

Blockchain Meets Morrison: Court Rejects Blockchain Class Settlement Because of Concerns About Adequacy of Representation

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The U.S. District Court for the Southern District of New York recently rejected a proposed settlement of a securities class action involving purchasers of digital tokens due to concerns about whether the lead plaintiff had adequately represented the class for settlement purposes. Judge Lewis A. Kaplan held in [Williams v. Block.one](#) that the federal securities laws did not appear to apply equally to all class members' token purchases and that the lead plaintiff had not produced evidence showing that its own purchases were (or were not) subject to the securities laws in a proportion similar to other class members' purchases.

The *Williams* decision highlights the complexity of applying to blockchain transactions the Supreme Court's transactional test for determining the securities laws' applicability. Those factual complexities could increase the difficulty of litigating or settling securities-law class actions involving classes of digital-coin purchasers.

Legal Background

For several decades before the Supreme Court's 2010 decision in *Morrison v. National Australia Bank*, courts had allowed securities plaintiffs to bring claims under the federal securities laws – regardless of where the securities transactions had occurred and regardless of the plaintiffs' residence or nationality – based on some version of the “conduct or effects” test. That test examined whether significant wrongful *conduct* related to non-U.S. securities transactions had occurred in the United States or whether wrongful conduct outside the United States had had a substantial *effect* on U.S. markets or investors.

In 2010, the Supreme Court threw out the “conduct or effects” test and announced a new “transactional” test for determining the federal securities laws’ reach. *Morrison* held that the securities laws apply only to alleged misstatements or omissions made “in connection with the purchase or sale of [i] a security listed on an American stock exchange, and [ii] the purchase or sale of any other security in the United States.” Most of the subsequent litigation has involved the second prong, for transactions in unlisted securities. In 2012, the Second Circuit – in a widely adopted ruling – held in *Absolute Activist Value Master Fund Ltd. v. Ficeto* that a transaction in unlisted securities is “domestic if irrevocable liability is incurred or title passes within the United States.”

Factual Background

The *Williams* plaintiffs asserted federal securities-law claims against defendants in connection with Block.one’s initial coin offering. Plaintiffs alleged that Block.one’s tokens were securities and that defendants had violated the securities laws by not registering the securities with the SEC and by making false or misleading statements to the public. Defendants contended that the tokens were not securities, and they had tried to prevent direct purchases by U.S. investors (although the court observed that “this prohibition was easily circumvented”).

The parties reached a proposed settlement while defendants’ motion to dismiss was pending. The settlement covered all purchasers of Block.one’s tokens during the class period and provided for a cash payment that would be shared *pro rata* among all class members regardless of whether the federal securities laws applied to each individual class member’s token purchases.

The court preliminarily approved the proposed settlement, but, after receiving further briefing, it requested additional information on the percentage of the lead plaintiff’s and the class members’ token purchases that were and were not subject to the federal securities laws under *Morrison* and *Absolute Activist*. The court ultimately declined to approve the proposed settlement because it concluded that the lead plaintiff had not established that it could adequately represent the class “in light of questions regarding the proportion of Lead Plaintiff’s purchases of tokens which were domestic – and therefore covered by the securities laws and eligible for a damages award – compared to the proportions of domestic purchases by the absent class members.”

The Court's Decision

To determine whether the lead plaintiff could adequately represent the class, the court first needed to consider which token purchases were and were not covered by the securities laws.

The easier part of that analysis involved *Morrison's* first prong, for listed securities. The court noted that the SEC had determined that at least one cryptocurrency exchange on which Block.one's tokens traded (Poloniex) was a national securities exchange.

Accordingly, class members who had purchased their tokens "on a domestic exchange such as Poloniex" *might* be able to recover damages under the federal securities laws.

The harder question, as usual, involved *Morrison's* second prong: whether tokens *not* purchased on a national securities exchange could be subject to the securities laws as domestic transactions. That question turned on whether "irrevocable liability" as between the purchaser and the seller had been incurred in the United States. The court expressed its view that "a transaction by transaction approach seems appropriate to determine whether off-domestic exchange blockchain transaction are domestic or foreign under the second prong of *Morrison*." "In general, 'irrevocable liability' is incurred when the transaction has been verified by at least one individual node of the blockchain. Accordingly, the location of the node that verified the specific transaction at issue should control in this circuit under *Morrison's* second prong as construed in *Absolute Activist*."

However, the court did not need definitively to conclude whether that test should apply because the lead plaintiff had provided "little to no information . . . regarding the proportion of its transactions which were domestic as compared to those of the absent class members." The court therefore could not determine whether the lead plaintiff could adequately represent the class.

The court was concerned that the lead plaintiff, “in view of the proportion of its investments made in domestic versus foreign transactions, may have an incentive to accept a lower settlement offer than would have been insisted upon by absent class members who purchased only or more predominantly in domestic transactions.” The lead plaintiff thus might have “had an incentive to take a bigger ‘haircut’ on the aggregate settlement price than would have existed for class members who had higher proportions of domestic purchases.” This potential intraclass conflict prevented the lead plaintiff from adequately representing the class.

Implications

The *Williams* decision raises at least two sets of issues that might play out in future litigation: questions concerning the securities laws’ applicability to blockchain transactions and questions about structuring a putative class for litigation or settlement purposes.

On the substantive securities-law question, the court did not issue a definitive ruling, although it expressed its view on how *Morrison* and *Absolute Activist* should apply to blockchain transactions. The court criticized other decisions that had focused on the purchaser’s location at the time of the transaction because, under Second Circuit precedent, “the purchaser’s location is not determinative of the situs of a transaction in non-blockchain transactions.” The court also disagreed with an approach holding that a blockchain transaction becomes irrevocable “‘only after it was validated by a network of global “nodes”’” and examining whether that network of global nodes was “‘clustered more densely in the United States than in any other country.’” In the *Williams* court’s view, “each blockchain transaction becomes irrevocable *for the purchaser and seller* when the transaction has been cryptographically validated by a single node.” Thus, “the location of other nodes on the blockchain that later may accept the transaction does not properly bear on when and where ‘irrevocable liability’ as between the purchaser and the seller is incurred.” This debate might continue in future blockchain cases.

On the procedural question, the *Williams* decision highlights the importance of ensuring that the lead plaintiff's interests are aligned with, and do not potentially conflict with, those of other class members. Perhaps the court's concern could have been assuaged if the class had been represented by several lead plaintiffs with significantly different proportions of U.S. and non-U.S. token transactions. The court observed that the settlement of the *Petrobras* securities class action – which also had involved U.S. and non-U.S. transactions – had had three named plaintiffs, each represented by separate counsel. Two of those plaintiffs had purchased only in domestic transactions, but they did not object to equal treatment of class members who had purchased in non-U.S. transactions. That acquiescence reduced concerns about intraclass conflicts between domestic and non-domestic purchasers. However, the *Williams* court noted that the non-U.S. claimants' transactions in *Petrobras* had constituted only about 2% of the settlement class – a relatively *de minimis* amount. Thus, the *Petrobras* decision might be distinguishable when the non-U.S. transactions constitute a significant percentage of the class, even if the domestic and the non-U.S. purchasers have separate counsel. Moreover, the court noted that, unlike in the *Williams* case, the classwide *Petrobras* settlement “does not appear to have been reduced to account for the presence of foreign claims.” Questions about adequacy of representation in class-action settlements covering transactions that are and are not subject to the federal securities laws will therefore continue to need careful attention and, depending on the facts, might require appropriate subclassing to protect all class members' differing interests.

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