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Watch your mouth: Liability for statements and omissions about digital assets

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When talking about digital assets, how much is saying too much? How much is saying too little? Did what you say ultimately matter? Recent court decisions arising from the purchase and sale of digital assets have grappled with liability claims posing such questions about information that had been stated or omitted.

Not saying enough

In re Ethereummax Investor Litigation, 2023 WL 6787458 (C.D. Calif. Oct. 3, 2023), was the most recent ruling in a long-running litigation against celebrity endorsers of and company executives behind EMAX tokens, a "blockchain-based digit asset" that "function like other digital cryptocurrencies" and "were sold on decentralized exchanges." Such exchanges "allow anyone to list and sell tokens" by using "liquidity pools and smart contracts to allow investors to exchange one asset for another without a direct counterparty," for which users must pay a so-called "gas fee" to process the transaction on the Ethereum blockchain.

In this latest ruling, the court considered the allegations of plaintiffs' third amended complaint, after several prior rounds of pleading, against challenges raised by certain of the executives and celebrity endorsers. The current pleading asserted claims under state consumer law, state securities laws and common law, many of which centered on statements made—or not made—by the defendants in connection the sales and promotion of the tokens.

The court first addressed motions to dismiss made by two of the celebrity endorser defendants, boxing champion Floyd Mayweather, Jr. and former NBA star Paul Pierce. (The court in an earlier ruling had dismissed certain claims against Kim Kardashian, another celebrity endorser defendant in the case.)

Plaintiffs asserted a fraud-by-omission claim under state consumer laws against Mayweather, alleging that because of his "exclusive knowledge" that "he was simply a paid promoter" of, but not "an actual backer/investor in," EMAX Tokens, he therefore was under a duty to disclose that fact when engaged in his promotional activity for those tokens. Mayweather argued that he was under no duty to disclose this information because it was not "material."

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The court agreed with the plaintiffs that a failure to disclose "material facts" in the defendant's "exclusive knowledge" that are "not known or reasonably accessible to the plaintiff" can "constitute actionable fraud or deceit." Citing the plaintiffs' allegations that they would not have purchased or continued to hold the EMAX tokens had all the facts been fully disclosed, but rather only purchased and held the tokens "as a direct and proximate result" of that non-disclosure, the court held the plaintiffs had "sufficiently pled that they would have acted differently had Mayweather disclosed the omitted information."

> "Moreover, Mayweather does not cite to any cases or otherwise demonstrate that this sort of allegation (i.e., the distinction between being just a paid promoter and an actual backer) is categorically immaterial as a matter of law."

Mayweather argued the plaintiffs knew he was a paid promoter, but "the court understands Plaintiffs' fraud-by-omission theory as alleging that Mayweather omitted the fact that he was not an actual investor in EMAX Tokens. In other words, Plaintiffs believed that Mayweather was a celebrity endorser *in addition to* being an actual investor." (Emphasis in original.) The court thus held Mayweather's argument "inapplicable" and upheld plaintiffs' state consumer law claims.

Consumer protection law claims were likewise upheld as to EMAX celebrity endorser Paul Pierce. The plaintiffs based their claims against Pierce on two Twitter posts of his boasting of the returns on EMAX tokens, including one showing a screen shot from an EMAX wallet. Paul argued the claim should be dismissed because plaintiffs had abandoned a prior allegation that the screen shots showed Paul's own trading or wallet.

The court disagreed, stating "contrary to Pierce's contention, this slight change in language does not undermine plaintiffs' allegation that Pierce, or an agent at his instruction, made the alleged transactions." Thus, the current pleading "makes it plausible that Pierce's agent sold and traded Pierce's EMAX Tokens for his benefit." The court also held "it is of no matter that someone closely connected to Pierce (as opposed to Pierce himself) owned the Pierce display wallet."

> "What is important is that, based on the tweets, consumers believed that Pierce held a large stake in EMAX Tokens, that he made substantial profits from his investments, and that he was committed in investing in EMAX as a long-term investment, as the TAC sufficiently alleges."

The court also upheld related securities manipulation claims against Pierce, holding the complaint plausibly alleged that "Pierce concealed his ownership interest in EMAX Tokens either to create a false or misleading appearance of active trading or to induce the purchase or sale of security by others."

The company executives who moved to dismiss, Giovanni Perone and Jona Rechnitz, did not fare much better on their motions. Perone was similarly unsuccessful in his attempt to avoid consumer protection law claims against him that were based on the company's marketing and social media activity. While the court rejected any argument that "Perone controlled the company's social media accounts" simply "by virtue of his position as CEO," it held that plaintiffs had gone further and alleged that "Perone was a 'central figure' behind the Company and its dealings, both before and after its incorporation."

