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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Open Questions After Elastos Crypto Class Action Settlement

By **Bradley Simon** (February 16, 2024, 2:02 PM EST)

Bradley Simon

After a four-year battle, Elastos Foundation has resolved a class action fight over whether it was required to register a cryptocurrency offering with U.S. regulators.

The battle began with a bang: In Owen v. Elastos Foundation, before the U.S. District Court for the Southern District of New York, the plaintiffs initially sought as much as $200 million in damages, arguing that the foundation's initial coin offering, and subsequent solicitations of purchases on the secondary market, were offers and sales of unregistered securities without an exemption.

Elastos, which is registered in Singapore and operates in China, should be held liable under U.S. securities law, the plaintiffs said.

But the case ended on a far quieter note. In December, a judge approved a $2 million settlement with a stipulation that Elastos continues to deny any wrongdoing, and that it saw the settlement as desirable to avoid the expense and risk of litigation, "especially in complex cases such as this litigation."

Complex may be an understatement. The Elastos case has raised several questions that may be of interest to lawyers litigating cryptocurrency-related cases.

Some of those unique issues include arguments over whether a crypto token constitutes a security under U.S. law, how domesticity issues played out in a case involving a decentralized foreign entity, and why the serious limitations of current e-discovery platforms created turmoil in the discovery process.

But Is It a Security?

The initial coin offering for the Elastos ELA token occurred in January 2018, with sales on secondary exchanges launching a month later.

After the plaintiffs filed the class action, the company responded that the initial coin offering did not meet the basic test for a security as set out in the 1946 case of SEC v. W.J. Howey Co., held in the U.S. Supreme Court.

Registration is required under the four-pronged Howey test if an asset requires: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profit, (4) to be derived from the efforts of others.

Elastos Foundation[1] argued that its ELA token is a digital asset, not a security or investment contract, and is intended for transactions within the Elastos ecosystem.

While the proposed settlement has mooted the point in this case, the issue of what constitutes a security is a potent one in cryptocurrency enforcements and class actions. Since 2017, the Howey test has powered the U.S. Securities and Exchange Commission's aggressive enforcement efforts around cryptocurrency — and has aided class action plaintiffs.

The SEC's approach has received a mixed reaction from judges. In July 2023, a judge in the Southern District of New York ruled against the SEC and held that a digital asset issued by San Francisco-based Ripple Labs Inc. and sold on public exchanges was not "a 'contract, transaction or scheme' that embodies the Howey requirements of an investment contract."

In December, however, another Southern District of New York judge granted summary judgment[2] in favor of the SEC in a case against Terraform Labs Pte. Ltd., holding that it had offered and sold unregistered securities to U.S. investors with its suit of crypto-assets. Terraform, based in South Korea, raised billions from investors before the high-profile[3] collapse of its tokens and its subsequent bankruptcy.

While the Ripple decision has been widely touted as a victory for the crypto industry and suggests some judges may be open to defenses questioning the status of tokens as securities, the Terraform case makes it clear the issue is far from settled — and that the securities bar will need to parse both decisions closely until the U.S. Court of Appeals for the Second Circuit or the Supreme Court weighs in.

Establishing Domesticity: Where Are the Nodes?

The plaintiffs faced another considerable obstacle in proving U.S. securities laws should apply.

Elastos Foundation is a foreign entity, with no website servers in the U.S. Of the 3,596 participants in the initial coin offering, just 312 were documented as U.S.-based. Secondary market transactions that followed the initial coin offering were also predominately foreign in nature.

The company cited the 2010 Supreme Court decision in Morrison v. National Australia Bank Ltd.,[4] and subsequent 2012 and 2017 decisions by the Second Circuit, that have limited the extraterritorial reach of the U.S. securities laws and raised the domesticity bar for class action plaintiffs.[5][6]

In an attempt to clear those hurdles, the plaintiffs focused on a critical component of blockchain and cryptocurrency — nodes, or more specifically, the location of nodes used by Elastos during its initial coin offering. Most cryptocurrencies require nodes, or computers linked to a cryptocurrency network to help produce, receive and move data.

