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ARTICLE

Circuit Split Brews Over Who's A Securities Seller Under Act

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Section 12 of the Securities Act of 1933,[1] long thought of as a mere tagalong to Section 11,[2] has ballooned in significance in the last couple of years, especially in the context of alternative public offerings involving direct listings or digital assets.

The development of Section 12 case law is particularly important given the U.S. Supreme Court's admonition in the June 1, 2023, Slack Technologies LLC v. Pirani decision, that Sections 11 and 12:

- Do not "necessarily travel together;"
- Contain "distinct language that warrants careful consideration;" and
- Should be analyzed individually.[3]

Unlike Section 11, which only applies to registration statements, Section 12(a)(2) creates liability for misleading statements in "a prospectus or oral communication." Meanwhile, Section 12(a)(1) creates private liability for the offer or sale of an unregistered security in violation of Section 5.[4]

In recent years, purchasers of digital assets, such as digital tokens or cryptocurrency, have pursued claims against creators of digital tokens, operators of digital-asset exchanges — centralized and decentralized — and investors thereof, alleging the sale of unregistered digital assets is unlawful under Section 12(a)(1).

While the issue of whether a particular digital asset is a security initially dominated the conversation, another issue with Section 12 has begun to percolate in the courts, namely who can be sued for Section 12 violations.[5]

By its text, Section 12 applies only to a person who offers or sells a security and is liable only to "the person purchasing such security from him."[6]

Courts have termed such defendants "statutory sellers," which include only those who (1) pass title to the purchaser, or (2) solicit the purchase, motivated at least in part by their own financial interest.

Courts routinely dismiss cases against other improper defendants.[7]

However, who constitutes a statutory seller is not as straightforward as it may seem, especially with respect to digital assets. Recent decisions provide guidance, but a potential circuit split may complicate the matter for all involved in the digital-asset space, as well as the traditional securities market.

PASSING TITLE

Analysis of the first category of defendants — those who transfer title to the purchaser — has traditionally been straightforward.

In the 1988 Pinter v. Dahl decision, the Supreme Court made clear that Section 12 "imposes liability on only the buyer's immediate seller; remote purchasers are precluded from bringing actions against remote sellers."[8] Thus, "a buyer cannot recover against his seller's seller."[9]

However, in the digital-asset context, who, if anyone, passed title is not always clear, especially with respect to decentralized exchanges, but also when the transfer occurs on a centralized exchange. A recent set of cases in the U.S. Court of Appeals for the Second Circuit dealt with these issues.

First, in the Aug 30, 2023, Risley v. Universal Navigation Inc. decision,[10] the court addressed whether the developers of and investors in a decentralized cryptocurrency exchange passed title of the tokens traded thereon.

Unlike a centralized exchange that relies on third-party intermediaries to match buyers and sellers, a decentralized exchange is programmed to run through smart contracts, which are automated digital contracts stored on a blockchain.

Further, instead of purchasing from a matched seller, buyers on decentralized exchanges acquire their tokens from "liquidity pools" — pools of tokens sitting on the exchange that were initially provided by the token's allocater.

Thus, a buyer does not purchase from a seller but rather acquires the desired token from the decentralized exchange's pool of assets. In Risley, the plaintiffs alleged that the defendants passed title because they wrote the smart contracts that allowed the exchange to function.

The court rejected the plaintiffs' position, finding instead that the developers of smart contracts did not pass title of the tokens.

The court analogized the smart contracts to the roles that lawyers and underwriters play in traditional exchanges, holding that

[j]ust as Section 12(a)(1) does not apply to those who draft base-level agreements for trades to access the stock market, it does not apply to software coders who create an exchange to efficiently facilitate trades.

In both cases, "the party sued facilitated — but was not party to — the contested transaction."

The court also found that the exchange and the other defendants did not "have title (even momentarily) over each token on the Protocol."

And even if "the Court were to find that title passes from, for example, the pool to the Protocol to one of the Plaintiffs, this split second, autonomous function would make the Protocol collateral to the transaction," which is an "insufficient predicate for Section 12 liability."

