November 16, 2022

Skadden

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Alexander C. Drylewski
Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Stuart D. Levi
Partner / New York
212.735.2750
stuart.levi@skadden.com

Daniel Michael
Partner / New York
212.735.2200
daniel.michael@skadden.com

Shireen Lankarani
Associate / New York
212.735.2456
shireen.lankarani@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

Court Rules in Favor of SEC in LBRY Enforcement Action

On November 7, 2022, Judge Paul Barbadoro of the U.S. District Court for the District of New Hampshire issued an order in *SEC v. LBRY, Inc.*, granting the SEC's motion for summary judgment against LBRY Inc. (LBRY). The court found that LBRY offered its digital asset, called LBC tokens, as a security in violation of Section 5 of the Securities Act of 1933 (Securities Act). The ruling comes about a year and a half after the SEC brought its enforcement action against LBRY and marks the SEC's latest summary judgment win in the digital asset space.[1] It also demonstrates a willingness by courts to adopt the SEC's interpretation of various prongs of the *Howey* analysis.[2]

Background

LBRY is self-described as the "first decentralized, open-source, fully encrypted content distribution service built using the same blockchain technology that underlies Bitcoin." In 2016, the company launched the LBRY Network as a decentralized platform for publishing and consuming content. As part of the launch, LBRY issued LBC, which could be spent on the LBRY Network to (1) publish content, (2) create channels, (3) tip content creators, (4) purchase access to content, (5) boost content or channels in searches, (6) edit published content and (7) pay miners. LBRY reserved 400 million LBC for itself in order to fund development, offset operational expenses and form institutional partnerships. The remaining 600 million LBC were to become available over 20 years.

On March 29, 2021, the SEC brought an enforcement action against LBRY alleging violations of Section 5 of the Securities Act. The SEC alleged that LBC tokens were offered as an investment contract and, therefore, were required to be offered and sold pursuant to a registration statement or subject to an available exemption from registration. Both the SEC and LBRY moved for summary judgment, and a hearing was held on July 20, 2022. On November 7, 2022, the court issued its order granting the SEC's motion for summary judgment and denying LBRY's cross-motion for summary judgment.

[1] Previously, the U.S. District Court for the Southern District of New York granted the SEC's motion for summary judgment against another issuer of digital assets in *SEC v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

[2] In *SEC v. W.J. Howey Co.*, 328 US 293, 298-99 (1946), the U.S. Supreme Court held that "an investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."

Ruling

In granting the SEC's motion for summary judgment, the court's analysis focused primarily on two issues: (1) whether purchasers of LBC had an expectation of profits based on the efforts of LBRY under *Howey*; and (2) whether the SEC give fair notice that LBRY needed to register its offerings. Both were answered in the affirmative.

(Some of) The Words Matter

In assessing whether there was a reasonable expectation of profits based on the efforts of others, Judge Barbadoro focused his analysis on statements that LBRY and its representatives made to prospective purchasers. The court concluded that these statements led investors to reasonably believe that LBC would grow in value as the company continued to develop and oversee the LBRY Network. The court explained that LBRY's market capitalization was $140 million in June 2016, but "skyrocket[ed]" to $1.2 billion the following month. In setting this background, the court then pointed to seven statements:

- an early-stage LBRY blog post stating, among other things, that "the long-term value proposition of LBRY is tremendous, but also dependent on our team staying focused" and "[o]ver the long-term, the interests of LBRY and the holders of [LBC] are aligned";
- an email from LBRY's COO to a potential investor that trading was moving at a healthy clip and opportunity was obvious;
- a blog post by LBRY's CEO outlining supply and demand reasons for why LBC's price was low, explaining that LBRY's goal was to replace YouTube and Amazon and encouraging investors to hold their LBC;
- communications on Reddit between a user and LBRY's community manager, where the manager explained that LBC would only be worth something if LBRY delivers on its promises to create a way to share and monetize content;
- an interview with LBRY's "technology evangelist" where he explained, among other things, how the future "value of LBRY credits" would depend on "the success of [LBRY's] media marketplace";
- an essay written by LBRY's CEO on "incentive problems" in developing open-source alternatives to existing technology companies; and
- an LBRY blog post discussing demand and the "token economy."

Based on these representative statements, the court concluded that "potential investors would understand that LBRY was pitching a speculative value proposition for its digital tokens" and the "messaging amounts to … a 'not-very-subtle form of economic inducement.'" In reaching this conclusion, the court rejected LBRY's argument that the statements the SEC identified were only 0.25% of all statements LBRY issued. The court explained that comparing these statements to all statements made by the company is misleading because LBRY made statements on various topics.

