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When Blockchain transactions meet US limits on extraterritoriality

Robert A. Schwinger, *International Litigation News – September, 2019*

In *Morrison v National Australia Bank Ltd.*,[1] the United States Supreme Court limited the reach of securities laws by holding that those laws did not apply to foreign securities claims with only tenuous connections to the United States. The Supreme Court grounded its holding in a 'longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.' The Supreme Court rejected various lines of thought from lower federal appellate courts that US law should also apply to fraudulent schemes that involve merely foreign conduct with US effects, or US conduct with purely foreign effects. Rather, the Supreme Court, holding there was no indication of congressional intent for the US securities laws to be applied extraterritorially, stated that it is 'only transactions in securities listed on domestic exchanges, and domestic transactions in other securities,' to which the anti-fraud provisions of those laws apply. Thus, in *Morrison*, so-called 'F-cubed' claims – brought against foreign companies by foreign claimants who purchased their shares on foreign exchanges – were not allowed to proceed.

But in the world of virtual currencies and blockchain transactions, where parties all over the globe may deal with one another through electronic systems and internet communications, and parties traffic in 'virtual' assets that have no real physical location, what is a 'domestic transaction' and what is not? When can US securities laws apply to such transactions? A California federal court recently confronted this question in *In re Tezos Securities Litigation*.[2] The court held that notwithstanding the defendants' attempt to position the entity selling a new virtual currency as being European and its sales as taking place in Europe, the fact of a domestic US plaintiff making purchases through US-based websites as a result of marketing that targeted the US, where the transaction was validated by blockchain nodes many of which were clustered in the US, it was not an improper extraterritorial application of US law to allow the plaintiff's claim of alleged securities violations to proceed in a US court under US federal securities laws.

Tezos involved defendants who had developed plans for a new cryptocurrency called Tezos that they asserted would overcome claimed shortcomings of predominant digital currencies such as Bitcoin and Ethereum. Eventually they conducted an Initial Coin Offering (ICO) in which purchasers paid millions of dollars' worth of Bitcoin and Ethereum to obtain Tezos tokens. However, the Tezos ICO was never registered under the US securities laws.

An Illinois resident who contributed 250 Ethereum coins to the Tezos ICO brought the *Tezos* case as a putative class action, seeking rescission of his Tezos purchase under Section 12 of the US Securities Exchange Act of 1934, based on his claim that the defendants had been running an unregistered securities sale. The plaintiff also sought additional relief under Section 15 of the Securities Exchange Act against various individual defendants who were alleged to be 'control persons' for these transactions.

1 561 U.S. 247 (2010).
2 Case No. 17-cv-06779-RS, 2018 WL 4293341 (N.D. Calif. 7 Aug 2018).

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The Tezos purchasers bought their Tezos tokens from the Tezos Foundation, a body that had been founded by two of the individual defendants who were from California. The Tezos Foundation was thus the primary defendant for the unregistered securities sale claim. The Tezos Foundation, however, was based in Alderney in the Channel Islands, and was governed by Swiss law. A provision within the 'Contribution Terms' drafted by the Foundation (which oddly were neither included in nor linked to any of the Foundation's English-language websites) purported to make Europe 'the legal situs of all ICO-related participation and litigation' for Tezos. The terms stated that: '[t]he Contribution Software and the Client are located in Alderney. Consequently, the contribution procedure... is considered to be executed in Alderney.' The terms further provided that '[t]he applicable law is Swiss law,' and that '[a]ny dispute ... shall be exclusively and finally settled in the courts of Zug, Switzerland.'

Faced with the plaintiff's California lawsuit under the US securities laws, the Tezos Foundation argued that the US securities laws could not apply to it in these circumstances. It predicated this argument on 'where such a sale would have necessarily occurred.' Pointing to the US Supreme Court's 2010 *Morrison* decision, the Foundation contended that 'any transaction taking place with [the plaintiff] could only have occurred in Alderney', as Alderney had been 'specified as the legal site of all ICO transactions by the Contribution Terms.' Moreover, the Foundation argued, even if the Contribution Terms were deemed not to apply, the court should look to where any 'ICO-related transfer of title or instance of 'irrevocable liability'' took place, as these factors had been identified as 'touchstones of the domestic transaction inquiry' by New York and California federal appellate courts after *Morrison*. Under those tests, the Foundation contended, the sale location should be deemed 'confined to Alderney, where the Foundation's 'contribution software' resides.'

The California federal court disagreed. While conceding that the Foundation was 'generally correct as to the scope of federal securities law,' the court stated that the Foundation's 'reliance on the validity of the Contribution Terms' was 'misplace[d]' and that those terms were 'of little significance at this juncture.' Rather, it said, what matters is to focus instead on 'the actual (rather than contractual) situs of ICO transactions.' Because of that, 'the operative question' was where does the sale of 'an unregistered security, purchased on the internet, and recorded 'on the blockchain,' actually take place?' The court found that under the facts alleged by the plaintiff, the answer must be the US.

'Try as the Foundation might to argue that all critical aspects of the sale occurred outside of the United States,' said the court, 'the realities of the transaction (at least as alleged by [the plaintiff]) belie this conclusion.' The court identified the following factors as supporting this conclusion:

- The plaintiff 'participated in the transaction from this country.'
- 'He did so by using an interactive website that was: (a.) hosted on a server in Arizona; and (b.) run primarily by [one of the California-based individual defendants] in California.'
- 'He presumably learned about the ICO and participated in response to marketing that almost exclusively targeted United States residents.'
- 'Finally, his contribution of Ethereum to the ICO became irrevocable only after it was validated by a network of global 'nodes' clustered more densely in the United States than in any other country.'

The court concluded that '[w]hile no single one of these factors is dispositive to the analysis, together they support an inference that [the plaintiff's] alleged securities purchase occurred inside the United States', citing case law holding that where non-exchange listed securities are offered and sold over the internet, the sale takes place in both the location of the seller and the location of the buyer. '[P]roceeding with all due consideration of the limited reach of this nation's laws, application of the [Securities] Exchange Act does not offend the mandate of *Morrison*.' The court thus denied the defendants' motion to dismiss the case based on an extraterritoriality defence. The court also rejected defendants' forum non conveniens argument because the supposed forum selection provision in the Tezos Foundation documents were not specified or linked to in the user agreement onto which plaintiff had clicked his assent, thus raising at least a factual question for the present about whether the plaintiff had truly been put on notice of those provisions.

In summary, *Tezos* shows that even under *Morrison*'s presumption against extraterritorial applications of US securities laws, attempts to centre blockchain transactions in non-US jurisdictions may not be enough to overcome factors

such as where the human parties and websites involved are based, where the underlying marketing had been directed, and whether the validating of those blockchain transactions was densely clustered in the US. *Tezos* suggests that *Morrison* may prove to be no panacea for those who hope creative structuring of blockchain ventures might suffice to bar US courts from applying US securities laws to blockchain transactions with US connections. When the realities of blockchain transactions meet US limits on extraterritoriality, it may require very contained and specific facts before the US courts will deem themselves barred from taking actions to address claimed wrongs under US law.

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