

Cryptocurrency Litigation Update

Court Allows Government's Criminal Case Against REcoin Founder to Proceed

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09 / 20 / 18

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Four Times Square
New York, NY 10036
212.735.3000

300 S. Grand Ave., Suite 3400
Los Angeles, CA 90071
213.687.5000

On September 11, 2018, Judge Raymond J. Dearie of the U.S. District Court for the Eastern District of New York issued a new decision in *U.S. v. Zaslavskiy*, No. 1:17-cr-00647-RJD-RER, Dkt. No. 37 (E.D.N.Y. Sept. 11, 2018), denying a motion to dismiss the government's criminal indictment on the grounds that the initial coin offerings (ICOs) at issue did not involve the offer or sale of "securities" and thus were beyond the reach of federal securities laws. Although the decision contains a discussion of the defendant's digital tokens and their potential regulation as "securities" under the federal securities laws — a hotly contested issue — we believe that the ruling's significance will prove to be limited.

As alleged in the indictment, defendant Maksim Zaslavskiy founded two companies called REcoin Group Foundation, LLC (REcoin) and DRC World, Inc., aka Diamond Reserve Club (Diamond). From January 2017 to October 2017, REcoin and Diamond engaged in a series of ICOs in which investors purchased cryptocurrency tokens issued by both companies. The government alleges that, contrary to Zaslavskiy's promises to investors, the ICOs were not backed by real estate investments and diamonds. As a result, the U.S. Attorney's Office for the Eastern District of New York brought criminal charges against Zaslavskiy for securities fraud in connection with the ICOs.¹

Zaslavskiy moved to dismiss the indictment against him on the grounds that the indictment did not provide adequate notice of the charges under Federal Rule of Criminal Procedure 7(c); the digital tokens were not "securities" under the U.S. Supreme Court's guiding decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); and the U.S. securities laws are unconstitutionally vague as applied to cryptocurrencies like the ones alleged to be at issue. As the decision was made at the motion-to-dismiss stage, the allegations in the indictment were accepted as pleaded.

Treating the allegations in the indictment as true, Judge Dearie concluded that the government had adequately alleged that (i) investors paid money for "membership" in REcoin and Diamond; (ii) a common enterprise existed because "it can be readily inferred from the facts alleged that the REcoin and Diamond investment strategies depended upon the pooling of investor assets to purchase real estate and diamonds"; and (iii) investors "reasonably expected their profits to be derived from the managerial efforts of Zaslavskiy and his team," based in part on the defendant's statements that his team "would use their expertise to develop the ventures, invest proceeds in real estate and diamonds, and generate profits." However, in conducting its analysis, the court expressly avoided finally resolving whether the tokens at issue qualified as securities, leaving the ultimate conclusion on that central question to later in the case.

The court also determined that the securities fraud laws under which Zaslavskiy was charged were not unconstitutionally vague as applied to his alleged conduct.

The Impact of *Zaslavskiy*

Although the decision, on its surface, may seem noteworthy because it applies the *Howey* test to the offer of digital tokens, we believe that it should not be viewed as particularly important for two primary reasons.

First, the court's holding did not include a final determination that the offerings at issue involved securities. To the contrary, the court merely held that the government had

¹ The Securities and Exchange Commission (SEC) also brought a similar civil suit in which the government intervened and stayed pending the resolution of the criminal case.

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included enough detail in its indictment to survive dismissal at this stage of the case. As such, the critical question under *Howey* remains unanswered, and, in the words of the court, will be decided by the ultimate fact-finder “based on the evidence presented at trial.”

Second, as the court acknowledged and as the SEC has previously stated, determining whether a particular digital asset is a security under the *Howey* test is necessarily a facts- and circumstances-specific inquiry. Indeed, the court's opinion expressly noted that a fact-specific assessment was especially necessary “in the context

of ‘relatively new, hybrid vehicle[s],’ which require ‘case-by-case analysis into the economic realities of the underlying transaction[s].’” This case involved a specific alleged fact pattern — the defendant promised to use the funds from ICOs to invest in real estate and diamonds but invested in neither. Thus, we believe that any attempt to draw broader conclusions from this decision in order to apply them to other fact patterns and/or the cryptocurrency industry at large should be avoided.

Contacts

Alexander C. Drylewski

Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Ryan J. Dzierniejko

Partner / New York
212.735.3712
ryan.dzierniejko@skadden.com

Gregory A. Fernicola

Partner / New York
212.735.2918
gregory.fernicola@skadden.com

Stuart D. Levi

Partner / New York
212.735.2750
stuart.levi@skadden.com

Peter B. Morrison

Partner / Los Angeles
213.687.5304
peter.morrison@skadden.com

Andrew R. Beatty

Associate / New York
212.735.3278
andrew.beatty@skadden.com