

Wave Of Suits Could Lead To New Era In Crypto Litigation

By Philip Rosenstein

Law360 (April 9, 2020, 10:47 PM EDT) -- A flood of securities class action complaints filed last week in New York federal court against a host of digital asset exchanges and issuers may foreshadow a new phase in fintech litigation, building on a flurry of targeted actions and guidance over the past year.

The plaintiffs, represented by Selendy & Gay PLLC and Roche Cyrulnik Freedman LLP, took aim at four exchanges and seven issuers that they claim took advantage of market enthusiasm following the success of Bitcoin and Ethereum and failed to adhere to federal and state securities laws. The suits were filed on April 3 in the Southern District of New York.

The suits target crypto-asset exchanges Binance, Bibox, KuCoin, and BitMEX operator HDR Global Trading Ltd., and token issuers Tron Foundation, Block.one, BProtocol Foundation aka Bancor, Civic Technologies Inc., KayDex Pte. Ltd. aka Kyber Network, Quantstamp Inc. and Status Research & Development GmbH, along with several of their executives.

"Any issuer or exchange in the space now has to anticipate that there will be heightened scrutiny over exactly what they're selling investors," Philippe Selendy, a partner at Selendy & Gay who is part of the plaintiffs' legal team, told Law360. "And the SEC framework approach, which was put in place a little over a year ago, is going to be much more scrupulously studied by litigators on behalf of investors."

All of the defendants face claims that they offered and sold unregistered securities. The exchanges also face unregistered broker-dealer claims, and BitMEX faces allegations of market manipulation in violation of the Commodity Exchange Act.

A New Wave of Litigation

These 11 suits come on the heels of a decision at the end of March in a widely followed case that the U.S. Securities and Exchange Commission brought against Telegram blocking the distribution of its Gram tokens. A New York federal judge ruled that Telegram's offering of its Gram tokens, through the distribution of the tokens themselves, constituted a securities offering, striking a blow to the structure used by Telegram and others.

Over the past year, the SEC has become more active in bringing suits against digital-asset companies and has provided some guidance as to how securities laws should be applied to the novel asset class. Selendy & Gay and Roche Cyrulnik are also lead counsel in a \$1.4 trillion consolidated class

action alleging that Bitfinex and Tether, two large players in the industry, manipulated the Bitcoin market.

"I think you are going to see a new wave of litigation," Michelle Gitlitz, a partner at Crowell & Moring LLP and global head of the firm's digital assets and blockchain practice, told Law360. "It's a matter of the plaintiffs bar pushing the legitimacy of the actions of certain companies in the space."

She added, "From my perception of the complaints, they're reading all of the guidance out there, they're looking at the mechanics of how the exchanges work, they're looking at the mechanics of the offerings, and they're saying: we see something wrong here."

"And just because everybody was doing it doesn't make it right," she said.

Individual investors Chase Williams, Alexander Clifford, William Zhang and Eric Lee, on behalf of the proposed investor classes, allege that the companies took advantage of the "Wild West" atmosphere of initial coin offerings in 2017 and 2018, before the SEC issued its April 2019 framework outlining how it would assess the application of federal securities laws and what is known as the Howey test to digital assets.

The Howey test stems from a 1946 U.S. Supreme Court case that broadly interprets the term "investment contract" under the Securities Act as an agreement in which a person invests money in a common enterprise, expecting profits based on the efforts of others.

Focus on Howey and ERC-20

All 11 complaints walk through an analysis of how an issuer's tokens or tokens offered on an exchange fit within the bounds of the Howey test and should therefore adhere to federal securities laws. A common thread throughout each complaint is that they all address ERC-20 tokens, a type of smart-contract token built on the Ethereum blockchain that follows a basic set of standards.

While the SEC and the plaintiffs bar have not taken a large bite out of the digital asset world yet, Kyle Roche, a partner at Roche Cyrulnik who is also part of the plaintiffs' legal team, told Law360 he believes they are on solid ground.

"I think that there is precedent," Roche said. "If you look at the EOS order, which was entered at the end of September last year, the order specifically states that the ERC-20 tokens that were sold by Block.one were securities and that [the company] failed to register. The focus in our complaints is on ERC-20 token, and that specific manner in which massive amounts of funds are raised, and advertised through a centralized process.

"There may be token projects that are a little bit more difficult to analyze, but we're on solid footing and have solid precedent with what the SEC over time has been able to say about the space and particular applications of tokens," Roche said.

The suits reference the SEC's September 2019 action against Block.one, a major token issuer and defendant in the present class actions, which agreed to pay a \$24 million penalty to the regulator for its unregistered offering of EOS tokens. The Block.one administrative order specifically outlines that "the ERC-20 tokens were securities under the federal securities laws pursuant to [the Howey test] and its progeny."

Block.one told Law360 that it was aware of the "opportunistic complaints," noting that it had yet to be served any claims but are "well prepared to address anything that may arise."

Given that there are many more digital tokens using the ERC-20 standard that did not register as securities, Philip Berg, a partner at Otterbourg PC and chair of the firm's privacy and cybersecurity practice, told Law360 that he would not be surprised if more such digital assets are targeted by investors.

"I would expect you would see some plaintiffs attorneys who might look at these cases and see them as an opportunity to get a flurry of things filed covering these other assets," Berg said.

Issues That Might Crop Up

One of the main defenses that the plaintiffs will have to contend with is the one-year statute of limitations that applies to suits brought over unregistered securities offerings, Kobre & Kim LLP litigator Benjamin Sauter told Law360. Under Section 13 of the Securities Act, claims based on a failure to register must be filed within a year of the date of the violation.

"A lot of the activity at issue took place in 2017, 2018, and so the statute of limitations has by and large run," Sauter said. "We didn't see a whole lot of these types of claims being brought back when it was easier to do so, back when the statute of limitations issue wasn't there."

The complaints don't directly address the statute of limitations, but they do make it clear that it wouldn't have been until the SEC released its digital asset framework in April 2019 that investors should have reasonably believed that some of these digital assets were unregistered securities.

"Prior to that time ... a reasonable investor would not have concluded that such tokens were securities under federal and state law," the Tron Foundation complaint says.

There are also some inherent issues with the demand for rescission, Sauter added. The plaintiffs have asked for rescission, where the parties would be put in their original positions and entire contracts would be canceled. There are a host of complicated issues surrounding how to calculate the amount of rescission, including what currency it should be provided in and how to offset any amounts the class plaintiffs might have received upon selling the alleged securities.

"You may see more of these types of complaints, but I think people probably will realize pretty quickly that even if they can certify a class and overcome the substantive pleading requirements and defenses, they could be left with empty judgments and that are going to be very difficult to enforce overseas," Sauter said.

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