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Fraud Claims Against Token Issuer Dismissed Based on Disclosures to Accredited Investor

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The organizers of an initial coin offering (ICO) recently won dismissal of an investor's fraud claims by establishing that their public risk disclosures negated the investor's claims of reliance on alleged misstatements. The project, a video service provider's ICO, was governed by a purchase agreement called a "Simple Agreement for Future Tokens" ("SAFT"). The plaintiff investor later lost his entire investment as the token collapsed, allegedly due to the provider's decision to scrap its initial plans for a decentralized platform and move to a permissioned blockchain (and also the provider's choice to seek additional capital via a "Regulation A" public offering). The New York court found that even if certain representations made by the issuer regarding the prospect of a decentralized network were actionable, the Plaintiff had not plausibly alleged "reasonable reliance" on such representations in signing the SAFT. (*Rostami v. Open Props, Inc.*, No. 22-03326 (S.D.N.Y. Jan. 9, 2023)).

In September 2017, Open Props, Inc. ("Open Props") it announced that it was creating a new cryptocurrency called "Props Tokens," which would power a new "decentralized digital media ecosystem" called "Rize." Open Props conducted an ICO and sold Props Tokens to investors under terms governed by SAFTs. Generally speaking, a SAFT is an investment contract offered to accredited investors to raise capital at the pre-sale/pre-functionality stage and entitles purchasers to the promise of the future delivery of the underlying token (typically before a specific deadline), say, when the project goes live. SAFTs can contain different terms related to refund rights, termination, disclaimers, deadlines, token definition and resale restrictions, among other things. As noted by the court, the SAFT in the instant case expressly stated that the Props Token "is a security."

In January 2018, Plaintiff Romein Rostami ("Plaintiff") entered into a SAFT with Open Props, purchasing the right to buy a certain amount of tokens upon the launch of the Rize ecosystem and related Props Tokens. The Plaintiff subsequently signed an amended SAFT extending the deadline date by one year, declining his right of redemption at that time. Fast forward to March 2019 and Plaintiff received Props Tokens pursuant to the Amended SAFT, and soon after Open Props published a whitepaper, which, according to Plaintiff, "removed discussion of a decentralized platform and indicated that the Props Network would transition going forward as a permissioned blockchain." As a result, Plaintiff alleged that, "[b]y not making the [Props] network decentralized, Defendants made it impossible for investors and token holders to maintain the network on their own." [Thus], according to Plaintiff, "Props tokens could no longer be traded because a platform no longer existed," rendering them 'completely worthless'". Plaintiff further alleged that Open Props then "decided to raise additional capital" through a "Regulation A" public offering with the SEC, thus making the Props token a security. Plaintiff deemed this maneuver, which he considered not legally or contractually required, as an "off ramp" for the previous pre-sale of tokens. In August 2021, Open Props published a letter announcing that it was ending its issuance of Props Tokens.

In April 2022, Plaintiff brought an action against Open Props, Inc. and its officers (collectively "Defendants"), asserting claims for fraudulent inducement, unjust enrichment and related state claims. Defendants then filed a motion to dismiss, which was granted, with leave to amend (note: on February 6, 2023, Plaintiff filed a First Amended Complaint).

The New York court stated that, even if Plaintiff has pled actionable misrepresentations made by Defendants during the promotional phase for the tokens regarding their intent to create a decentralized protocol, which Plaintiff alleged were a key factor in his decision to invest, such allegations otherwise fell short of the heightened pleading standard applicable to fraud claims. According to the court, “although Defendants publicly expressed their vision for creating a ‘decentralized’ Props network, Plaintiff—an accredited investor—cannot establish reasonable reliance on those statements alone.” In looking at the totality of the transaction to gauge reasonable reliance, the court found that Plaintiff was “privy to multiple pieces of information that communicated the inherent risks of the Props investment,” including pre-SAFT whitepapers that stated: “The ultimate implementation of the PROPS Ecosystem is dependent upon several factors and risks outside of the control of [Defendants], including regulatory risks, contributor participation [and the adoption of blockchain technology…]”. The SAFT itself provided that “the Purchaser . . . is able to incur a complete loss of such investment without impairing the Purchaser’s financial condition….” The court therefore concluded that Plaintiff, an accredited investor, failed to establish reasonable reliance on such statements.

