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Recovery by ICO Token Investors May Be Challenged in Bankruptcy

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Bankruptcy courts may provide relief to debtors by discharging pre-petition obligations to repay existing debts owed to creditors, and claims by equity holders. Creditors who hold debt and investors who hold equity interests, regardless of their form, can rely on the bankruptcy code's well-established rules and well-developed case law to anticipate how their claims will be treated.

The rights of holders of cryptographic tokens sold in initial coin offerings (ICOs) that are not clearly equity or debt, however, may not be so clear. Some tokens were offered as "utility tokens," which promised access to a service or product to be created by the issuer in the future. Bankruptcy courts will need to evaluate the circumstances of the token sales and representations made by debtor-issuers to induce buyers to purchase tokens to determine how claims against bankrupt token issuers should be handled.

The difficulty facing courts is shared by investors, funds, exchanges, and regulators. While the form of a sold token rarely varies — most were issued as Ethereum ERC20 tokens — the legal significance, rights, responsibilities, and promises made with the sale of these tokens varied widely.

Some tokens were not expressly offered and sold as debt or equity. However, a court would likely ignore the labels assigned to the instruments and the transaction and, instead, treat holders of those assets based on the asset's legal significance.[1] Some later ICO tokens that were not offered as debt or equity products, but which were offered pursuant to exemptions from the registration obligations of the securities laws, may be considered equity by the bankruptcy courts. The trickier questions relate to so-called utility tokens that were not offered and sold as a security but, instead, were offered to allow the purchaser to access a product or service. If a token is not equity or debt, what is it?

When evaluating claims by token holders, a court would presumably start by analyzing the promises made by the issuer to determine the instrument's legal significance and the issuer-debtor's obligations. If a debtor promised token purchasers an ownership stake, or voting rights, or a right to participate in governance, or a financial return, a court could consider that instrument, no matter how it was sold, as a form of equity.[2] Similarly, if a token was offered with a binding promise to repay some amount of money paid to a debtor, a court would likely conclude that the token is a debt instrument.

However, if a bankruptcy court determined that the debtor issued improper securities or committed fraud in its offering of tokens, the debtor could be denied relief against the token purchasers. Although securities-related claims against a debtor are generally subordinated, and often effectively worthless,[3] a debtor cannot obtain a discharge for debts incurred in violation of the federal or state securities law.[4] Likewise, debts incurred through fraud or as a result of an intentional tort can generally be excepted from the discharge a debtor receives in bankruptcy.[5] Therefore, if a court decides that a debtor's issuance of tokens violated securities law or was fraudulent, a discharge may be unavailable to the debtor as to token holders. This may prove a significant issue for token issuers whose issuances did not comply with securities laws.

Utility Tokens, SAFTS May Not Be Safe, and the UCC

If the tokens sold did not promise repayment of a debt, or provide ownership, a right to participate in governance, or a right to a dividend, they may not be considered a form of either debt or equity. Although these so-called utility tokens may not be a security and nor subject to applicable securities laws, recent statements from the SEC and various trial courts cast doubt about the viability of "utility tokens" under U.S. law. Thus, these assets may have been offered and sold under circumstances that would prevent their issuer from obtaining a discharge for that obligation, as discussed above. This could potentially include instruments and obligations marketed as "simple agreements for future tokens," or SAFTs, which were popular from 2018–2019.

Assuming courts do not view a utility token sale as the sale of an illegal security or a fraudulent sale, they may then be required to determine the token's legal significance. The court would examine the promises made by the issuer to determine if the debtor provided the token purchasers with any rights. Is the utility token a right to future performance owed by the issuer? Is it stored value? Is it value held in an issuer-run loyalty program like frequent flier miles? From the substance of the promises, the court is likely to infer the form.

In some cases, if the court examines the context of the sale and determines that the debtor owes the token holder no further obligation, the court may merely view a token sold as a good as defined by the Uniform Commercial Code.[6] In that case, token holders may not have any claim against the debtor.