The court also discounted other statements in which LBRY disclaimed and disavowed that LBC purchasers should expect profits based on LBRY's ongoing efforts. In doing so, the court emphasized that "a disclaimer cannot undo the objective economic realities of a transaction."

Even absent these statements, the court concluded that reasonable investors who looked to LBRY's business model would have understood that LBC was to grow from managerial efforts because LBRY's profitability was tied to LBC's value. LBRY would be profitable if it increased the value of LBC by increasing usage of the LBRY Network. In so holding, the court concluded that by retaining 400 million LBC for itself, LBRY "signaled that it was motivated to work tirelessly to improve the value of its blockchain for itself and any LBC purchasers."

To Consume or Not To Consume: Is That the Question?

The court only briefly addressed LBRY's argument that LBC was purchased by many as a utility token for consumptive use rather than to invest. In rejecting this argument, the court stated that "[n]othing in the case law suggests that a token with both consumptive and speculative uses cannot be sold as an investment contract." The court also found "limited relevance" in statements from some purchasers indicating they purchased LBC for consumptive use on the LBRY Network. The court concluded that even if some tokens were purchased with consumptive intent, that did not mean that LBC was not offered as a security.

Fair Notice

Lastly, the court rejected LBRY's argument that the SEC failed to provide fair notice that its offerings were subject to securities laws. LBRY based this argument on the assertion that prior SEC enforcement actions were all in the context of initial coin offerings (ICOs). The court reasoned that nothing suggests that *Howey* is applicable only to ICOs, and emphasized that the *Howey* analysis is inherently fact-specific and could be applied to variety of new circumstances.

Key Takeaways

The decision is notable in several respects. In general, the court's analysis is brief, consisting of only 15 pages and lacking guidance on certain issues, such as whether there was a common enterprise. For the analysis that the decision does provide, the court appears to engage in a "SEC-friendly" review of the reasonable expectation of profits prong of *Howey*. While the court acknowledged it must assess the objective economic realities of the transaction, it spent little time focusing on those realities as set forth in a White Paper or other pre-offering statements. Rather, the court focused on private statements to potential purchasers, statements to Reddit users, statements on blog posts and statements in interviews. Some of these statements, such as the e-mail to the potential investor, were not made broadly, and most statements to which the court pointed were made post-offering, at which point it could be argued that the expectations of purchasers are far less probative or relevant.

Also notable is the court's lack of meaningful engagement with statements made by LBC purchasers indicating they acquired LBC for consumptive use. Concluding that these statements were of "limited relevance," the court failed to explain why that was so or what sort of evidence (if any) would be sufficient to show non-investment intent or to counteract post-offering suggestions by an issuer. Moreover, the court seemingly applied a standard to this question that required LBRY to demonstrate that consumptive use was the only motivation for purchasers to acquire LBC. But such an interpretation arguably is inconsistent with the Supreme Court's application of *Howey*, which suggests that the profits from the efforts of others must be the most significant element of the instrument's character to satisfy *Howey*. *See Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 560-61 (1979) (*Howey* requires that interest acquired must be "substantially the characteristics of a security"); see also *SEC v. Aqua-Sonic Products Corp.*, 687 F.2d 577, 582 (2d Cir. 1982) (assessing "whether, under all the circumstances, the scheme was being promoted *primarily* as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way" (emphasis added)). At the very least, given the existence of evidence that some purchasers acquired LBC for consumptive purposes, it is surprising that the court did not allow the question of consumptive versus investment intent to be presented to a jury.

Further, although the court concluded that a token can have consumptive uses but still constitute an investment contract, it did not analyze LBC's specific consumptive uses in drawing this conclusion. The court's analysis may have been driven by a general skepticism regarding the level of engagement of users with the LBRY Network and the claimed specific uses of LBC, evidenced by the fact that by the time LBRY's market capitalization "ballooned" from $400 million to $1.2 billion in a month, "only three videos were available on the blockchain, each produced by LBRY itself."

Finally, the court gave little credence to LBRY's fair notice defense. While this does not sound the death knell for the fair notice defense, it marks the second decision in the digital asset space (the first being Judge Hellerstein's decision in *Kik*) that signals a skepticism to the argument. Here, LBRY's fair notice argument appears to have been limited to whether the SEC had provided guidance on Section 5 liability as it relates to digital assets offered outside the context of ICOs. Given this focus, it is questionable whether the court's reasoning on this narrow issue will be instructive in other cases determining whether fair notice was provided in the digital asset space.

It bears emphasis that the LBRY decision is not binding on any other court or party, and may be limited to the specific facts and circumstances of the case.