The court also determined that Plaintiff failed to plead fraudulent intent, rejecting Plaintiff’s argument that Open Props’s decision to obtain additional funding from non-SAFT, non-accredited investors via a Regulation A offering evinced some sort of scheme to abandon the project. The court stated that: “Defendants had always represented that Prop Tokens constituted securities, so Defendants’ continued efforts to comply with SEC regulations do not plausibly raise an inference that they intended to mislead investors.” The court made quick work of the Plaintiff’s unjust enrichment claim, finding nothing “unjust” about Plaintiff’s investment in Props Tokens and nothing in equity that would mandate a return of Plaintiff’s funds “simply because the inherent risks of that investment were realized.”

This litigation dates back to the 2017 boom days of crypto ICOs, which quickly became a popular method to participate in investment opportunities or raise capital from investors around the world. As a fundraising event, an ICO allowed an web3 entity to offer participants a unique “coin” or “utility token” in exchange for consideration, often in the form of virtual currency or fiat currency. ICO proceeds typically were designed to fund the development of a new web3 start-up or product, with investors at the time typically believing in the possibility of outsized returns based on future increases in the token’s secondary market value on exchanges. While a number of offerings were legitimate projects (separate and apart from securities law compliance), many ICOs were outright financial scams. Both types of offerings quickly attracted regulatory scrutiny, particularly from the SEC, and appetite for this type of unregistered offering eventually cooled.

Interestingly, SAFTs themselves have also attracted scrutiny from the SEC. Generally speaking, a SAFT is a “pre-sale” of tokens that entitles investors to the promise of receipt of tokens on a future date, a transaction that is typically viewed as an investment contract, or “security” by issuers. But the question arises which parts of the transaction involve “securities” – Only the SAFTs themselves? The issued tokens? Or are both considered an integrated whole? In prior disputes, the SEC and courts have treated the pre-sale SAFTs and the public distribution of tokens as one event.[1] In one particular SEC settled enforcement from 2021, the respondent Wireline Inc. offered and sold digital assets through SAFTs but the offering was not registered pursuant to federal securities laws and did not qualify for an exemption and, according to the SEC, Wireline distributed marketing materials that materially misrepresented the functionality of its platform and the timing of the token distribution. In a concurrence to the settlement, Commissioner Hester Peirce supported the enforcement action based on the alleged securities violations and misrepresentations with respect to the SAFT, but expressed her concern about how “[t]he Commission and courts have treated the token as inseparable from the SAFT by treating the pre-sale and public distribution of tokens as one event.” She concluded by noting: “A better course would be for us to treat the original capital-raising event for an unlaunched network as a sale of securities, but not to stretch the securities analysis to include subsequent sales of tokens for use on a launched network.”

[1] See e.g., *SEC v. Kik Interactive Inc.*, 492 F. Supp.3d 169 (S.D.N.Y. 2020) (SEC complaint asserted that Kik offered and sold unregistered, non-exempt “investment contracts” in violation of securities laws: “Although Kik’s SAFT specifically stated that the SAFT was itself a security, it failed to state that the [underlying token] Kin to be delivered under the SAFT were securities sold pursuant to the SAFTs. And although Kik’s PPM [private placement memorandum] claimed that the offer and sale of the SAFTs were subject to an exemption from registration…Kik did not claim any exemption for the offer and sale of Kin through the SAFT”; the New York court granted the SEC’s motion for summary judgment and also stated that Kik’s private pre-sale SAFT and its public token sales were a single integrated offering subject to SEC registration requirements; the parties later reached a $5 million settlement).

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