The problem is that unless the information is recorded at the time of a transaction, the location of a node is practically impossible to determine. While the issue was not fully litigated in this case, other recent cases[7] have included complex debates over the location of nodes, and it is not hard to imagine these battles becoming a routine fixture of blockchain-related litigation.

Discovery and a DAO

Elastos Foundation is a nonprofit operating as a decentralized autonomous organization, or DAO. Its blockchain is entirely open source and decentralized. To communicate, exchange documents or collaborate, the foundation used web applications commonly available to community members and platform developers, and handed out access to its accounts on an as-needed basis.

This open approach fueled significant challenges during the discovery process. WeChat is China's leading messaging app, and was used extensively by Elastos. Not surprisingly, the plaintiffs sought hundreds of pages of messages sent by the Elastos team during discovery.

However, many of the messages delivered by the e-discovery collection tool seemed to show attached files and links were missing. In fact, files and links were not missing.

Rather, current mainstream forensics tools and e-discovery platforms were unable to adequately extract and render conversations like those in WeChat outside of the application itself. Many of the missing links and file attachments referred to ephemera, like emojis and stickers or webpage logos and filetype icons. While those images were visible in WeChat on a smart phone, no physical file existed for collection and production.

A similar problem occurred with Google email, documents and drives. In a traditional email, users who want to send a document attach an electronic file to a message.

However, Google and others are increasingly relying on modern attachments, also known as "embedded files" or "pointers," which are, in essence, hyperlinks that direct users to electronic content. Unfortunately, e-discovery technology has not kept pace with this issue. During discovery in the Elastos case, many of the email messages produced included the message "missing attachments/links."

The plaintiffs then attempted to cast a wider net. In March 2023, they asked the court to compel production from an employee's personal Gmail account in an attempt to find missing documents. The defense responded that the employee had already turned over more than 40,000 documents and that the motion was an overreach in a case controlled entirely by the Howey test.

The court cited the Federal Rules of Civil Procedure's Rule 34(a), which states that a party may obtain discovery of documents that are "in the responding party's possession, custody, or control."[8] Because Elastos did not have a policy giving it control over data on an employee's personal devices or accounts, the employee had no obligation to turn over access to his account, the court said.

Final Thoughts

Although the case has concluded, we are left with a number of unresolved questions:

- How far can plaintiffs and federal regulators stretch the Howey test in defining crypto tokens as securities? Will the courts side with the SEC like in Terraform, or continue to push back as in the Ripple case? How will they respond to critiques[9] that Ripple goes too far in distinguishing between institutional and retail purchasers?
- In light of the growing body of case law on extraterritoriality, will plaintiffs suing foreign crypto companies be able to establish domesticity by focusing on issues like blockchain nodes? If so, how will the courts account for the decentralization inherent in blockchain applications where nodes may shift significantly over time?
- When will e-discovery platforms update their tools to account for the proliferation of web tools that include hyperlinked content? Clearly, significant work is needed to adequately collect, render and produce modern attachments. Otherwise, litigants and the courts can expect to see lengthy and expensive discovery battles over phantom content for the foreseeable future.

Bradley D. Simon is a partner at Schlam Stone & Dolan LLP. He previously served as an assistant U.S. attorney for the Eastern District of New York and as a trial attorney with the criminal division of the U.S. Department of Justice.

[1] https://www.elastos.org/en/.

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[3] https://www.cnbc.com/2023/02/16/sec-charges-do-kwon-with-fraud-in-connection-with-terra-collapse.html.

[4] https://www.google.com/url?q=https://supreme.justia.com/cases/federal/us/561/247/&sa=D&source=docs&ust=1708027190044478&usg=AOvVaw3vi1onvrjZlxNECpV02jXv.

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[6] https://law.justia.com/cases/federal/appellate-courts/ca2/16-1914/16-1914-2017-07-07.html.

[7] https://www.reuters.com/legal/transactional/blockones-revived-22-mln-settlement-could-be-template-crypto-class-actions-2023-01-30/.

[8] https://uscode.house.gov/view.xhtml?req=granuleid:USC-1999-title28a-node79-node117-rule34&num=0&edition=1999#:~:text=Any%20party%20may%20serve%20on,data%20compilations%20from%20which%20information.

[9] https://www.law.com/newyorklawjournal/2023/09/20/the-next-big-case-in-the-crypto-wars/.
