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Issuers of Tokens: Beware, Class Action Lawsuits Are Coming

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Initial Coin Offerings, or ICOs, were an extremely popular way of raising capital¹ in exchange for crypto tokens in 2017 and have led to class action litigation in 2017 and 2018. While ICOs have been around since 2013, they recently became a particularly popular way to finance a project. **These ICOs enable companies to easily release their own freely tradable tokens in exchange for Bitcoin or Ether for projects that may or may not ever succeed.**

The Securities and Exchange Commission (“SEC”), Commodity Futures Trading Commission (“CFTC”) and other governmental agencies have sat on the sidelines for a few years, but this is no longer the case. The Federal Trade Commission (“FTC”) brought one of the first governmental actions against a company involved in Bitcoin—Polsinelli’s client, Butterfly Labs (or BF Labs)—in 2014 relating to BF Labs’ preorder model wherein consumers prepaid for BF Labs bitcoin miners that were under development. **BF Labs’ successful defense against the FTC amid allegations of fraud may provide insight on class action lawsuits and governmental actions in the future.**

Background on Bitcoin

Roughly nine years ago, one or more cryptographers and computer programmers known only as Satoshi Nakamoto created a decentralized digital currency called Bitcoin. This electronic, open-source, crypto-currency is based on mathematical proof. Bitcoins are mined, using computing power in a distributed network. The Bitcoin protocol—the rules that make Bitcoin work—state only 21 million Bitcoins can ever be found by miners. Virtual currencies, like Bitcoin, are monetary units of exchange stored or represented in a digital or other electronic format that operate like currency in some environments, but that do not have legal tender status in any jurisdiction. Bitcoin is not backed by any tangible real asset and without specie, such as coin or precious metal. “Bitcoin is a decentralized store of value and open-ledger payment network that operates securely, efficiently and at low cost without the need for any third-party

¹ That capital being either Bitcoin or Ether.

intermediaries. The Bitcoin protocol allows individuals or service providers' access to a global financial system that will see rapid innovation."² No single institution controls or regulates this Bitcoin network.

The complex computer algorithm, when mined successfully, creates new Bitcoins. Bitcoin was initially mined with the central processing unit in laptop or desktop computers, and subsequently with the more powerful graphics cards in these types of computers. This type of mining required a degree of technical knowledge, largely within the province of techies.

Initial Coin Offerings

In the last 12 months there has been an explosion of sales of digital tokens through what are known as ICOs that are viewed by regulators in many jurisdictions as a form of crowd fund investing using crypto currencies. These ICOs raise money through whitepapers that generally describe the individuals involved in the project and the project they intend to develop and that the public assists in its development by offering its tokens in exchange for crypto currencies. The ICOs founders may also put together a webpage and make forum posts (through places like Bitcointalk.org) touting the project or even had celebrities endorse the projects.

While the first ICO was held by Mastercoin (now known as Omni) in July 2013, ICOs raised approximately \$4 billion in 2017 alone. In fact, ICOs actually out valued early-stage venture capital funding in 2017. Naturally, with that kind of money involved, you will see governments and lawyers quickly turn their attention to these projects. Also interesting is that the companies that took in the investments of Bitcoin, Ether, or other cryptocurrencies in exchange for tokens (and held on to the tokens) earlier this year have made significant gains in fiat currency through the market alone.

² See Testimony of Patrick Murck General Counsel, the Bitcoin Foundation to the Senate Committee on Homeland Security and Governmental Affairs "Beyond Silk Road: Potential Risks, Threats, and Promises of Virtual Currencies" dated November 18, 2013, available at: <https://www.hsgac.senate.gov/download/?id=4cd1ff12-312d-429f-aa41-1d77034ec5a8>

Recent SEC Statements and Actions

On July 25, 2017, the Securities and Exchange Commission ("SEC") issued a Report of Investigation under Section 21(a) of the Exchange Act which concluded that tokens offered by the Distributed Autonomous Organization ("DAO"), an unincorporated organization, Slock.it UG, a German corporation, Slock.it's co-founders, and intermediaries may have violated federal securities laws.³ The SEC concluded the DAO tokens were securities that should have been registered with the SEC or sold pursuant to an exemption from registration. The SEC did not state that all tokens offered through an ICO constitute securities. The SEC indicated that the determination of whether a token constitutes a security was dependent on the "particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale." The DAO Report was a warning to companies considering conducting a token offering using an ICO of what the SEC.

