Blockchain Law

When plaintiffs raise claims of platforms behaving badly

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Consumers and businesses should be able to control their financial assets and investments through use of electronic cryptocurrency platforms with confidence. What happens, however, when these platforms do not function properly or the platform operators work against their own users? Does the user have any remedies? A series of rulings over recent months provides little encouragement for plaintiffs.

The vision of consumers and businesses being able to directly control their own financial assets and investments through use of electronic cryptocurrency platforms rests upon the idea that when users seek to use such platforms they will in fact function properly and that the platform operators will not work against their own users. But what happens when a user charges that the platform and/or its operator in fact behaved badly and that the user was injured as a result? Irrespective of whatever contract claims the user might try to assert under the particular terms of the platform's user agreement, does the user have any common-law tort remedies?

A series of rulings over recent months in three Northern District of California cases provides such plaintiffs with little encouragement. On motions to dismiss in these cases, the courts have rejected proposed tort claims variously sounding in negligence, conversion, trespass to chattels, defamation and prima facie tort, among other common-law theories, and seeking compensatory and punitive damages.

No duty, no negligence

The first of these rulings came in the *Berk v. Coinbase* litigation, which this column first noted at an earlier stage. See R. Schwinger, "Blockchain Law: Liability Rumblings Along the Blockchain," N.Y.L.J. (July 15, 2019). The claims in *Berk* centered around the Global Digital Asset Exchange (GDAX) through which Coinbase users could buy and sell cryptocurrencies pursuant to their Coinbase user agreements. The *Berk* plaintiffs claimed they had suffered injuries buying and selling Bitcoin Cash because, when Coinbase launched Bitcoin Cash trading on GDAX, the plaintiffs claimed it had failed to make accurate pre-announcements about the launch of trading, and did not take deposits sufficiently in advance to allow liquidity to develop, so as to be able to open an orderly market.

The plaintiffs sought recovery from Coinbase for these allegations not simply pursuant to their user agreements but also under various tort law theories. As this column reported in July 2019, the trial judge reportedly made comments during

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oral argument of the defendant's motion to dismiss that the platform operator had a responsibility that went above and beyond its contracts and that it had a duty to ensure the trading was not going to be dysfunctional, on the theory that it had a relationship of trust with persons trading on its platform.

In a written ruling later that summer, 2019 WL 3561926 (N.D. Calif. Aug. 6, 2019), the trial court referred the *Berk* plaintiffs' contract claims under their user agreements to arbitration, but held that certain of the plaintiffs' other claims—specifically the negligence claim of plaintiffs who attempted to engage in Bitcoin Cash transactions on the platform—arose out of "a duty of reasonable care to its traders 'originating outside of the agreement'" and thus were not subject to mandatory arbitration. The court dismissed claims for fraud and alleged violations of California's Unfair Competition Law (UCL), Cal. Bus. & Prof. Code §17200, however, noting the plaintiffs' failure to plead reliance on allegedly fraudulent statements, or to allege any unlawful conduct under the Commodities Exchange Act (CEA), FinCEN rules or New York state regulations.

On the appeal to the Ninth Circuit, though, the Court of Appeals denied even the small area of tort recovery that the trial court held might be possible. The Court of Appeals rejected the notion that the platform operator owed the plaintiffs any tort duties beyond its contractual duties under its user agreements. The Ninth Circuit thus reversed the holding below that plaintiffs had alleged non-arbitrable tort claims that would preclude sending the entire dispute to arbitration under the user agreement. *Berk v. Coinbase*, 840 Fed. Appx. 914 (9th Cir. Dec. 23, 2020) (not for publication), rev'g 2019 WL 3561926 (N.D. Calif. Aug. 6, 2019).

The Ninth Circuit held that "[a]lthough plaintiffs have framed their claim as one for 'negligence' sounding in tort, we conclude the claim 'relat[es] to the interpretation and performance of the [User Agreement] itself'" (quoting *Tracer Rsch. v. Nat'l Envtl. Servs. Co.*, 42 F.3d 1292, 1295 (9th Cir. 1994)) so that it fell under the User Agreement's arbitration provision along with all plaintiffs' other claims. While the plaintiffs contended that their claim sounded in tort under California law because there allegedly was an independent duty of care to ensure a functioning marketplace for Bitcoin Cash, citing the California Supreme Court's ruling in *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958), the Ninth Circuit disagreed. It held that as a general rule, California law provides that "a business entity has no duty to prevent financial loss to others with whom it deals directly." While it acknowledged that the California Supreme Court in *Biakanja* had carved out a "narrow exception" to this general rule based on a six-factor test, it asserted that "[l]ower California courts have declined to extend *Biakanja* to cases where the parties are in privity with one another."