The court noted in particular plaintiffs' allegation that "Perone was the creator of both EMAX and the company and the *sole* director of the company after its incorporation." (Emphasis in original.) "Based on these allegations," said the court, "it is plausible that Perone actively and directly participated in the social media posts." The motion to dismiss those claims was thus denied.

Defendant Rechnitz challenged certain securities manipulation claims against him, which were based not so much on his speech but rather on his alleged silence. Plaintiffs alleged "that Rechnitz plausibly concealed his ownership interest when making transactions to create a false appearance of active and organic market activity" in the EMAX tokens. Rechnitz argued "that his alleged activity could not possibly have created an appearance of market activity" because the alleged transactions "were non-public, wallet-to-wallet transfers."

But the court held that "this argument relies on facts regarding whether the transactions were public or private that appear to contradict" the allegations in plaintiffs' pleading, and thus raised "a factual dispute that is inappropriate to resolve at this stage." Rechnitz's motion to dismiss these claims was this denied.

No need to say more

A challenge to statements and omissions about digital assets was made but dismissed in *Free Holdings v. McCoy*, 2023 WL 2561576 (S.D.N.Y Mar. 17, 2023), although the Second Circuit later reversed and remanded to make the dismissal without prejudice, 2024 WL 177447 (2d Cir. Jan. 17, 2024).

As recounted by the district court, *Free Holdings* arose from the sale of a digital artwork called *Quantum* and "the first non-fungible token ('NFT') ever created." The plaintiff Free Holdings sued *Quantum*'s creator McCoy and the auction house Sotheby's over statements made in promotional materials for the auction.

The difficulty arose from the operation of a blockchain that tracks the ownership of NFT names, called Namecoin. Because ownership on Namecoin can be traded, and also periodically expires and then can be re-registered by others, "'there is an ongoing debate' about the status of names that expire and are then re-registered: namely, whether re-registered names become new NFTs or are the same NFTs that were previously claimed." There are also thus "three different interpretations of the significance of ownership of a re-registered name on Namecoin"—whether it is the same NFT as before, a new NFT, or a new NFT that retains the blockchain history of the old.

The original Namecoin entry for the *Quantum* NFT was created by the defendant in 2014, expired in 2015, and then was taken over by the plaintiff, who migrated its history off Namecoin onto an Ethereum-based blockchain. Following some online disagreements between the original creator and the plaintiff Free Holdings about who owned the *Quantum* NFT and its history, *Quantum* was sold in a 2021 auction by Sotheby's. The auction house marketed *Quantum* as "the most art historically important work in the history of NFTs," describing it as a "genesis block" and a "prime mover" that occupied "a singular position in art history."

Following the auction and sale, plaintiff objected, saying that the Sotheby's description had been inaccurate and requested that Sotheby's make public statements to "correct the record." The additional statements plaintiff sought included saying that the record of *Quantum* on Namecoin "remains active and in private hands, was not listed for sale as part of Sotheby's auction, and that the item Sotheby's auctioned was in fact an authorized print of the Namecoin-*Quantum* token." Plaintiff eventually filed suit against *Quantum*'s creator, the auction house and others, raising claims that included slander, deceptive and unlawful trade practices, commercial disparagement, and false or misleading representations, and sought relief that included a declaration that plaintiff was the "rightful owner of the Namecoin-based *Quantum*."

The defendants moved to dismiss. They argued that plaintiff had "failed to allege an injury sufficient for standing or a claim that is ripe for review, warranting dismissal for lack of subject matter jurisdiction."

The court agreed with the defendants. It held that plaintiff "has alleged no concrete or particularized injury sufficient for standing to sue in federal court."

Plaintiff claimed a proprietary interest in "[t]he blockchain record for the Namecoin-*Quantum*," which it alleged "remains active and under [its] control," and argued that his ownership "confers a property interest in *Quantum* itself." But plaintiff "nowhere alleges an interest in the NFT minted on Ethereum that [defendants] McCoy and Sotheby's sold," and "[i]ndeed, it alleges that the two 'are different NFTs.'" The defendant McCoy disputed Free Holdings' theory of ownership, arguing that a name on Namecoin is distinct from the underlying NFT.

The court held that while the plaintiff "has thus alleged a proprietary interest in [the Namecoin blockchain record] sufficient for standing," it "has not articulated any facts to support its claim to ownership of *Quantum* vis-à-vis its claim to [that blockchain record]."