Since the publication of the DAO Report, the SEC and its Chairman have made a number of public statements regarding token offerings that use an ICO. On December 11, 2017, Chairman Clayton issued a statement on Cryptocurrencies and ICOs noting that "[t]here are tales of fortunes made and dreams to be made" relating to cryptocurrencies and ICOs but urged investors to "exercise extreme caution" as investors' "funds may quickly travel overseas without [their] knowledge."⁴ Clayton's statement suggests that ICOs are going to be highly scrutinized by the SEC and held to the same bar as securities offerings. Clayton also noted that while ICOs "can be effective ways for entrepreneurs and others to raise funding . . . a change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed."

All issuers of tokens through ICOs should be aware the SEC believes it has jurisdiction over such offerings. That means that we are more likely to see civil class action

³ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO; see <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁴ Statement on Cryptocurrencies and Initial Coin Offerings, available at: www.sec.gov/news/public-statement/statement-clayton-2017-12-11



lawsuits against issuers of tokens that use ICOs that do not live up to the token purchasers' expectations. It is important to remember that just because the tokens have been labeled a utility token or product token, the SEC and the courts are likely to treat the tokens as securities.

Recent CFTC Actions

The CFTC has also recently filed three cryptocurrency fraud lawsuits. On January 16, 2018, the CFTC sued and froze the assets of two individuals and My Big Coin Pay, Inc., related to the supposed cryptocurrency called My Big Coin, alleging they took \$6 million in funds and transferred money into their personal accounts and paid off earlier investors. The government alleged that “[t]he supposed trading results were illusory, and any payouts of funds to My Big Coin customers were derived from funds fraudulently obtained from other My Big Coin customers in the manner of a Ponzi scheme.”⁵ The CFTC’s enforcement chief said that “[t]he CFTC is actively policing the virtual currency markets and will vigorously enforce the anti-fraud provisions of the Commodity Exchange Act. In addition to harming customers, fraud in connection with virtual currencies inhibits potentially market-enhancing developments in this area.”⁶ A preliminary injunction hearing in that matter has been set for March 15, 2018.

This came less than a week after the CFTC sued two other virtual currency businesses for fraud. In one case, they brought a lawsuit against a company called CabbageTech Corp., accusing the company and its founder for making off with funds they scammed from customers in exchange for cryptocurrency trading advice.⁷ The CFTC also launched an enforcement action against The Entrepreneurs Headquarters Ltd. and its founder, alleging they had fraudulently raise more than \$1 million in bitcoin for options trading and then

⁵ *Commodity Futures Trading Commission v. My Big Coin Pay, Inc. et al.*, Case No. 1:18-cv-10077 in the United States District Court for the District of Massachusetts.

⁶ CFTC Charges Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc. with Fraud and Misappropriation in Ongoing Virtual Currency Scam, available at: www.cftc.gov/PressRoom/PressReleases/pr7678-18.

⁷ *Commodity Futures Trading Commission v. McDonnell et al.*, case number 1:18-cv-00361, in the U.S. District Court for the Eastern District of New York.

covered up the fact they had not done any trading with the funds.⁸

Recent Class Actions Against Token ICO Issuers

A. Tezos

In October and November 2017, four class action lawsuits were filed against Dynamic Ledger Solutions, Inc. which owns Tezos-related intellectual property, including the source code of the Tezos cryptographic ledger, the founders of the Tezos project, a Swiss Corporation (the Tezos Foundation) established to conduct the Tezos ICO, and others.⁹ These four class action lawsuits arise out of an ICO that raised approximately \$232 million (through cryptocurrency) which is now likely worth over twice that much because of the significant rise in the price of cryptocurrencies like Bitcoin and Ether that were used to buy the tokens known as Tezzies. These tokens would purportedly allow their holders to facilitate payments or execute smart contracts on the Tezos blockchain network.

The plaintiffs generally alleged that because of an internal dispute between the Tezos founders and Tezos Foundation that was established to conduct the Tezos ICO, the Tezos project has been delayed and the futures price for the Tezos token (which investors have not received yet) has fallen, losing nearly 50 percent of its value. The four lawsuits also allege that the defendants misrepresented how the funds used during the ICO would be spent, when the Tezos network would be up and running (similar to the BF Labs matter), and that the Tezzies should have been registered with the SEC, among many other misrepresentations.

