

# LURKING BENEATH THE SURFACE: UDAP CLAIMS IN ICO LITIGATION

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## U.S. Financial Institutions Services Litigation Alert

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## INTRODUCTION

An increasing number of class action complaints have been filed over the past several months regarding initial coin offerings ("ICOs"). These suits have primarily focused on alleged securities law implications—for example, whether the token is a security, whether the token issuer conducted the ICO in compliance with federal and state securities laws, and whether the issuer engaged in securities fraud. Enforcement actions brought by state and federal regulators have also focused on alleged securities laws implications.

An often-overlooked aspect of many ICO lawsuits, however, are the claims alleging violation of state unfair and deceptive acts and practices ("UDAP") laws. Defendants in ICO litigation and other companies contemplating an ICO should pay careful attention to potential UDAP claims because the standard of proof in a UDAP claim may vary from that of a securities law claim, and UDAP claims can carry significant monetary liability, among other sanctions. State consumer protection regulators, often belonging to a different division from state securities regulators, are empowered to bring UDAP claims seeking monetary penalties and injunctive relief. Once the initial wave of securities-related ICO litigation and enforcement matters are resolved, there will likely be an increasing focus—both in existing and new suits—on UDAP claims.

## ELEMENTS OF A UDAP CLAIM

Every state has a UDAP-type statute. Although the statutes vary in their scope, standards of proof, and damages, they all share at least one common theme: significant consequences for defendants that are found liable.

Consider, for example, the Florida Deceptive and Unfair Trade Practices Act. The act prohibits a broad range of activity; anyone engaging in trade or commerce is barred from conducting "unfair methods of competition," and "unconscionable," "unfair," or "deceptive" acts or practices. [1] An unfair practice is one that "offends" public policy and is unethical, oppressive, or substantially injurious to a consumer; [2] an act is deceptive if it is likely to mislead a consumer acting reasonably to her detriment. [3] The act also covers a wide range of economic activity because trade and commerce are defined to include advertising, soliciting, providing, offering, or distributing any good, service, property, or thing of value. [4]

To prove a violation of the Florida UDAP statute, a plaintiff must show: (1) the defendant committed a deceptive or unfair practice in any act of trade or commerce; (2) the plaintiff suffered damages; and (3) the plaintiff's unfair or deceptive act caused the damages. [5] When establishing damages, the plaintiff need not show her own

reliance on the alleged unfair or deceptive act. [6] The plaintiff must show, however, that a similarly situated, reasonable consumer would have relied on the alleged unfair or deceptive act. [7] Under the Florida law, a successful plaintiff can obtain injunctive relief and recover actual damages, attorneys' fees, and court costs. [8] But not all UDAP statutes are created equal. The California Unfair Competition Law ("UCL") prohibits "unfair competition," which includes "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising." [9] To assert a UCL claim, a plaintiff must allege that (1) the defendant committed an unfair, unlawful, or fraudulent business act or practice, or put forth a deceptive, false, or misleading advertisement, and (2) the plaintiff suffered economic injury because of the defendant's act. [10] A plaintiff asserting a California UCL claim alleging fraud or false, deceptive, or misleading advertising must prove that she relied on the challenged action. [11] In particular, the plaintiff must demonstrate that the alleged unlawful conduct was "an immediate cause of [the plaintiff's] injury-producing conduct." [12] A successful private plaintiff can obtain restitution and injunctive relief. [13]

## RISE IN ICO-RELATED UDAP CLAIMS

In the last five months, plaintiffs have filed approximately 15 ICO class actions, some concerning the same ICO. At least one-third of these suits have alleged violations of state UDAP statutes. The UDAP allegations generally fall into two categories: (1) statements about the status of the network to be employed, and (2) statements about potential profits.

For instance, in *Hodges v. Monkey Capital, LLC*, [14] the plaintiffs prefunded the Monkey Capital ICO for the company's to-be-developed cryptocurrency exchange, hedge fund, and "unified network of news and data distribution" of "virtual capital assets." According to the complaint, the defendants originally announced that the Monkey Capital ICO would commence by a date certain but then delayed the launch date. The plaintiffs also claimed they were told the network would be fully operational soon after the ICO period ended. When the ICO did not occur, and the promised network was not launched, the plaintiffs filed suit for, among other claims, violations of the Florida UDAP statute. They based their UDAP claims primarily on the defendants' statements about the status of the promised ICO and attendant network.

Similarly, in *Baker v. Dynamic Ledger Solutions, Inc.*, [15] one of several cases regarding the Tezos token, the plaintiffs claimed, among other things, that the defendants had violated the California UDAP statute. Specifically, they alleged that the defendants "made numerous statements exaggerating the progress of the Tezos Network, misrepresenting the relationship between Defendants ..., and misrepresenting how funds raised during an ICO would be spent." For instance, the plaintiffs cited to a blog post by the Tezos Chief Technology Officer and to a post on the Tezos website that the plaintiffs claimed overstated how quickly the network launch date could be achieved. Additionally, the plaintiffs pointed to a document found on the Tezos crowdfunding website detailing how the Tezos Foundation would spend the money raised through the ICO, including that Tezos would purchase a banking license and expand its team. According to the complaint, all of the foregoing statements were exaggerations or misrepresentations that violated the California UDAP statutes.

In other cases, the UDAP allegations are tied to alleged statements about profitability. For example, in some cases, plaintiffs assert violations of UDAP statutes based largely on alleged statements about the profitability of

investing in the ICO. These plaintiffs typically point to marketing or website materials promising a certain return per year or the opportunity to earn "substantial" interest.