Biakanja, said the Ninth Circuit, did not "create broad tort duties in arms-length business dealings whenever it is convenient to resort to the law of negligence." Rather, its exception recognizing such duties only applies to a "narrow class of cases" where the defendant was acting pursuant to a contract and the defendant's negligent performance of the contract injures a "third party." The Court of Appeals cautioned that applying *Biakanja* to cases where the parties are in contractual privity with one another "would circumvent this rule and blur the law's distinction between contract and tort remedies."

Thus, because Coinbase and the plaintiffs were "not strangers" but rather were "in privity via the User Agreement" and the plaintiffs' alleged injuries "resulted from their direct, arms-length dealings with Coinbase," the Ninth Circuit was "persuaded that the California Supreme Court would not extend a special duty of care between Coinbase and plaintiffs." As a result, any duties between them could arise only under the user agreement. The Ninth Circuit accordingly reversed the lower court's ruling that had allowed the negligence claim to proceed in litigation, and remanded the entire case back to the district court with instructions to compel arbitration.

Accusations of 'manipulation'

Many of the issues from *Berk* were reprised several months after the Ninth Circuit's ruling in a different Northern District of California case, but with no more success. In *BMA LLC v. HDR Global Trading Ltd.*, 2021 WL 949371 (N.D. Calif. March 12, 2021), the court was confronted with a 237-page, 618-paragraph, 18-exhibit complaint filed by a group of plaintiffs who sought to recover from losses they claimed to have sustained on the defendant's cryptocurrency derivatives trading platform known as Bitcoin Mercantile Exchange (BitMEX). In addition to federal RICO and CEA claims, the plaintiffs asserted claims under California law for negligence, fraud, conversion, UCL violations, unjust enrichment and other causes of action.

The *BMA LLC* plaintiffs alleged that the BitMEX platform "enables traders to place bets on direction of cryptocurrency prices" but claimed that the platform was designed without "any financial controls mandated by the traditional banking system" and that the operator refused to implement any "know your customer" or anti-money-laundering checks, such that the defendants allegedly "would open account[s] and accept unlimited funds from anyone, without a single question asked." Plaintiffs alleged on information and belief that there were various price manipulation schemes on the platform that could be causally linked to losses the plaintiffs claimed to have suffered, and that the platform facilitated manipulation by allegedly "trading against its customers."

Despite the length and detail of the *BMA LLC* plaintiffs' complaint, their claims did not survive a motion to dismiss. At the outset, the district court granted a motion to dismiss the entire complaint on implausibility grounds, concluding that its allegations failed to provide any plausible basis for concluding that the defendants might be responsible for the alleged cryptocurrency price manipulation complained of. Merely alleging that the defendants had the "means, motive, and opportunity to manipulate," said the court, was not sufficient.

The court also granted dismissal for lack of standing, holding that the plaintiffs had not alleged any basis for suing the defendant platform as the supposed perpetrator of the plaintiffs' claimed losses, and further holding that plaintiffs had not even advanced plausible allegations showing that they had sustained any "injury in fact" from the trading.

The court could have stopped there, but it continued on to address the merits of the various claims asserted and found them all wanting. It rejected plaintiffs' RICO claims for failure to allege required statutory elements and their CEA claims for failure to plead with the requisite particularity, especially as to scienter. It then went on to reject plaintiffs' California state law claims, starting with the negligence claim.

The *BMA LLC* plaintiffs, similar to the *Berk* plaintiffs, claimed negligence based on the argument that "defendants owed them a duty to maintain a functional cryptocurrency marketplace and prevent economic harm to them." They alleged this duty arose because the defendants allegedly "enticed them to trade on their platform by advertising the BitMEX Perpetual Swap contract as 'the most traded cryptocurrency product of all time.'"

The plaintiffs alleged that this supposed duty to maintain a functional marketplace was breached through claimed market manipulation and because the platform had been taken offline for a time due to a distributed denial-of-service attack, either "deliberately" or due to defendants' alleged "fail[ure] to utilize widely available industry solutions."

The court held that these allegations failed to "adequately plead the existence of a 'special relationship' giving rise to an actionable duty of care under the circumstances" as required under California law for a negligence claim. The plaintiffs pointed to the New York law decision in *In re Facebook IPO Sec. and Deriv. Litig*., 986 F. Supp. 2d 428, 461 (S.D.N.Y. 2013).

