchain Island.

As with any new industry that is fast-developing, there is an element of uncertainty, which is why early last year a white paper was released with a proposal to tackle private law issues. As Dr. Ganado elaborates, 'the first challenge was trying to find out which of our regulatory laws apply when.' One aspect of legal uncertainty was which part of the industry, which type of tokens or digital aspects would be caught by existing law and which wouldn't be.

"It created a massive risk for everyone involved. What we did is we came out with a set of regulatory laws (the most focused of which is Virtual Financial Assets Act) and as a result the Financial Instrument Test was proposed."

Pinning down the essence of these definitions has helped determine a number of specific parameters, such as whether the MFSA has authority or which tax rule is applied and whether it might affect the public and thus needs greater attention to protect the public interest agenda. Once defined, it is a lot easier to know which laws apply and whether new laws are needed to catch the middle ground, thus avoiding the unregulated limbo of an ambiguous arena and mitigating reputational risk. The public is also protected.

"This is now a new classification for regulatory law and we know exactly where it falls - and that is the VFA Act."

Now that the boundaries are set, Dr. Ganado moves on to the possible automation of new technology arrangements, such as DLT and smart contracts. A number of pertinent questions arise, such as whether smart contracts are enforceable and which laws apply to them, and more seriously – whether the designer of open source software or smart contracts can be considered liable, especially when limitations of space and time and the transient nature of human life is applied.

Dr. Ganado goes on to say, “The other issue is that current laws always think of finding a person, they don’t stop at a situation. Law doesn’t apply liability to things. When there are things that cause harm, there is always someone who owns or controls them. Technology can

create distance. For liability to arise there has to be proximity, there has to be cause and effect or bad faith or negligence.”

Part of the difficulty arises when you have the type of DLT that is decentralised, permissionless, public and ownerless. The Bitcoin or Ethereum platform comes to mind for example.

As Dr. Ganado explains, “When you have hundreds of people contributing, it’s very hard to determine who is responsible for a specific loss which may affect a user or a third party many years

and versions later. The consequence of this situation is a massive risk for everyone involved. Of course when someone specific is willing to post a guarantee against loss or to be the identified person who will be liable there is no problem at all, and the law already caters for that.”

It is very often the developers, users, and creative thinkers that become tangled in ambiguity – left vulnerable to potential liability of an outcome they have no control over and may not even have known was happening. This will kill innovation if not addressed.

“We have a situation where a traditional legal entity doesn’t work because it’s not designed for this context.

The only solution is to solve the issue of uncertainty through the design of a legal entity that will start from the premise that it doesn’t have owners or administrators, or if it does, then the liability is pre-determined. Then it is predictable and can be covered by other forms of recourse, like insurance, as no one should assume that liability ought to be eliminated or that loss should not be catered for. And when there is identifiable fraud, willful misconduct or negligence by a known person, then of course he should be liable personally.”

There are two main aspects that need legal certainty: capacity, which is critical to the stability of legal relationships, and predictable liability rules. As Dr. Ganado says, it is essential to create a centralised point of reference, an entity which has functionality. He assures me that this will not detract from the decentralised nature of the DLT itself, as ownership is a passive function and does not interfere in the way the DLT technology platform operates.

Dr. Ganado goes on to give three examples of how various features in the structure will minimise risk. The first is if a developer has developed tech based on fraudulent intent, he will remain liable for the consequences of his act. Secondly, if you create an entity, you’re going to be able to vest it with an insurance policy that is able to cover breaches of fiduciary obligations (if there are any), negligence, defects and possibly some kind of no-fault-based loss. The third thing is if you recognise the tech as public benefit tech, then you can give it a special status at law, which you can call “public domain” or “commons”. That means it is not owned by anyone but it is there for the benefit of everyone, meaning you can then clearly state that the individual users and, members of the public using such a “utility” will never be liable for losses of others.

“What you can do in a legal entity is you can create a segregated cell which will own and have vested in it all the software in such a way that bankruptcy, regulatory interface and possibly enforcement actions against the legal entity will not affect the continuity of that software – because hundreds of thousands of people will be dependent on that software for the services it facilitates and for the proof of and access to their assets.”

As he explains, if you hold the platform which holds user assets you cannot hold the platform which validates the user assets ransom to creditor claims. “So you have to create what you call a non-recourse status of that software. If there’s a problem with the legal entity you have to migrate that software, lock, stock and barrel, with all the data in it, to another foundation – sans the problems that arose. So any criminality, illegal activity, or defects have to be kept back, investigated and penalised without affecting the rest of the activity. Security interests of lenders, investors and other proprietary interests can move together with the segregated cell.”

Do these elements stop it from being decentralised? Dr. Ganado doesn’t think so. The ability of the centralised features to undermine the decentralisation of the platform design is going to be extremely limited. Today smart contracts are solving many problems of governance but so far they cannot solve all of them, such as AML and GDPR compliance, so you still need human input to ensure compliance with the law, someone with power to intervene if the tech fails to operate as intended. This assumes that the tech wasn’t designed to breach the law in the first place, which is yet another scenario to be considered.

“If you do something considered to be beneficial, whether you do it through a legal entity and a board of that legal entity, or you do it through a third party functionary called the technical administrator (who comes as a requirement of the new Maltese law), this doesn’t make the slightest difference, because the restricted functionalities that you’ve retained from the traditionally centralised structures will not impact on the decentralised nature of the platform.”

This is a time for creative thinking in the development of the law. The law is there to facilitate human interaction and always keeps up with developments as the contexts change – it’s great to be part of the conversation on the way forward. 

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