After Token Rush: International Litigation and Initial Coin Offerings (ICO) – Part 1

Between the end of 2016 and the beginning of 2017, many things that we thought were impossible happened. Among them was the meteoric rise of Initial Coin Offerings (***ICO***), an unprecedented development in the fields of venture capital, blockchain technologies and corporate finance law. This post considers some of the international litigation questions that arise out of the phenomenon, especially in light of the recent proliferation of ICO-related court cases.

<u>What is an ICO?</u>

ICOs are a crowdfunding instrument for startup companies. While the details may vary depending on the project, most ICOs are based on the same structure: a startup company is seeking to raise capital to develop a project, typically concerning distributed ledgers and other Blockchain-related technologies. Rather than resorting to more traditional methods to raise capitals, the startup advertises its project in a "*white paper*", where the company's agenda for future technological

and commercial development is described and a minimum amount of funds necessary for the project is set. Investors (and especially retail investors) are invited to support to the startup by buying "*tokens*", arguably the Blockchain equivalent of securities. The procedure whereby the investors contribute their money and receive the tokens is normally regulated by a document, sometimes called "*Contribution and Token Allocation Terms*", setting forth the ICO general terms and conditions. The ICO campaign lasts for a limited period of time, at the end of which the funds coming from the investors should be used to undertake the project, as long as the minimum threshold is reached; if, instead, the funds are insufficient, the ICO is unsuccessful, and the money should be returned to the investors.

Tokens are digital items registered on a blockchain. The investors will be able to benefit from the tokens once the startup project comes to fruition: they may be used as a fiat currency, or entitle holders to receive services of goods, or have some other kind of purpose, depending on the terms of the ICO. And, most importantly, tokens are tradable: investors can exchange them on the secondary market, and thus do not necessarily need to wait until the startup has completed its project.

In 2017, startup companies raised a staggering USD 6 billion through ICOs; the price of Ethereum, the cryptocurrency most frequently used to buy tokens, went from USD 9,70 on 1 January 2017 to USD 1.016,50 on 1 January 2018. For a short period of time, ICOs seemed destined to subvert the landscape of corporate finance, funding a wave of innovation-driven ideas that would disrupt the world as we know it. In the words of the Bard, "*when the sea was calm, all boats alike showed mastership in floating*". Pretty soon, however, waves became to appear. In some cases, the idea underlying the ICO proved to be unviable or unrealistic: the instrument of ICOs was used to fund a wide range of projects, many of which quickly turned

out to be unsuccessful. Furthermore, regulators (such as the Securities and Exchange Commission in the United States) turned their attention to the phenomenon, suggesting that tokens qualified as securities and that, hence, many ICOs violated securities law.

From Enthusiasm to Litigation

At the end of 2017, lawsuits began to be filed against legal entities that had conducted ICOs. The causes of action vary, including securities fraud, false advertisement, unfair competition, breach of contract and breach of consumer law. A notable example is the one of the *Tezos* ICO. In 2017, the *Tezos* ICO raised USD 232 million, which investors paid in exchange for tokens called "*tezzies*". Despite the remarkable initial success, the *Tezos* project quickly turned controversial, also due to an internal dispute for the control of the foundation that conducted the ICO. At the time of writing, several class actions concerning the *Tezos* class action have been filed[1], and a United States District Judge for the Northern District of California denied a motion to dismiss filed by the defendants[2].

While probably the most notable case to date, *Tezos* is not the only case of an ICO resulting in court litigation. A number of other cases have been filed in US courts[3]. and the same trend is likely to spread to other jurisdictions as well, given that investors from all over the world were attracted to ICOs in 2017. These cases raise a number of very interesting and largely unresolved legal issues, such as the nature of tokens, the legal qualification of the transaction (sometimes labeled as a donation) whereby funds are exchanged for tokens and the applicability of consumer law. It is, of course, not possible to analyse all of these problems in detail in a single blog post. However, it is interesting to focus on the private international law problems raised by this type of litigation, in order to consider different solutions that may be adopted

by courts in the United States and, in a not so distant future, also in Europe.

The International Dimension

An obvious problem arising out of cases such as *Tezos* is the one of jurisdiction, especially in scenarios where the entities conducting the ICO are not located in the same state where the litigation is pending. In the United States, in cases where general jurisdiction does not attach to the defendant, the law imposes three requirements for personal jurisdiction to exist[4]: (i) the defendant must purposefully direct his activities or conduct transactions with the forum or a resident thereof; (ii) the claim must arise out of these activities; (iii) the exercise of jurisdiction must be reasonable. In light of these criteria, specific personal jurisdiction may arguably be established if, for instance, the ICO was advertised on a website hosted on a server located in the forum, which marketed the ICO to retail investors resident in the forum.