Plaintiff claimed "loss of opportunity to profit" from the auction sale, "damage to the value of its claimed Namecoin property," and the expense of public statements to correct the supposedly "false and misleading claims" made in connection with the auction sale. The court held that plaintiff had not alleged any basis why the defendants were legally obligated to include plaintiff in the auction sale or any claim to share in that sale, and thus no basis to support any inference of injury.

As to the alleged damage to the value to plaintiff's claimed Namecoin property, the court noted that there was no allegation of any current attempt to sell that property, and that "vague speculation that '[a]ny prospective purchaser of Namecoin-*Quantum* would now have valid reason to doubt [its] value'" was legally insufficient to create injury in fact and thus standing. Similarly, it held, plaintiff could not "manufacture standing" by spending its own money on corrective disclosures "based on…fears of hypothetical future harm that is not certainly impending."

While not needing to reach the substantive sufficiency of the claims due to the subject-matter jurisdiction dismissal for lack of concrete and particularized injury, the court nevertheless addressed in dicta defendants' motion to dismiss for failure to state a claim. Fundamentally, it said, these claims could not succeed for lack of facts showing any "falsity" in the statements made, noting that the representations about the characterization of the NFT sold at auction were in these circumstances "topics of debate," particularly since it was disclosed how the blockchain history of the original Namecoin token had been moved to a new Ethereum token. "Free Holdings has thus failed to sufficiently allege that any statements made by McCoy or Sotheby's were substantially false."

On appeal to the Second Circuit, the trial court's ruling was in substance upheld in a summary order on the standing point, without reaching the trial court's ruling on the substantive sufficiency of the claims, but the trial court's dismissal was vacated and remanded to make it without prejudice to repleading. The Second Circuit held that "Free Holdings' claim that Appellees' Ethereum NFT sale damaged the value of its Namecoin NFT fails," explaining:

> "Even assuming that Free Holdings' NFT was in fact the first-ever NFT, absent allegations that Free Holdings actually attempted to sell that NFT, or any alleged mechanism by which Appellees' sale would have damaged the value of Free Holdings' NFT, any relationship between Appellees' sale and damage to Free Holdings' NFT is too conjectural to support standing."

Statements too general to matter

In re Ethereummax involved defendants who arguably should have said more about digital assets. *Free Holdings* involved defendants whom the court found hadn't said too little. A third recent digital assets case, *Patterson v. Jump Trading LLC*, 2024 WL 49055 (N.D. Cal. Jan. 4, 2024), presented allegedly troublesome statements about the digital assets that the court held were simply too general to matter.

Patterson involved securities fraud claims asserted by disappointed purchasers of various tokens operating on the "Terra" blockchain of Terraform Labs (TFL). These tokens, referred to collectively as "Terra Tokens," included TFL's LUNA coin and its UST "algorithmic stablecoin," which was pegged to the U.S. dollar. Plaintiffs, who "allegedly invested fiat and digital currencies to purchase Terra Tokens with the expectation of profit," asserted securities fraud claims against defendant Jump Trading LLC for its alleged "involvement in the promotion and sale" of these tokens, after the tokens "dramatically dropped in price within a matter of days in May 2022."

Plaintiffs alleged that to maintain price stability for its UST algorithmic stablecoin, "TFL's algorithm mints and burns UST and LUNA to control the supply and keep the value of UST steady at $1, while at the same time incentivizing arbitrageurs to trade the UST back to its peg of $1 if it deviates."

The complaint alleged that the defendant Jump Trading had been involved in dealings with TFL for several years. These alleged dealings included Jump's having received loans of LUNA tokens from TFL, which Jump then allegedly sold into the market for secondary trading. "The loan and Jump's sales of LUNA 'allowed public investors, including U.S. investors, to acquire LUNA through transactions in the secondary market, and generated speculative interest in LUNA.'"

In late May 2021, UST tokens began to de-peg from the U.S. dollar, dropping to $0.90 in value. TFL and Jump allegedly had discussions about how to restore UST's peg to the dollar, and Jump thereafter allegedly purchased large quantities of UST over the next few days. Thereafter "UST's market price began to rise" and "eventually was restored to near $1." Plaintiffs alleged this conduct was "central in efforts to mislead investors about the stability of the algorithm."