The causes of actions in the lawsuits vary as two of the suits merely allege violations of the securities act, the other two contain other various causes of action, including state law false advertising, unfair competition and deceptive trade

⁸ *Commodity Futures Trading Commission v. Dean, et al.*, Case No. 1:18-cv-00345, in the U.S. District Court for the Eastern District of New York.

⁹ See Case Nos. 3:17-cv-6779-RS; 3:17-cv-6829-RS; 3:17-cv-6850-RS (all in the Northern District of California) and Case No. 6:17-cv-1959-ORL-40-KRS (in the Middle District of Florida).



practices act claims, as well as seeking rescission and alter ego liability. The state law consumer protection act claims are brought as a way for plaintiffs' attorneys to receive their attorneys' fees.

B. The other class action complaints that then followed the Tezos action

On December 13, 2017, another class action was filed, this time against Centra Tech, Inc., and the individuals involved in the Centra ICO.¹⁰ In this complaint, the plaintiff alleged that the Centra sale constituted an unregistered offering and sale of securities. The complaint also accused the defendants of misleading investors about the nature of its relationship with card networks Visa and MasterCard, as well as listing fake team members on its website. The Centra Tech ICO was notably promoted by Floyd Mayweather as well as music producer DJ Khaled prior to its completion.

On December 19, 2017, Monkey Capital, a company seeking to create a decentralized hedge fund, was hit with a class action lawsuit alleging a fraudulent issuance of securities.¹¹ The class action, filed by the same firm that filed a case against Tezos, contended the investors bought into a common enterprise with an expectation of profit from the efforts of others (the Howey test). On December 21, 2017, a class action was filed against ATBCoin LLC and others based on allegations that ATBCoin had violated the Securities Act by issuing unregistered securities.¹²

On December 28, 2017, investors in the Giga Watt ICO filed a class action lawsuit alleging they invested in tokens, which have yet to be supplied that have all the makings of a security, yet the company did not register the coins with regulators.¹³ Giga Watt held an ICO last summer to raise money to build a cryptocurrency mining facility. Like what was alleged against

BF Labs, the plaintiffs alleged that it is unclear whether the mining project remained in development and if it would ever be fully developed at all.

Finally, on January 30, 2018, a cryptocurrency startup that focuses on marijuana was hit with a class action relating to allegations that the defendants violated United States securities laws with a \$70 million ICO that was not properly registered.¹⁴ While the lawsuit does not accuse the defendants of fraud, the plaintiff alleges that the defendants were strictly liable for violating section 5 of the securities act and must disgorge proceeds of the ICO.

Butterfly Labs

Two years after Bitcoin came into existence in 2009, BF Labs was incorporated. BF Labs was one of the few United States-based manufacturers of Bitcoin mining equipment. BF Labs' FPGA technology (introduced in 2012) was approximately three times faster than graphics cards, which were, in turn, hundreds of times faster than the original CPUs. Then, in 2013, BF Labs introduced ASIC 65nm technology that was approximately 80 times faster than its FPGA technology. The ASIC 28nm technology that BF Labs rolled out to the market in 2014 was then approximately 10 times faster than the ASIC 65nm technology.

Because the CPU/GPU Bitcoin miners were a relatively small group and had the space to themselves, the introduction of specialized mining chips that made mining possible for non-technical consumers disrupted the mining industry status quo and upset the apple cart for many of the original miners. While the majority of them accepted the new development, they now had to be willing to invest money in specialized equipment to compete with thousands of new entrants into their industry, or they risked not being able to keep pace. A vocal minority, however, chose to try to scare off the new miners by painting BF Labs and later other mining rig manufacturers as unreliable and untrustworthy, or even as scams and frauds.

¹⁰ See *Rensel v. Centra Tech Inc.*, et al., 17-cv-24500-JLK (S.D. Fla.).

¹¹ See *Hodges, et al. v. Monkey Capital, LLC, et al.*, Case No. 17-81370 in the U.S. District Court for the Southern District of Florida.

¹² See *Balestra v. ATBCOIN, LLC, et al.*, Case No. 17-10001 in the U.S. District Court for the Southern District of New York.

¹³ See *Stormsmedia, LLC v. Giga Watt, Inc.*, et al., Case No. 17-438 in the U.S. District Court for the Eastern District of Washington.

¹⁴ See *Davy, et al. v. Paragon Coin, Inc.*, et al., Case No. 18-671 in the U.S. District Court for the Northern District of California.