In that case, the New York federal court found a duty of care when an exchange platform promoted trade orders relating to Facebook's IPO but failed to properly process the trade orders it had enticed traders to make, holding that "[w]hen initiating an IPO, an exchange has an obligation to ensure that its systems, processes and contingency planning are robust and adequate to manage the IPO without disruption to the market." But the court in *BMA LLC* held that *In re Facebook* did not help the plaintiffs under the facts they had alleged under California law. In re Facebook, said the court:

> does not address how plaintiffs' negligence claims survive under California law [as interpreted in *Biakanja*], let alone explain how plaintiffs have shown a special relationship existed between them and defendants outside the IPO context. Plaintiffs fail to allege any facts supporting the conclusion that privity, or the functional equivalent of privity, existed between them and defendants such that there was a special relationship that would give rise to a duty of care.

The court also noted that the facts alleged in *BMA LLC* did not even approach the level of those alleged in *Berk*, "which centered on the negligent launch of a digital currency, [since] plaintiffs fail to plausibly allege that defendants enticed them to trade any specific products on BitMEX or take the specific leveraged positions that were ultimately liquidated." It further noted that even under *Berk*'s facts the Ninth Circuit ultimately reversed the lower court's conclusion that a negligence claim against the platform was viable under California law.

The court then dismissed plaintiffs' remaining state-law claims in short order. It held that the plaintiffs' generalized allegation that defendants had "inject[ed] false market information" into the marketplace failed to allege plausible facts with particularity sufficient to sustain a fraud claim, particularly since California law does not recognize any "fraud on the market" theory of reliance. The court dismissed the UCL claims against the platform that plaintiffs based on supposed unlawful or fraudulent conduct, given the court's rejection of plaintiff's RICO, CEA and fraud claims. Plaintiff's claims for unjust enrichment, civil conspiracy, constructive trust and an accounting were dismissed because they were based on the same allegations of market manipulation that the court previously rejected as insufficient.

The court lastly rejected a conversion claim and related aiding and abetting claims that were based on the theory that defendants improperly "took and converted … to their own use" the bitcoin holdings deposited in the plaintiffs' trading accounts that the plaintiffs alleged they were entitled to possess, concluding that those claims "rel[ied] entirely on the fraud-based market manipulation allegations that plaintiffs have failed to plead with particularity." While the court thus dismissed the complaint in its entirety, it did afford the plaintiffs an opportunity to replead to try to address the deficiencies noted in the ruling.

Anomalies and changes in the platform's code

The third of the recent California cases, *Shin v. ICON Found.,* 2021 WL 1893117 (N.D. Calif. May 11, 2021), presented a dispute between an investor and a platform based on allegations that seem like they might have furnished the premise for a caper movie.

Shin involved a cryptocurrency called ICX whose tokens were maintained on the ICON blockchain. While some blockchains operate on a "proof of work" basis—in which new tokens are "mined" by having complex verifications of transactions performed by "miners" who are rewarded with issuances of new tokens—ICON is a so-called "proof of stake" blockchain, in which new tokens are issued to those who "stake" at least a minimum amount of their tokens for at least a minimum amount of time (during which time their tokens are not available for trading) to "public representatives" or "P-Reps" who verify transactions on and exercise voting power over the code upgrades to the ICON blockchain.

In August 2020, after ICON implemented a software revision known as Revision 9, the plaintiff Shin made an intriguing discovery: Whenever he attempted to direct some of his staked ICX tokens from one P-Rep to another P-Rep through his ICON wallet, 25,000 new ICX tokens appeared in his ICON wallet each time. Shin then continued to repeat the process over and over, and by the end of the day he had received approximately 14 million ICX tokens. Shin analogized this to a slot machine that paid out on every spin, except that he received newly-issued tokens and not tokens that had previously belonged to ICON or anyone else.

While Shin acknowledged that this may not have been how the authors and developers of Revision 9 had intended the network to behave, he contended that his actions were not malicious and that he was the lawful owner of the tokens under the approved software code. He then transferred a significant portion of those tokens to other exchanges.

ICON, however, then launched a vigorous multi-pronged response. Shin alleged that he soon found himself unable to transfer any of his ICX tokens, even those he owned before this incident. He claimed that ICON had contacted the exchanges where Shin had transferred the tokens, told them that the accountholder was a "malicious attacker" and that the transferred ICX tokens had been "stolen", and directed the exchanges to freeze the accounts, which they did.

Soon after, ICON issued a social media post stating that it had "experienced an attack by a malicious individual exploiting a vulnerability in" its software to "mint unauthorized ICX tokens."

ICON then also allegedly obtained quick P-Rep approval to implement a Revision 10 to its code to address this situation. Shin alleged that while the Revision 10 proposal simply stated that it was aimed at "fixing a vulnerability," the coding change in fact was "interfering with and programmatically restricting all of Shin's ICX," effectively freezing all Shin's ICX tokens including those he had previously purchased.

