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The 1st Judicial Finding That Digital Tokens Are Securities

By **Deborah Meshulam, Benjamin Klein and Richard Kelley** (July 11, 2018, 2:03 PM EDT)

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On June 25, 2018, a magistrate judge in Florida issued a report in a class action — Rensel v. Centra Tech Inc. — finding that tokens issued and sold by technology startup Centra Tech were investment contracts. While the report and its recommendations are not final until approved by a district court judge, it appears to be the first judicial finding that a company's issuance and sale of tokens through an initial coin offering, or ICO, must comply with federal securities laws.

Background and Procedural History

On Dec. 13, 2017, plaintiff Jacob Rensel filed a class action against Miami-based Centra Tech as well as its founders and president (collectively, defendants) in the U.S. District Court for the Southern District of Florida. Rensel claimed that the defendants violated federal securities laws, including Section 12(a) and 15(a) of the Securities Act, by selling unregistered securities in the form of Centra Tokens, or CTR Tokens. The three cofounders of Centra Tech are also battling parallel actions filed earlier this year by the U.S. Securities and Exchange Commission and the U.S. Department of Justice in Manhattan federal court as a result of their ICO token sales.

From July 30, 2017, through Oct. 5, 2017, the defendants allegedly raised over $30 million in digital cryptocurrencies through the sale of CTR Tokens. According to the complaint, the purpose of the ICO was to raise capital to develop a suite of technology products, including the Centra Debit Card, the Centra Wallet, and an online market place called cBay. The defendants allegedly promoted Centra Tech as a company that would revolutionize the way people store and spend cryptocurrency.

On April 5, 2018, Rensel renewed his motion seeking a temporary restraining order, an asset freeze, a document preservation order, and an order for other relief. For the purpose of the motion, the defendants conceded that their CTR Tokens were securities. They reserved their right to challenge that classification if necessary at a later time.

Application of the Howey Test to CTR Token Sales

On June 25, 2018, Chief Magistrate Judge Andrea Simonton issued a report and recommendation finding that the CTR Tokens offered and sold by the defendants were investment contracts governed by federal securities laws. Even though the defendants conceded for purposes of the motion that the CTR Token sales at issue were securities, Judge Simonton conducted an independent assessment of whether the CTR Tokens were securities under the U.S. Supreme Court's Howey test, which provides that an investment contract requires (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) derived primarily from the efforts of others.

First, Judge Simonton found that the "investment of money" requirement was satisfied because investors committed assets — in the form of cryptocurrencies — to the venture. The purchasers of CTR Tokens thereby subjected themselves to the risk of financial loss.

Next, she found that the "common enterprise" requirement was satisfied because the fortunes of the investors were "interwoven with and dependent upon the efforts and success of those seeking the investment" and investors could not exert control over the success or failure of their investments. Judge Simonton noted that the fortunes of individual investors were directly tied to the ability of Centra Tech to successfully develop and deliver on their promised technology, and that "individual investor[s] could exert no control over the success or failure of [their] investment."

Finally, Judge Simonton found that Howey's "efforts of others" requirement was satisfied "because the success of Centra Tech and the Centra Debit Card, CTR Tokens, and cBay that it purported to develop was entirely dependent on the efforts and actions of the Defendants." As a result, Judge Simonton concluded that the defendants offered and sold securities — in the form of investment contracts — through the ICO.

Absent from Judge Simonton's report was any discussion of Howey's expectation-of-profits requirement. When performing a Howey analysis, courts typically include a finding that the purchaser had a reasonable expectation that they would receive a profit or benefit in exchange for their investment. However, Judge Simonton appears to have been satisfied that the Howey test was met absent a specific analysis of whether Rensel had an expectation of profits.

Impact and Implications

The precedential value of Judge Simonton's finding that CTR Tokens are securities, made in the context of a temporary restraining order motion and without the benefit of a trial, remains an open question since her report has not yet been adopted by the district court and her findings may be treated as dicta. Nonetheless, her assessment of the Howey factors could serve as a road map for the evaluation of token sales in other cases, including the parallel SEC civil and DOJ criminal proceedings involving Centra Tech's three co-founders. In those cases, federal regulators have accused the co-founders of launching a "fraudulent ICO" in violation of federal securities laws. The SEC complaint and the DOJ indictment accuse them of touting nonexistent relationships with credit card companies, fabricating the identity of a CEO, and leveraging paid celebrity promotions. In those cases, Centra Tech's co-founders have yet to challenge the government's allegations that CTR Tokens are securities.

The courts that are currently evaluating whether tokens qualify as securities are focusing their attention on nonfunctional token sales tainted by fraud allegations. In the instant case, CTR Tokens had no utility at the time of their sale and the promised technology had yet to be developed. Additionally, the government has accused the cofounders of defrauding the public — lying about relationships with credit card companies, misrepresenting their executive management, and engaging in other deceptive behavior.

The DOJ has leveled similar fraud allegations in another case — United States v. Zaslavskiy — that will likely offer the next glimpse at how the courts are approaching and analyzing token sales. In Zaslavskiy, a Brooklyn federal judge is considering whether the sale of nonfunctional tokens qualify as securities. The SEC is pursuing a parallel action against Zaslavskiy and others. Similar to the Centra Tech enforcement action, the government has accused Zaslavskiy and his companies of engaging in fraud, including material misstatements and misrepresentations.

The Centra Tech and Zaslavskiy matters are helping to shape a body of law that courts will look to when faced with deciding the more challenging question of whether functional utility tokens sold in the absence of fraud are securities. The crypto industry must take note and prepare itself for an environment where bad facts will likely make bad law. These early judicial determinations will, at least temporarily, muddy the waters for other industry participants.

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