Looking at the same problem from the point of view of EU law, in cases where jurisdiction may not be established on the basis of the general head of Article 4(1) of Regulation (EU) No 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the ***Brussels I bis Regulation***), some guidance as to the establishment of special jurisdiction may be found in *Kolassa*[5]. In that case, the Court of Justice of the European Union (the ***CJEU***) held that consumer jurisdiction can be established in accordance with Articles 15 and 16 of Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the ***Brussels I Regulation***) – corresponding to Articles 17 and 18 of the Brussels I *bis* Regulation – only if a direct contractual relationship exists between the securities issuer and the consumer. Transposing this reasoning

to the field of ICOs, then, claimants may only invoke the protective head of consumer jurisdiction if they acquired the tokens (as non-professional investors) directly from the entities conducting the ICO (and not, conversely, if the tokens were purchased on the secondary market). The same line of reasoning would probably apply to special jurisdiction in contractual matters, as *Kolassa* seems to entail the existence of a privity requirement, which would of course be absent in cases where the claimant did not acquire the tokens directly from the respondent. The door, however, could potentially remain open for tortious jurisdiction (Article 7(2) of the Brussels I *bis* Regulation / Article 5(3) of the Brussels I Regulation). Drawing on its previous case-law, the CJEU held in *Kolassa* that, while the mere fact of having suffered financial damage is not enough to establish tortious jurisdiction at a given location, Member State courts have jurisdiction when the "*damage alleged occurred directly in the applicant's bank account held with a bank established within the area of jurisdiction of those courts*"[6]. Adapting the same reasoning to the case of ICOs, the courts of a Member State may possibly have jurisdiction under Article 7(2) of the Brussels I *bis* Regulation, if the private encryption key through which an investor accessed her/his (*e.g.* Ethereum) wallet was stored on a device located in that Member State. It must be noted, though, that the analogy is not perfectly fitting, since the decentralised nature of Blockchain technologies is not entirely comparable with the structure of bank accounts, and physical location of the assets may thus only indirectly be established by assessing where the private key was stored, rather than looking directly at the tokens, or the funds (*e.g.* Ether) through which those tokens were acquired, which essentially exist on a global and non-localised distributed ledger. Furthermore, the CJEU itself distinguished *Kolassa* in the *Universal Music* judgment[7], holding that for tortious jurisdiction to exist the location of a bank account is not sufficient in and of itself, further

factual circumstances being necessary to this end. Thus, given that the physical location of a private encryption key may be difficult to determine in practice and easy to manipulate for *forum shopping* purposes, no certainty exists in practice as to the applicability of Article 7(2) to the case of security fraud actions brought by tokenholders who have acquired the tokens on the secondary market. In the near future, further guidance on the matter may be given by the CJEU in the *Löber* case[8].

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The second part of this article is available here.

[1] *In re Tezos Sec. Litig.*, No. 17-CV-06779-RS, 2018 WL 2387845 (N.D. Cal. May 25, 2018); see also *Baker v. Dynamic Ledger Sols., Inc.*, No. 17-CV-06850-RS, 2018 WL 656012 (N.D. Cal. Feb. 1, 2018); *MacDonald v. Dynamic Ledger Sols., Inc.*, No. 17-CV-07095-RS, 2017 WL 6513439 (N.D. Cal. Dec. 20, 2017); *Okusko v. Dynamic Ledger Solutions, Inc. et al.*, Case No. 17-cv-6829; *GGCC, LLC v. Dynamic Ledger Sols., Inc.*, No. 17-CV-06779-RS, 2018 WL 1388488 (N.D. Cal. Mar. 16, 2018).

[2] Order on Defendant's Motion to Dismiss, available at here.

[3] *Rensel v. Centra Tech Inc., et al.*, 17-cv-24500-JLK (S.D. Fla.); *Hodges, et al. v. Monkey Calital, LLC, et al.*, 17-81370 (S.D. Fla.); *Balestra v. ATBCOIN, LLC, et al.*, 17-10001 (S.D.N.Y.); *Stormsmedia, LLC v. Giva Watt, Inc., et al.*, 17-00438 (E.D.Wash.); *Davy, et al. v. Paragon Coin, Inc., et al.*, 18-00671 (N.D.Cal.).

[4] *Schwarzenegger v. Fred Martin Motor Co.*, 374 F.3d 797, 802 (9th Cir. 2004).

[5] Case C-375/13, *Harald Kolassa v. Barclays Bank plc*, ECLI:EU:C:2015:37.

[6] Case C-375/13, *Harald Kolassa v. Barclays Bank plc*, ECLI:EU:C:2015:37, paras 42-57.

[7] Case C-12/15, *Universal Music International Holding BV v. Michael Tétreault Schilling and Others*, ECLI:EU:C:2016:449, paras 36-39. See also the AG Opinion in the same case, ECLI:EU:C:2016:161, paras 44-45.

[8] Case C-304/17, *Löber*; see AG Opinion, ECLI:EU:C:2018:310, in particular paras 68-81, also with reference to Gargantini, M., "*Capital markets and the market for judicial decisions: in search of consistency*", MPILux Working Paper 1, 2016, p. 18; Lehmann, M., "*Prospectus liability and private international law – assessing the landscape after the CJEU Kolassa ruling (Case C-375/13)*", Journal of Private International Law, 2016, p. 318, at p. 331; Cotiga, A., "*C.J.U.E., 28 janvier 2015, Harald Kolassa c. Barclays Bank PLC, Aff. C-375-13*", Revue internationale des services financiers,2015, p. 40, at pp. 48 to 49.

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