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## Cryptocurrency Class Action Lawsuits: A New Frontier

By Michael S. Foster, Mark A. Olthoff, and Richard B. Levin

Cryptocurrencies, like Bitcoin and Ethereum<sup>1</sup>, had a breakout year in 2017. The price of Bitcoin rose from approximately \$1,000 per Bitcoin on January 1, 2017, to \$13,000 per Bitcoin on December 31, 2017, with a high of approximately \$20,000 per Bitcoin. Ethereum increased from approximately \$10 per Ether to \$755 during the same time period. Both Ether and Bitcoin are used by investors to buy into Initial Coin Offering (“ICO”) opportunities, which are similar to Initial Public Offerings (“IPOs”) and were an extremely popular way of raising capital in exchange for “crypto tokens” in 2017. **These ICOs, however, have spurred recent class action lawsuits.**

Given the wide fluctuations in the price of cryptocurrencies—and recent precipitous drop—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 financial backing without going through the formalities of an IPO, there are obvious chances for the public to be scammed, leading to potential lawsuits.

**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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<sup>1</sup> In extremely simple terms, Bitcoin and Ether are a digital unit of value on a distributed online ledger. The ledger is what is known as the blockchain. No single institution controls the cryptocurrency market. And, while governmental agencies have sat on the sidelines for the first few years, this is no longer the case. Many regulators have their eye on the industry, including the Commodities Futures Trading Commission, Securities and Exchange Commission, and state agencies.



## Initial Coin Offerings

In the last 12 months, there has been an explosion of sales of digital tokens through ICOs that are viewed by regulators in many jurisdictions as a form of crowdfund investing using cryptocurrencies. These ICOs often raise money through whitepapers that generally describe the individuals involved in the project, provide details on the project to be developed and seek the public to assist in its development by offering its tokens in exchange for cryptocurrencies. The ICO's founders may also put together a webpage and make forum posts touting the project. ICOs raised approximately \$4 billion in 2017 alone, outpacing all venture capital raised in the United States.

## Recent Class Actions Against Token ICO Issuers

In October and November 2017, four class action lawsuits were filed against Dynamic Ledger Solutions, Inc., the founders of the Tezos project, the Tezos Foundation established to conduct the Tezos ICO, and others.<sup>2</sup> These class action lawsuits arise out of an ICO that raised approximately \$232 million (of cryptocurrency) in exchange for tokens known as Tezzies, which 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 was delayed and the futures price for the Tezos token fell, losing nearly 50 percent of its value. The lawsuits also allege that the defendants misrepresented how the funds used during the ICO would be spent, when the Tezos network would be running (similar to the Butterfly Labs matter), and that the Tezzies should have been registered with the SEC. The causes of actions in the lawsuits vary, as two of the suits merely allege violations of the Securities Act and the other two contain various causes of action, including state law false advertising, unfair competition and deceptive trade practices act claims as well as seeking rescission and alter ego liability.

<sup>2</sup> 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).

Several other lawsuits started near the end of 2017 and in early 2018:

- On December 13, 2017, another class action was filed, this time against Centra Tech, Inc., and the individuals involved in the Centra ICO.<sup>3</sup> In this complaint, the plaintiff alleged that the 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 Visa and MasterCard, as well as listing fake team members on its website.
- 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.<sup>4</sup>
- 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.<sup>5</sup>
- On December 28, 2017, investors in the Giga Watt ICO filed a class action lawsuit alleging the tokens had all the makings of a security, yet the company did not register the coins with regulators.<sup>6</sup> Giga Watt held its ICO to raise money to build a cryptocurrency mining facility. Like the Butterfly Labs matter, the plaintiffs alleged that it was unclear whether the mining project remained in development and would ever be fully developed.
- On January 30, 2018, a cryptocurrency marijuana startup was hit with a \$70 million dollar class action relating to allegations that the defendants violated United States securities laws.<sup>7</sup>

<sup>3</sup> See *Rensel v. Centra Tech Inc., et al.*, 17-cv-24500-JLK (S.D. Fla.).

<sup>4</sup> 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.

<sup>5</sup> See *Balestra v. ATBCOIN, LLC, et al.*, Case No. 17-10001 in the U.S. District Court for the Southern District of New York.

<sup>6</sup> 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.

<sup>7</sup> 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.





## Analysis of Potential Token Class Actions

**The thread running through many ICO models is that they are often sold in a manner that may be contrary to state and federal securities laws.** For example, the company that puts together the ICO receives cryptocurrencies during the ICO sale (usually a short period of time—typically one month or less) and tokens are then issued to those people or entities who contributed to the ICO. The cryptocurrency raised through the issuance of the tokens is then (or is supposed to be) used to advance the project. **ICOs, therefore, may be fodder for lawsuits by investors alleging harm by being taken advantage of by the founders and the lack of regulatory oversight.**<sup>8</sup>

The Terms and Conditions of the ICO may attempt to 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 also 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 could be Exhibit A to any class action complaint or at trial.

Why is a class action a potential risk? 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. Numerosity would likely be established in a class action involving an ICO because there may be hundreds, if not thousands, of putative class members. 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. Common questions relating to ICOs gone bad could surround 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.

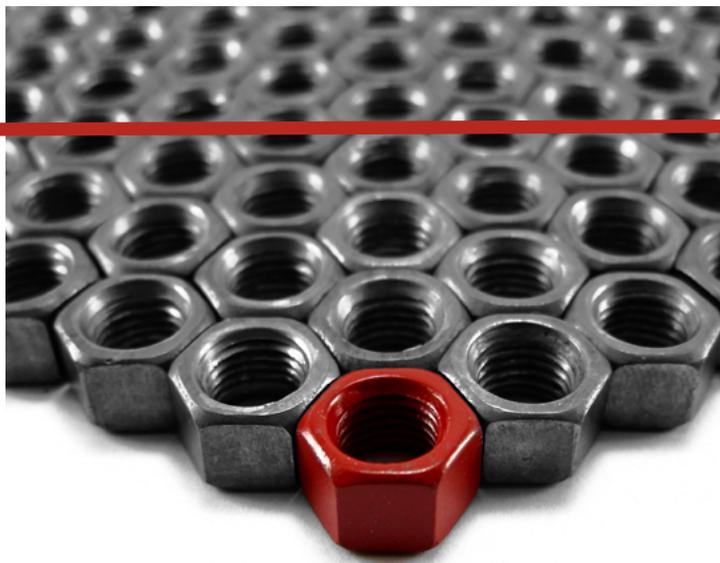
A court may also compare whether individual actions against the founders of an ICO would be superior to a classwide trial. Predominance and superiority may fail if there is a wide variation in state laws, an inability to identify or provide notice to class members, or a large number of individualized inquiries. But, 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 argue this requirement is satisfied when trying to certify a class. The likelihood of certification will depend on the particular ICO, underlying facts and what has been pled in the Complaint.

## For More Information

For questions regarding this alert or to learn more about how it may impact your business, please contact one of the authors, a member of our Class Action practice, or your Polsinelli attorney.

<sup>8</sup> 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.





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