Second, in the April 5 Oberlander v. Coinbase Global Inc. decision,[11] the U.S. Court of Appeals for the Second Circuit addressed the issue of passing title of digital assets on a centralized exchange.

The plaintiffs alleged that Coinbase — a centralized digital-asset exchange — violated Sections 5 and 12(a)(1) of the Securities Act by selling unregistered securities to the plaintiffs.

The U.S. District Court for the Southern District of New York initially dismissed the Section 12 claims, finding that Coinbase did not hold title to the subject tokens, did not pass title to the plaintiffs, and thus was not a statutory seller.[12]

In doing so, the district court relied on a version of Coinbase's user agreement that provided purchasers were not buying digital assets directly from Coinbase.[13]

Specifically, the agreement provided thatt "when you purchase (buy) or sell Digital Currency on the Coinbase Site, you are not buying Digital Currency from Coinbase."[14]

On appeal, the Second Circuit reversed, holding that there were other user agreements in effect during the class period that stated the opposite, specifically that the users were purchasing "Digital Currency from Coinbase."[15]

The court held that

[i]n light of the varying language in different versions of the user agreement in effect during the class period, the district court could not treat [the nonsale version] as conclusive for the purposes of evaluating the legal sufficiency of the amended complaint [and therefore plaintiffs] have plausibly alleged claims under Section 12(a)(1) that survive a motion to dismiss.[16]

Notably, the Second Circuit did not confront the argument in Risley that "split second" passing of title is insufficient under Section 12 since it is collateral to the underlying transaction between a buyer and seller.

Rather, the Second Circuit focused on the fact that Coinbase's user agreement said buyers were purchasing from Coinbase. The Second Circuit's decision is instructive for digital-asset exchanges in drafting user agreements and other similar governance documents.

SOLICITATION

Analysis of the second category of defendants — those who do not pass title but instead solicit the purchase motivated by their own financial interest — is less straightforward.

The Supreme Court has been clear — in Pinter — that "mere participation in unlawful sales transactions" or being a "collateral" participant is insufficient to qualify as a statutory seller.[17]

Because Section 12 "contemplates a buyer-seller relationship not unlike traditional contractual privity,"[18] courts had long required that the defendant directly solicit the buyer's purchase.[19]

In the last couple of years, however, both the U.S. Court of Appeals for the Ninth Circuit and U.S. Court of Appeals for the Eleventh Circuit have taken broader approaches, holding that solicitation need not be directed or targeted to a particular purchaser; rather, the promotion of a security in a mass communication may be enough to make someone a statutory seller.[20]

The loosening of the direct solicitation requirement has implications for anyone promoting a digital asset or traditional security, and has potentially created a circuit split with the Second Circuit,[21] as well as the U.S. Court of Appeals for the Third Circuit,[22] and the U.S. Court of Appleals for the Fifth Circuit,[23] as demonstrated in recent disparate district court outcomes.

For example, in the Sept. 20, 2023, Houghton v. Leshner[24] decision, the U.S. District Court for the Northern District of California declined to dismiss a case against the founders and partners of Compound DAO based on the theory that the defendants solicited purchases of Compound's governance tokens.

The purchasers alleged that the defendants designed the governance tokens, monetized the tokens by encouraging secondary markets, and commented publicly about them.

The court found that such allegations are sufficient to allege the defendants were statutory sellers because "[s]olicitation is broadly construed in the Ninth Circuit" and the defendants do not have to "directly or actively target the particular plaintiff."[25]

Houghton found inapposite cases from the Second Circuit, including the Risley decision discussed earlier. Risley held that the developers of and investors in a decentralized exchange were not statutory sellers because, inter alia, they did not directly solicit the plaintiffs' purchases.[26]

Likewise, the U.S. District Court for the Southern District of New York rejected a solicitation claim where plaintiff had not "shown that he was directly contacted by [d]efendants or that he purchased securities as a result of any active solicitation by [d]efendants."[27]

Houghton distinguished these cases as being decided under a "materially different standard," noting that the "standard is decidedly broader in the Ninth Circuit ... where 'direct' contact is not required and liability may flow from mass communications."[28]

A recent decision from the U.S. District Court for the District of Utah — in the U.S. Court of Appeals for the Tenth Circuit — also followed the Ninth and Eleventh Circuits' standard in declining to dismiss Section 12 claims against a token's creators and promoters who made a series of promotions on social media.[29]

It is apparent, then, that there is a developing circuit split, and the jurisdiction in which a case is filed may be outcome determinative at the pleading stage.

