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Feature

By Alan Rosenberg

Are Debts Stemming from ICOs Dischargeable in Bankruptcy?

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Step aside, initial public offerings (IPOs):[1] Initial coin offerings (ICOs) are the newest and most exciting way for budding companies to raise money. For those who are new to the world of cryptocurrency,[2] an ICO is "a way for start-ups or online projects to raise money without selling stock or going to venture capitalists — essentially a new form of crowdfunding."[3] By utilizing ICOs, entrepreneurs raise capital during the early stages of business development without giving up equity. Sounds great, doesn't it?

Unfortunately, not all that glitters turns into gold, and ICOs are no different. Like any investment opportunity, if an ICO goes awry, lawsuits and other administrative actions will undoubtedly be filed. When litigation intensifies and judgments are entered, corporations and corporate officers might also find themselves in bankruptcy.

Debtors with ICO-related debts might be in store for a shocking surprise. Depending on the nature of the ICO and the rights bestowed upon its investors, certain ICO-related debts might be nondischargeable in bankruptcy.

Primer: What Exactly Is an ICO?

An ICO "involve[s] the opportunity for individual investors to exchange currency such as U.S. dollars or cryptocurrencies in return for a digital asset labeled as a coin or token."[4] Unlike IPOs, which sell stock in a company, the "coins" or "tokens" purchased from ICOs are typically (but not always) designed to purchase the goods or services being created by the issuing company.[5] Nevertheless, ICOs "take many different forms, and the rights and interests [that] a coin is purported to provide the holder can vary widely."[6]

To the extent that an ICO offers investors the opportunity to share in future profits of a company, an ICO might resemble a securities offering — thus implicating the application of securities laws. Jay Clayton, chairman of the Securities and Exchange Commission (SEC), uses the following as an example:

> [A] token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value — with the ability to lock in those increases by reselling the tokens on a secondary market — or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.[7]

1 An IPO "is the first time that the stock of a private company is offered to the public." *See* "Initial Public Offering," *Investopedia, available at* investopedia.com/terms/i/ipo.asp (defining initial public offerings) (unless otherwise specified, all links in this article were last visited on May 21, 2018).
2 "Cryptocurrencies are a form of virtual currency" that "act[s] as an alternative to traditional currency, based upon a technology known as a 'blockchain.'" Alexander B. Lindgren, "Blockchain Regulation: Growing Pains of a Financial Revolution," *Orange County Law.*, October 2017, at 38.
3 Nathaniel Popper, "An Explanation of Initial Coin Offerings," *N.Y. Times*, Oct. 27, 2017.
4 SEC Statement on Cryptocurrencies and Initial Coin Offerings, SEC Chairman Jay Clapton, Dec. 11, 2017, at ¶ 4.
5 *See* Popper, *supra* n.3 (noting that "new tokens are usually designed so that they can be used only on a computing service the programmers are building").
6 *See* SEC Statement, *supra* n.4.
7 *Id.*

To the extent that an ICO resembles a securities' offering or the tokens themselves resemble securities, the issuing company's failure to comply with applicable securities' laws could result in fines, penalties and judgments. These ICO-related debts would potentially become nondischargeable under § 523(a)(19) of the Bankruptcy Code.

Section 523(a)(19): Inadvertently Making ICO Debts Nondischargeable Since 2002

In the early 2000s, presumably before anyone uttered the phrase "initial coin offering," the financial world was rocked by a barrage of financial scandals.[8] In the wake of these events, the "zeal for corporate governance reform gained unexpected momentum and resulted in the surprisingly quick enactment of the Sarbanes-Oxley Act to correct systemic weaknesses in corporate governance structures."[9] The Sarbanes-Oxley Act also included a supplement to the Bankruptcy Code: 11 U.S.C. § 523(a)(19)(A).[10]

Section 523(a)(19)(A) "renders debts nondischargeable when they arise in connection with a violation of state or federal securities law."[11] The application of § 523(a)(19) requires a relatively simple analysis:

> Essentially, a debtor cannot discharge his or her debt if two conditions are satisfied: first, the debt must stem from a violation of securities laws or a fraud in connection with the purchase or sale of a security, and second, the debt must be memorialized in a judicial or administrative order or settlement agreement.[12]

Some courts have extended 11 U.S.C. § 523(a)(19) to debts imposed on a debtor as a result of a third party's conduct.[13] In other words, a violation of securities laws by a corporate *entity* could render the debt of a corporate *officer* nondischargeable if the debt arises from that securities violation.[14]

If an ICO-related securities' judgment is entered against a debtor pre-petition, the bankruptcy court's task is easy. If the judgment at issue indicates that the debtor's ICO-related activities violated securities laws, the debt stemming from that judgment would almost certainly be nondischargeable. However, if a debtor files for bankruptcy *before* the entry of a judgment, the bankruptcy court's analysis is more complicated.

In that situation, the bankruptcy court must make its own determination as to whether a debtor's ICO-related activities are violative of applicable securities laws. Moreover, some bankruptcy courts have held that the court can determine the liability and damages for alleged securities violations, then make its own dischargeability determination under § 523(a)(19).[15] Because it does not appear that any U.S. bankruptcy court has undertaken such an analysis in the context of ICOs, we must look to other authorities for guidance.