TFL and Jump then allegedly altered the terms of their agreement for loaning LUNA tokens to Jump, agreeing to deliver LUNA tokens for $0.40 when they were trading for more than $90 in the secondary market, which allegedly enabled Jump to generate $1.28 billion in profits. Plaintiffs alleged:

> "The cause of the re-peg, TFL's loans to Jump, and Jump's role in increasing the price of Terra Tokens were not publicly disclosed to investors. Rather, the plaintiffs allege that Jump joined TFL and others in "mislead[ing] investors who were actively buying and trading UST to believe that the algorithm had 'self-heal[ed]' to restore the peg without any human involvement."

Plaintiffs also complained that a group formed by TFL called the "Luna Foundation Guard" and its members "made a series of statements 'attributing UST's recovery from the May 2021 depegging to the resiliency of algorithmic stablecoins—rather than an infusion of capital' without disclosing the nature of the intervention that restored the UST's peg." They further alleged that "Jump, without disclosing its role in stabilizing the peg, made a series of misleading statements and misrepresentations" over the following months. The statements they cited, however, were essentially general statements of optimism or excitement about "the stablecoin space" and its future, and about TFL and UST, and about possible ways to for holders of LUNA tokens to earn money by "staking" those tokens.

Plaintiffs alleged that matters came to a head in May 2022, when "structural vulnerabilities within the Terra ecosystem precipitated a massive selloff of both UST and LUNA," such that "[t]he price of UST and LUNA Tokens dropped by 91% and 99.7% . . . after it was revealed that TFL's largest digital assets were unstable and unsustainable.'" Plaintiffs claimed they suffered significant losses in the Terra tokens they purchased prior to this selloff, and brought claims under the federal securities laws.

Jump moved to dismiss plaintiffs' securities fraud claims for failure to state a claim. While the court held that "the plaintiffs have adequately pleaded that their purchases of Terra Tokens were investment contracts constituting securities under federal law" under the governing "*Howey* test," because they had invested money "as part of a common enterprise," and "with a reasonable expectation of profit from the efforts of TFL and others" given that they did so "prior to the Terra ecosystem being fully developed," the court held that plaintiffs failed to "adequately plead that Jump made material misrepresentations."

To challenge various statements as "materially false or misleading," plaintiffs "rel[ied] primarily on an omissions theory of liability…arguing that Jump failed to disclose that it 'knew that the algorithm supporting the Terra ecosystem was insufficient, without human intervention to support the peg.'" The court held, however, that plaintiffs' allegations failed because they did not meet the requirements under the Private Securities Litigation Reform Act that "to properly allege falsity, a securities fraud complaint must now 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief… state with particularity all facts on which that belief is formed'" (citing 15 U.S.C. §78u-4(b)(1)).

The court held that plaintiffs never explained "why" the various general statements of optimism to which they pointed were made "misleading or untrue" by virtue of Jump's not having "disclosed that it was the conduct of TFL, [its CEO] Kwon and Jump, and not the algorithm, that restored UST's peg," or by "the absence of the information plaintiffs contend was improperly omitted." Any failure to disclose "that the algorithmic nature of the UST stablecoin had already failed once and required a secret bailout from Jump to maintain its dollar peg," said the court, did not render the general statements to which plaintiffs pointed misleading or deceptive. Moreover, the court held in a number of instances that the statements to which plaintiffs pointed were simply "expressions of opinion, as opposed to knowingly false statements of fact."

Plaintiffs' vague allegations that Jump and TFL executives had appeared on a social media talk show and "promoted the stability and security of the UST and LUNA peg as Terra's two most 'attractive' features," were likewise held not to be sufficient to support their claim. The court explained that such allegations "do not identify any *specific* statement made by [Jump's president], nor facts indicating what statements or omissions can be attributed to him specifically," thus "fail[ing] to plead any actionable statement" by Jump's president. (Emphasis in original.)

In sum, the court held that despite all the cited statements, plaintiffs failed to plead that Jump "had any duty to disclose its role in the re-peg," as their complaint was "devoid of any specific allegations that Jump had such a duty."

Conclusion

While digital assets are still something of a new world, familiar legal principles from earlier contexts still govern liability for what people say and what they don't.

Liability can arise from omissions when a defendant seeking to make or promote a sale tells only half the story but leaves out information that could be deemed material to that sale. But plaintiffs have to be able to present facts showing why the omission of particular information caused their claimed loss. And when fraud claims are involved, the factual particulars about the complained-of statements need to be specific in identifying the speaker, where and when the statements were made, and what specifically was said that could have caused a loss. In any case, liability usually can arise only from assertions or omissions of facts, not debatable matters of opinion.

When it comes to statements about digital assets, the courts are speaking. Should you?