If a token is viewed as stored value, like a gift card or gift certificate, token holders may lose any expectation of value because in many cases, bankruptcy courts have allowed debtors to stop accepting those instruments. For example, when Sharper Image filed for bankruptcy protection in 2008, a court allowed the debtor to disclaim gift certificates and store credit. Likewise, Borders did not allow holders of gift cards to redeem them for value after filing bankruptcy in 2012. In those instances, the only recourse available may be to file a claim as an unsecured creditor, which would be unlikely to result in any recovery.

However, the treatment of stored value instruments may vary as states take differing approaches to these assets. Some states, like California and Washington, require debtors in bankruptcy to continue to honor gift certificates issued before the bankruptcy filing. *See* Cal. Civ. Code § 1749.6(b) ("An issuer of a gift certificate who is in bankruptcy shall continue to honor a gift certificate issued prior to the date of the bankruptcy filing on the grounds that the value of the gift certificate constitutes trust property of the beneficiary."); RCW 19.240.090. Further, external considerations may impact whether debtors are obligated to honor gift cards after filing for bankruptcy; after the intervention of multiple state attorneys general, Radio Shack was obligated to honor more than $46 million in outstanding gift certificates. Generally, however, unless relevant state law creates an exception, a bankruptcy court may zero out any stored value.

If a court views a token to be more like a frequent flier mile, token holders may lose the value of their tokens unless the debtor reorganizes under Chapter 11, merges with, or is acquired by another entity. In many cases, reward-type assets are not considered the property of passengers and may be eliminated at the airline's discretion. A bankruptcy court may also allow the issuer to alter the contractual rights promised to token holders. In some instances, businesses that are separate from the airline may offer frequent flier programs, which may protect the program from insolvency, but the bankruptcy court may still provide the debtor with relief by altering the contractual relationship between these entities to reduce or eliminate the value of the frequent flier mile.

Whether considered stored value or frequent flier miles, token holders may find themselves filing unsecured claims and unlikely to recover any value in a liquidation or reorganization. In other cases, such as a merger or buyout, those assets may retain some value.

Offshore "Foundation" Complications and Investor Risk

Claimants may face unexpected hurdles caused by token issuance strategies that separated the token-issuing entity from the entity that promised future performance. In many cases, the actual issuer may have been an offshore entity (often foundations incorporated in Switzerland or Singapore), while the party that owes performance may be a U.S.-based company. In such a case, it may be unclear which entity made which promises to token purchasers. Depending on the facts,

including any covenants or representations found in token sale agreements, courts may imply a collaborative venture or may honor the separation of the entities.

Even sophisticated venture capital firms that participated in highly visible token offerings could find their funds and, by extension, their limited partners, standing behind shareholders and creditors in bankruptcy proceedings. Indeed, some tokens may not confer any claims at all.

To date, no bankruptcy court has opined on whether holders of tokens purchased via ICO may be included as creditors in a token issuer's bankruptcy proceeding. If you are concerned about the status of your assets and claims that may be available to you as a token holder, contact Carlton Fields' Crypto Insolvency and Fiduciary Practice.

[1] *See* Framework for "Investment Contract" Analysis of Digital Assets, April 3, 2019, https://www.sec.gov/files/dlt-framework.pdf ("The focus of the *Howey* analysis is not only on the form and terms of the instrument itself (in this case, the digital asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales.)"

[2] Most tokens sold as private placements were offered pursuant to Regulation D and were declared offers of equity on the respective Form Ds filed with the SEC.

[3] *See* 11 U.S.C. § 510(b).

[4] Sarbanes-Oxley Act § 803(3), 116 Stat. 745, 801, codified at 11 U.S.C. § 523(a)(19).

[5] *See* 11 U.S.C. § 523(a)(2) (excepting debts obtained through false pretenses, false representations, actual fraud, or materially false written statements); 11 U.S.C. § 523(a)(4) (excepting debts "for fraud or defalcation while acting in a fiduciary capacity"); 11 U.S.C. § 523(a)(6) (excepting debts "for willful and malicious injury").

[6] UCC § 2-105(1) ("'Goods' means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action.").

Related Practices

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