The DAO: A Modern Day Example

On July 25, 2017, the SEC released its "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO" (hereinafter the "report"). It analyzed whether a decentralized autonomous organization (DAO)[16] and its affiliates violated federal securities laws through their ICO. The DAO operated

> as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ... that supported secondary trading in The DAO Tokens.[17]

Unfortunately, a hacker stole approximately one-third of the DAO's assets before the DAO could fund any projects. The theft prompted an investigation that "raised questions regarding the application of U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question [of] whether DAO Tokens are securities."[18] The SEC eventually found that DAO tokens were securities, likening them to investment contracts.[19]

In conducting its analysis, the SEC applied the *Howey* test, set forth by U.S. Supreme Court in *SEC v. W.J. Howey Co.*,[20] to determine whether an investment scheme qualifies as an investment contract. The *Howey* test requires the court to determine "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[21] In applying the *Howey* test, the SEC found that (1) investors in the DAO invested money, albeit in the form of virtual currency; (2) as evident from its promotional materials, investors in the DAO expected to share in profits generated from proposed projects; (3) the

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8 An author coined 2002 as the "Year of the Scandal," noting the financial scandals at Enron, WorldCom, Tyco and other companies. *See* Jake Ulick, "2002: Year of the Scandal," CNN Money (Dec. 17, 2002), *available at* money.cnn.com/2002/12/17/news/review_scandals/index.htm.

9 Kathleen F. Brickey, "From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley," 81 *Wash. U.L.Q.* 357, 359 (2003).

10 11 U.S.C. § 523(a)(19) excepts from discharge any debt that:
(A) is for —
(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or
(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and
(B) results, before, on, or after the date on which the petition was filed, from —
(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;
(ii) any settlement agreement entered into by the debtor; or
(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

11 *Tripodi v. Welch*, 810 F.3d 761, 766 (10th Cir. 2016).

12 *Id.* (citations omitted).

13 *See, e.g., In re Lunsford*, 848 F.3d 963, 968 (11th Cir. 2017) (noting that "[t]he text and structure of section 523(a)(19)(A) unambiguously prevent discharge of debts 'for the violation' of securities laws irrespective of debtor conduct").

14 *Id.* (stating that "section 523(a)(19)(A) precludes discharge regardless of whether the debtor violated securities laws as long as the securities violation caused the debt").

15 *See, e.g., In re Sato*, 512 B.R. 241, 251 (Bankr. C.D. Cal. 2014) (finding that "[t]he more expanded view holds that the bankruptcy court can determine the liability, damages, and dischargeability of the debt for securities violations and securities fraud and issue its own judgment to satisfy § 523(a)(19)(B)") (citations omitted); *In re Chan*, 355 B.R. 494, 505 (Bankr. E.D. Pa. 2006) (finding that "it is perfectly appropriate for either the bankruptcy court or another court to make a dischargeability determination under § 523(a)(19)").

16 A DAO "is a term used to describe a 'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain." *See* "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO," Exchange Act Release No. 81207, P.1 (July 25, 2017).

17 *See* report, *id.*

18 *Id.*

19 *Id.* at p. 11 (July 25, 2017) (noting that "an investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others") (citations omitted).

20 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946).

21 *SEC v. Edwards*, 540 U.S. 389, 393 (2004) (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946)).

investors' profits were to be derived from the managerial efforts of others; and (4) although investors were given the right to vote on the acceptance of revenue-generating projects, their rights were limited and did not equate to the significant managerial efforts or control exercised by the promoters of the DAO.[22] Because the DAO tokens were deemed securities and there was no applicable exemption, the DAO was required to register the offer and sale of DAO tokens with the SEC.[23]

Conclusion

According to the SEC, "[c]ompanies and individuals are increasingly considering [ICOs] as a way to raise capital or participate in investment opportunities."[24] Although ICOs possess certain characteristics that can make them more attractive than traditional capital-raising activities, the traits of an individual ICO might require its issuer to comply with securities laws.

Moreover, if an ICO is deemed to be a securities offering, it must be registered and accepted by the SEC.[25] Absent registration and acceptance by the SEC, the ICO issuer and its officers might be subject to fines, penalties or judgments — debts that might ultimately be deemed nondischargeable in bankruptcy. Accordingly, ICO issuers must carefully determine whether their particular ICO implicates securities laws, and if so, they must ensure strict compliance therewith. Otherwise, the debt stemming from an ICO might equate to a nondischargeable IOU to the U.S. government or other creditors. abi

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22 Report, *supra* n.16 at p. 11-15.

23 *Id.* at p. 16.

24 "Initial Coin Offerings (ICOs)," U.S. Securities and Exchange Commission, *available at* sec.gov/ICO.

25 This feat does not yet appear to have been accomplished by any ICO. However, in March 2018, the Praetorian Group (a cryptocurrency real estate investment vehicle) filed paperwork with the SEC to register a $75 million ICO as a security offering. If accepted by the SEC, the Praeotorian Group will hold the first SEC-registered ICO. *See* Molly Jane Zuckerman, "Praetorian Group Files to be First ICO to Sell Registered Security Tokens in U.S.," *Cointelegraph* (March 9, 2018), *available at* cointelegraph.com/news/praetorian-group-files-to-be-first-ico-to-sell-registered-security-tokens-in-us.