Most products a consumer purchases do not have a potential return on investment. Bitcoin-mining equipment, however, was seen as an almost sure-fire way to make money. Early entrants, in particular, could mine for Bitcoin when there was less competition for solving the mathematical puzzles (and the puzzles were easier to solve). As faster and better equipment became available, more people sought to join the mining efforts. Because of this, some people felt that any wait required for delivery of their new, cutting-edge equipment would be harmful to them as a result of their inability to mine. However, they did not consider that their returns are affected by the fluctuating price of Bitcoin, the electricity cost of running their equipment, and their luck in solving the required algorithms, as well as their timing of selling or spending any Bitcoins that are mined. Holding miner manufacturers responsible for speculative investment losses made manufacturing a risky proposition, and drove nearly all of them out of business. It also led to investigations and lawsuits.

BF Labs was one of those companies hardest hit. Over three years ago, the FTC obtained a temporary restraining order and receivership was entered.¹⁵ BF Labs' shock, felt as United States marshals were escorting employees out of the building, was painful and unexpected as the FTC secured the receivership by filing its motion *ex parte*.¹⁶ BF Labs (with Polsinelli's help) eventually defeated the FTC in court, as the FTC was unable to secure a permanent injunction after a three-day hearing (the FTC loses less than 1 percent of these cases). BF Labs was allowed to return to business,¹⁷ but the cost of the receivership (which lasted approximately three months), coupled with the fact that BF Labs was not allowed to ship the products (causing an avalanche of refund requests), the FTC effectively shuttered the company.

¹⁵ See *Federal Trade Commission v. BF Labs Inc., et al.*, Case No. 14-cv-815-BCW, United States District Court for the Western District of Missouri. Further, when the FTC received their temporary restraining order against BF Labs on September 19, 2014, the price of a Bitcoin was \$391.94. The price of a Bitcoin now is approximately \$10,400 (with its high approximately \$20,000) per Bitcoin.

¹⁶ BF Labs contended that the FTC did not tell the court numerous material facts that, if known, would have caused the court to reject the receivership and temporary restraining order it entered even without hearing BF Labs' story.

¹⁷ Decimated by the FTC's actions, BF Labs settled the matter for nearly nothing to avoid further litigation expenses, as the government had unlimited resources.

Initially, BF Labs used a preorder model to sell its Bitcoin miners and warned potential customers that the miners were under development and not to preorder the miners if they did not want to wait. Because of unexpected delays from its component manufacturers, some of BF Labs' products took longer than expected to develop and ship to its customers. While the FTC contended that the preorder model was a scam, it was effectively proven at the hearing there was no real alternative to fund these first-rate Bitcoin miners without a preorder model because of the volatility of the Bitcoin price. In fact, its customers demanded the preorder model so they could get in line for BF Labs' hardware once it was fully developed. BF Labs argued in court in 2014 that the Bitcoin price could spike in the coming years and that some people even believed a Bitcoin could be worth \$1 million. The FTC argued the opposite.

Prior to the FTC's actions in 2014, a class action was filed earlier that year on behalf of consumers against BF Labs based on virtually the same allegations. Like the FTC action, BF Labs has resolved these civil suits in large part because nothing remains.

Analysis of Potential Token Class Actions

The ICOs model and the fact that they are often sold in a manner that is possibly in violation of state and federal securities laws make class action lawsuits inevitable. The company that puts together the ICO receives cryptocurrencies during the ICO sale (usually a short period of time—usually one month or less) and tokens are issued to those people or entities who contributed to the ICO. The cryptocurrency raised through the issuance of the tokens is then (or supposed to) be used to advance the project. ICOs, therefore, are potentially prime for an area where investors could be harmed by being taken advantage of by the lack of regulatory oversight and may be ideal fodder for lawsuits.¹⁸

The Terms and Conditions of the ICO may attempt to

¹⁸ Assuming the entities and/or founders have enough ties to the United States—as many ICOs are started offshore but may have United States based founders or owners.



prohibit causes of action from being filed in the United States but, depending on how those Terms and Conditions were drafted, courts may find the provisions unenforceable or even unconscionable. An ICO may include class action waivers or mandatory arbitration clauses. But these and other disclaimers may not hold up in court. Cases conflict whether a disclaimer may be valid with different rules in different jurisdictions. Further, many (if not all) ICOs publish a whitepaper describing the project and many of the putative class members would have reviewed the same whitepaper. This whitepaper would likely be Exhibit A to any class action complaint or at trial.