TAKEAWAYS

In sum, Section 12 is rapidly becoming a favored statute for plaintiffs to assert strict liability claims against a host of participants in both the digital asset and traditional securities markets.

Courts have just recently begun to grapple with Section 12's intricacies, including the statutory seller requirement. In this regard, courts look to contracts between the parties to determine who passed title of the asset to the purchaser.

And, with respect to solicitation, the Ninth and Eleventh Circuits' loosening of the so-called direct requirement has created potential liability for a vast number of defendants, while those same defendants may successfully move to dismiss such actions in the Second, Third and Fifth Circuits.

Absent congruent rulings from the circuit courts, the Supreme Court may have to decide this issue of nationwide importance.

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[1] 15 U.S.C. § 77l.

[2] 15 U.S.C. § 77k.

[3] Slack Techs., LLC v. Pirani , 598 U.S. 759, 770 n.3 (2023).

[4] 15 U.S.C. § 77e.

[5] Whether digital assets are securities is beyond the scope of this article.

[6] 15 U.S.C § 77l.

[7] See, e.g., Lozada v. TaskUs, Inc. , 2024 WL 68571, at *17–20 (S.D.N.Y. Jan. 5, 2024); In re 2U, Inc. Sec. Class Action , 2021 WL 3418841, at *27–28 (D. Md. Aug. 5, 2021).

[8] Pinter v. Dahl , 486 U.S. 622, 643-644 n.21 (1988).

[9] Id.

[10] 2023 WL 5609200 (S.D.N.Y. Aug. 29, 2023), appeal filed, 2nd Cir., September 28, 2023.

[11] 2024 WL 1478773 (2d Cir. Apr. 5, 2024).

[12] Underwood v. Coinbase Glob., Inc . 654 F. Supp. 3d 224, 236–39 (S.D.N.Y. 2023).

[13] Id. at 237.

[14] Id.

[15] Oberlander, 2024 WL 1478773 at *4.

[16] Id.

[17] Pinter, 486 U.S. at 650.

[18] Pinter, 486 U.S. at 642.

[19] See, e.g., In Re Violin Memory Sec. Litig. , 2014 WL 5525946, at *18 (N.D. Cal. Oct. 31, 2014).

[20] Pino v. Cardone Cap., LLC , 55 F.4th 1253, 1258 (9th Cir. 2022); Wildes v. BitConnect Int'l PLC , 25 F.4th 1341, 1345–46 (11th Cir. 2022).

[21] Capri v. Murphy , 856 F.2d 473, 478 (2d Cir. 1988) ("plaintiffs must show that [defendant] actually solicited their investment").

[22] In re Westinghouse Sec. Litig. , 90 F.3d 696, n. 19 (3d Cir.1996) (Alito, J.) (direct and active participation in solicitation is necessary for solicitation liability).

[23] Rosenzweig v. Azurix Corp. , 332 F.3d 854, 871 (5th Cir. 2003) ("To count as a 'solicitation,' the seller must, at a minimum, directly communicate with the buyer.").

[24] Houghton v. Leshner , 2023 WL 6826814 (N.D. Cal. Sept. 20, 2023).

[25] Id. at *3, n.1.

[26] 2023 WL 5609200, at *18–19 (S.D.N.Y. Aug. 29, 2023).

[27] Holsworth v. BProtocol Found , 2021 WL 706549, at *3 (S.D.N.Y. Feb. 22, 2021).

[28] 2023 WL 6826814 at *4.

[29] Combs v. SafeMoon, LLC , 2024 WL 1347409, at *21–22 (D. Utah Mar. 29, 2024).

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