

First Civil Litigation in the U.S. Brought in Response to the Crash of the Stablecoin TerraUSD

JUNE 23, 2022

On June 13, 2022, a class-action lawsuit was filed in the Northern District of California against Binance U.S. (“Binance”), the United States-headquartered partner of one of the most prominent global digital asset exchange platforms. The named Plaintiff, who had purchased Terra USD (“UST”) through Binance since April 13, 2022, alleges, among other things, that Binance misrepresented UST as a “safe” asset to purchasers and violated U.S. federal and state securities laws.^[1]

The impetus for the lawsuit was the rapid collapse in the value of UST, an algorithmic stablecoin, and its sister token, LUNA, which occurred in May 2022. This action is the first civil litigation in the U.S. brought in response to the crash of UST.^[2] As a result, it could portend the future landscape of private litigation related to stablecoins and digital assets in general.

Algorithmic Stablecoins

While traditional stablecoins such as Tether are purportedly backed by assets to protect the digital asset against price volatility, algorithmic stablecoins are designed to maintain their peg utilizing an algorithm and, at least in the case of UST, a relationship with a second digital asset. For UST and LUNA, the algorithm was meant to keep the value of UST pegged to U.S. \$1. The “frictionlessly swappable” digital assets were designed to make UST “widely used in multiple markets” and provide a means for “low-friction cross-border transfers.”^[3]

The ecosystem for UST and LUNA revolved around various decentralized applications (“dApps”) and protocols, which are sets of codes or rules governing a system. For example, Do Kwon, the founder of UST, advertised that an “Anchor Protocol” for UST provided purchasers of the stablecoin with a “stable yield.”^[4] UST’s peg to \$1 was designed to be ensured by investors’ incentive for arbitrage. When the price of one UST rises above \$1, the algorithm would allow LUNA holders to mint UST by exchanging \$1 of LUNA for one UST, hence earning a profit. This would increase the supply of UST and decrease the supply of LUNA, and the price of UST would return to \$1. On the other hand, when the price of UST falls below \$1, UST holders would presumably mint LUNA in exchange for UST. This would remove the UST from circulation and increase the supply of LUNA.

Collapse of UST

Beginning in early 2022, UST slowly abandoned a purely algorithmic approach and began to rely on Bitcoin reserves to maintain UST's peg to the U.S. dollar. This, along with various market factors, propped the price of UST and LUNA to all-time highs.

In May 2022, however, UST's value dropped precipitously. This prompted holders of UST to sell the digital asset, which created a downward spiral for both UST and LUNA. The Bitcoin reserves intended to defend UST's peg dwindled from 80,394 Bitcoins from May 7, 2022, to 313 by May 16, 2022.^[5] By the end of May 2022, the U.S Dollar price of UST was approximately one cent.

Allegations That UST Is an Unregistered Security

In the lawsuit, the proposed class representative argues that UST is an unregistered security under both the *Howey* test and as a derivative product of LUNA. In the *Howey* case, the U.S. Supreme Court had developed a multi-factor test that defines an "investment contract," which is a category of security, under Section 2(a)(1) of the Securities Act.^[6] The *Howey* test entails an analysis of the four characteristics of an "investment contract": (1) the investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) derived solely through the efforts of others.^[7]

Here, the Plaintiff argues that UST satisfies all four factors. First, UST purchasers had traded their digital assets in exchange for value, with real currency or LUNA.^[8] Second, the Plaintiff alleges that UST purchasers were pooled into a "common enterprise" linked to the success of the overall enterprise and UST's developers and promoters.^[9] The Plaintiff also claims that UST purchasers had a reasonable expectation to earn profits based on the efforts of UST's creators and promoters, who used reserves and protocols to maintain the UST ecosystem, thereby satisfying the third and fourth factors.^[10] The Plaintiff further states in its complaint that UST is an unregistered security because it is a derivative of LUNA, which it alleges is also an unregistered security.^[11]

The Plaintiff alleges that Binance violated U.S. securities law by listing and selling UST. The Plaintiff points out in its complaint that Binance, as a centralized exchange platform, directly transacts with its customers. As a result, according to the complaint, Binance directly sold unregistered securities to UST purchasers.^[12] Furthermore, the Plaintiff alleges that, because Binance earns trading fees from the sale of digital assets on its platform, it had actively promoted UST to customers.^[13]

Though it remains to be seen whether the court will allow this class-action lawsuit to proceed, the decision could be an important harbinger in defining the legal status of stablecoins and potentially other digital assets. The circumstances under which a digital asset is regarded as a security is a controversial and much-debated topic, even within the major federal regulatory agencies in the United States. If successful, the case could also impose the onus on digital asset exchanges to conduct more extensive diligence on the digital assets listed on their platforms.

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^[1] Complaint, *Lockhart v. Bam Trading Services Inc.*, No. 3:22-cv-03461 (N.D. Cal. June 13, 2022).

^[2] A similar class-action lawsuit has been filed against Coinbase Inc. on June 16, 2022 for its promotion of UST. See Complaint, *Pearl v. Coinbase Global Inc.*, No. 3:22-cv-3561 (N.D. Cal. June 16, 2022).

^[3] Nicholas Platias, *On Swap Fees: the Greedy and the Wise*, Medium (Sept. 8, 2019), <https://medium.com/terra-money/on-swap-fees-the-greedy-and-the-wise-b967f0c8914e>.

^[4] Do Kwon, *Announcing TerraUSD (UST)*, Medium (Sept. 21, 2020) <https://medium.com/terra-money/announcing-terrausd-ust-the-interchain-stablecoin-53eab0f8f0ac>.

^[6] Christiaan Hetzner, *Luna Foundation Guard has Now Dumped \$2.4 Billion From Its Bitcoin Reserves in Failed Attempt to Defend TerraUSD Peg*, *Fortune* (May 16, 2022), <https://fortune.com/2022/05/16/luna-foundation-guard-dumps-bitcoin-reserves-terra-usd-peg/>.

^[8] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

^[7] *Id.* at 301.

^[8] Complaint at 23, *Lockhart v. Bam Trading Services Inc.*, No. 3:22-cv-03461 (N.D. Cal. June 13, 2022).

^[9] *Id.* at 24.

^[10] *Id.* at 25-35.

^[11] *Id.* at 35.

^[12] *Id.* at 40-41.

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^[13] *Id.* at 41.

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