In order for a class action to be certified, the plaintiff will need to meet all four requirements under Rule 23(a)—numerosity, commonality, typicality, and adequacy—and one requirement under Rule 23(b)—likely, predominance and superiority under (b)(3)—of the Federal Rules of Civil Procedure. Further, courts may also require the implicit prerequisite that a class be ascertainable, defined by identifying the class members using objective criteria that identifies a particular group, harmed during a particular time frame, in a particular location, in a particular way. The plaintiff bears the burden of proving the prerequisites to class certification have been met by a preponderance of the evidence.

A. Numerosity

Numerosity would likely be established because there may be hundreds, if not thousands, of putative class members. While there is no magic number that satisfies numerosity, some courts have found this element satisfied when the putative class consists of 40 members. Assuming the ICO allowed people living in the United States to buy its tokens, it is likely that the factor will be met.

B. Commonality

Commonality requires that there are “questions of law or fact common to the class.” Common questions relating to ICOs gone bad could be: whether the tokens constitute securities, whether material facts were misrepresented about the network, whether the terms were unconscionable or even

whether the members of the class have been injured and what type of damages they are entitled to. These common questions must be of such a nature that they are capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke.

C. Typicality

Typicality is usually met when the class representative’s claim arises from the same course of conduct that gives rise to the claims of the other class members and the claims are based on the same legal theory. The typicality requirement determines whether the legal or factual position of the named plaintiff “is markedly different” from the position of other class members. Courts may consider whether the named plaintiff is subject to a unique defense.

D. Adequacy

Adequacy requires the plaintiff to show that “the representative parties will fairly and adequately protect the interests of the class” and seeks to uncover conflicts of interest between named parties and the class they seek to represent. Intra-class conflicts may arise when members seek conflicting remedies or some of the class members actually benefit from the challenged conflict. Some courts also address whether the class members’ attorneys are competent through the adequacy requirement though some may address that under Rule 23(g).

E. Rule 23(b)(3)’s Predominance and Superiority Requirements

An attorney representing a class of purchasers who purchased tokens in ICO will more than likely, as plaintiffs did in the Tezos case, seek to certify a damages class under Rule 23(b)(3). This rule requires the plaintiff to establish predominance and superiority. Rule 23(b)(3) requires the court to find that “questions of law or fact common to class members predominate over any questions affecting only individual members.” To generally meet the predominance requirement, a court must analyze the elements of the parties’ claims and defenses and the nature of the evidence that will



be presented at trial, compare the relative importance of the contested issues in the case, and make some prediction as to how specific issues will play out. A court may find a lack of predominance if the plaintiffs cannot prove injury, causation, or an element of a substantive claim on a classwide basis. Predominance may also be lacking if the defendant can assert individualized defenses to class members' claims or different state laws with material variations apply to different class members' claims but the mere existence of individualized damages likely would not preclude certification.

The rule also requires the court to find that "a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include: (A) the class members' interests in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already begun by or against class members; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (D) the likely difficulties in managing a class action." The superiority requirement ensures that classes will only be certified under Rule 23(b)(3) if, as the United States Supreme Court has stated, they will "achieve economies of time, effort, and expense, and promote . . . uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results."

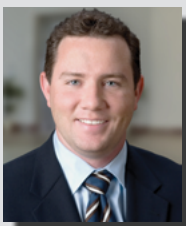
A court may compare whether individual actions against the founders of an ICO would be superior to a classwide trial.

Superiority may fail if there is a wide variation in state laws, an inability to identify or provide notice to class members, or a large number of individualized inquiries. Because the causes of action may implicate federal securities laws, breach of contract, and consumer protection laws (assuming there is not a nationwide consumer protection act claim), plaintiffs may make some arguments for this requirement when trying to certify a class. Obviously, the likelihood of certification will depend on the ICO and underlying fact and what has been pled by the class representatives' attorneys.

Conclusion

Given the amount of fluctuations in the price of crypto currencies and the fact that many people paid for tokens of blockchain based start-ups, we have only likely begun to see the beginning of class action lawsuits filed relating to blockchain related companies or companies that participated in ICOs. Because anyone with an idea for a project can gain massive financial backing without going through the formalities of an IPO, there are obvious chances for the public to be scammed, leading to potential lawsuits. In light of the recent statements and enforcements actions by the SEC and the CFTC and the recent class actions brought against token issuers, we believe it is highly likely other issuers of tokens will face class action lawsuits. Any company planning to conduct a token offering using an ICO should proceed with caution. Similarly, anyone looking to invest in a token offering should make sure the offering is conducted in compliance with applicable state and federal laws.

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