Shin alleged that "ICON fabricated and communicated both public and private false statements for the purpose of encouraging, coercing, and ensuring support for its Revision 10 Proposal, which ICON deliberately designed and intended to interfere with Shin's ICX tokens." Shin also alleged that ICON threatened to contact law enforcement if Shin did not return the ICX tokens.

Shin filed suit against ICON raising a claim for declaratory relief regarding his property rights in the tokens, along with claims for conversion and trespass to chattel, and for defamation and prima facie tort. All these claims failed.

In dismissing Shin's defamation claim, the court noted that the social media blog post had not identified Shin by name. While the blog post revealed Shin's ICON wallet address, and Shin alleged that this was sufficient to link the claimed "attack" to him, the court rejected his allegations as conclusory and implausible given the lack of specific allegations of how this was possible given his own allegations of how "cryptocurrency is grounded in anonymity." Likewise, the court held that Shin had failed to allege sufficient facts about how his accounts on other exchanges were created and with what kind of identifying information, so as to support a defamation claim based on statements ICON made to those exchanges about the unnamed holder of those accounts.

The court also rejected Shin's allegation that being characterized as a "malicious attacker" in the blog post should be viewed as more than just the non-actionable expression of an opinion. The court noted that the factual details of how Shin came to acquire the tokens, which formed the basis of the statements in the blog post that Shin challenged, were described in the blog post, and were essentially identical to the story Shin himself alleged in his complaint. For this reason, the court concluded, "the phrases he identifies as defamatory—'malicious attacker' and the word 'stolen'—are unactionable opinions as pleaded and cannot form the basis of his defamation claim," because they would be understood as the speaker's interpretation of the facts disclosed.

The court also rejected Shin's claims for conversion and trespass to chattel. While there was no physical taking of his ICX tokens, Shin argued that ICON "substantially interfered" with those tokens when it released the Revision 10 Proposal that "blacklist[ed]" and "effectively froze" both the ICX tokens he had obtained through the Revision 9 coding anomaly and those Shin had previously purchased. While ultimately it was the P-Reps who approved the adoption of the Revision 10 Proposal, Shin argued that ICON obtained their approval by not being entirely candid with the P-Reps about the circumstances that gave rise to the Revision 10 Proposal.

The court acknowledged that these allegations and certain statements ICON made about the approval process could "plausibly establish that ICON had de facto control over the network approval process, including approval of the Revision 10 Network Proposal," but it found Shin's allegations contradictory regarding to what extent he continued to have access or at least restricted access to some amount of the tokens in question. The court thus dismissed the conversion claim with leave to amend.

The court likewise dismissed Shin's trespass to chattel claim, holding that such a claim required Shin to show that ICON had interfered with Shin's "possessory interest in personal property," but that this had not been properly alleged given the lack of clarity noted above regarding what access Shin still had over the tokens in his ICON account. The court also held that there were no sufficient allegations of "intermeddling" by ICON with respect to the ICX tokens that Shin had moved to other exchanges that ICON did not control.

The court then disposed of the remainder of Shin's complaint. Shin's request for a declaration that the ICX tokens he obtained through Revision 9's coding were his property, and that he was entitled to exercise his property interests as to both them and the ICX tokens he had accumulated previously, was rejected as "needlessly duplicative" given the substantive claims for conversion and trespass to chattels in the amended complaint.

The court rejected Shin's attempt to plead a claim under Colorado law for prima facie tort, holding that there was no Colorado caselaw indicating that such a claim would be cognizable here under Colorado law. Shin's claim for punitive damages was also rejected, not simply because the underlying tort claims were dismissed but also because his allegations about ICON's conduct did not show that ICON had acted with "oppression, fraud, or malice," even given the statements ICON had made to other exchanges or in the blog post, or by its allegedly threatening to contact law enforcement.

Conclusion

These three cases highlight the difficulties that plaintiffs can face when attempting to assert non-contractual claims against allegedly misbehaving cryptocurrency platforms. The courts in these cases were not receptive to the suggestion that platforms owe their users the kind of extracontractual duties that would support a claim for negligence. The nature of the disputes that might arise may not involve reliance on misstatements of the kind that would support fraud claims. The injuries allegedly sustained may not rise to the level of property deprivation redressable through claims sounding in conversion or similar theories. The anonymous nature of holding cryptocurrency may impede the ability to claim defamation, even if the complained-of statements were viewed as more than just non-actionable statements of opinion.

In short, without a user agreement that provides effective remedies and a good forum for addressing the possibility of platforms behaving badly, users may not have much in the way of viable non-contractual options for obtaining relief in disputes with the platforms they use for cryptocurrency activity. So far, courts have not proved receptive to applying common-law tort remedies within the user-platform relationship.

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