## KEY DIFFERENCES BETWEEN UDAP AND SECURITIES FRAUD CLAIMS

In federal court and a growing number of state courts, UDAP plaintiffs face an initial pleading burden requiring them to allege "plausible" claims. The standard prevents plaintiffs from relying on vague and conclusory allegations. Where plaintiffs survive a motion to dismiss, however, they can then apply early pressure for settlement. By contrast, securities fraud plaintiffs have a more exacting standard to meet. To bring a claim under the Securities Act of 1933, for example, the plaintiff must have entered into an "investment contract" with the defendant. An investment contract is (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) derived solely from the efforts of a promoter or third party. Once the plaintiff demonstrates that she entered into an investment contract with the defendant, she must then demonstrate that the defendant (1) made an untrue statement of material fact or omitted material facts related to the purchase or sale of the security, (2) knowingly made the materially false statement or omitted material information, and (3) used instrumentalities of interstate commerce in connection with the purchase or sale of securities, and that the plaintiff (4) *justifiably relied* on the defendant's statements or omissions, and (5) suffered damages due to her reliance. [17]

UDAP claims also apply a different standard of proof than securities fraud claims. As noted, a plaintiff alleging a violation of some state UDAP statutes, such as the Florida act, does not need to establish that she herself relied on the alleged unfair or deceptive act; she needs to prove, rather, that a reasonable consumer would have relied on the challenged act. By contrast, in a securities' law fraud claim, a plaintiff must establish her own reliance on the alleged material omissions or statements. Yet, as noted, the California UCL requires actual reliance where a plaintiff alleges an act sounding in fraud or misrepresentation. Thus, a plaintiff's ability to use the same allegations to support both a securities claim and a UDAP claim will depend largely on state-specific requirements and the particular type of allegations pled.

## UDAP CLAIMS OPEN THE DOOR TO ENFORCEMENT BY DIFFERENT STATE REGULATORS

Although state and federal securities laws allow the SEC, state securities regulators, and private litigants to bring securities claims against companies in connection with their ICOs, state UDAP statutes enable other types of state regulators—who may lack securities enforcement authority—to target ICOs. In Florida, for example, the Office of Financial Regulation enforces the state's Securities and Investor Protection Act, but the Attorney General is authorized to enforce the Florida UDAP statute. [18] Similarly, the California Attorney General is authorized to enforce the UCL. [19] Accordingly, a company could be the target of different state regulators for the same ICO activity. [20]

Pursuant to its authority under the Florida UDAP act, the Florida attorney general can obtain injunctive relief, can seek to freeze assets, invalidate contracts, and restitution, and can dissolve the enterprise. [21] Additionally, the attorney general can recover attorneys' fees and costs and can secure significant civil monetary penalties. For

willful violations, the Florida attorney general can recover \$10,000 per violation and \$15,000 per violation if the defendant has attempted to "victimize" a senior citizen, a person with a disability, or a military service member (including the service member's spouse or dependents). [22] A willful violation is one in which the defendant knew or should have known that his conduct was unfair, deceptive, or prohibited. [23] Yet civil penalties are not only limited to willful acts. Unlike the Securities Act, which requires knowing misconduct, the Florida UDAP statute allows the Florida attorney general to impose civil penalties for negligence. And, at a minimum, the Florida attorney general can recover unjust enrichment damages even if the defendant's error was bona fide. [24]

Pursuant to the UCL, the California attorney general can seek injunctive relief, restitution for consumers, and civil penalties of up to \$2,500 per violation. [25] The courts can impose these penalties on any person who "engages, has engaged, or proposes to engage in unfair competition;" there is no intent requirement in the statute. [26] If the challenged unfair conduct harmed senior citizens or disabled persons, the California attorney general can seek additional civil penalties of up to \$2,500 per violation. The attorney general must prove, however, actual reliance and damage to consumers when claim is based on fraud or misrepresentation.

## CONCLUSION

As the pace of ICO lawsuits increases, it is likely that plaintiffs will continue to assert UDAP claims similar to those outlined above. As private litigants bring more UDAP allegations, state regulators empowered to enforce UDAP statutes may also follow suit. And once courts resolve the securities law questions presented by these cases, their focus will likely turn to the UDAP issues. Accordingly, companies that are planning an ICO should continue to carefully review actions and statements in connection with the ICO process to help protect against a UDAP-based lawsuit.

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[1] Fla. Stat. § 501.204.

[2] *Rollins, Inc. v. Butland*, 951 So. 2d 860, 869 (Fla. Dist. Ct. App. 2006).

[3] *Caribbean Cruise Line, Inc. v. Better Bus. Bureau of Palm Beach Cty., Inc.*, 169 So. 3d 164, 169 (Fla. Dist. Ct. App. 2015).

[4] Fla. Stat. § 501.203(8).

[5] *Global Tel\*Link Corp. v. Scott*, 652 F. Supp. 2d 1240 (M.D. Fla. 2009).

[6] *Attorney General v. Wyndham Int'l, Inc.*, 869 So. 2d 592 (Fla. Dist. Ct. App. 2004).

[7] *Morris v. ADT Security Servs.*, 580 F. Supp. 2d 1305 (S.D. Fla. 2008) (internal citation omitted).

[8] Fla. Stat. § 501.211(2).

[9] Cal. Bus. & Prof. Code § 17200.

[10] *Kwikset Corp. v. Superior Court*, 51 Cal. 4th 310, 326 (2011).

[11] *Sateriale v. R.J. Reynolds Tobacco Co.*, 697 F.3d 777, 793 (9th Cir. 2012) (citing *Kwikset Corp.*, *supra* note 13.)

[12] *Id.* (citing in *re Tobacco II Cases*, 207 P.3d 20, 39 (Cal. 2009)).

[13] Cal. Bus. & Prof. Code § 17206. Under the UCL, acts proscribed by law can constitute unfair competition. *Goonewardene v. ADP, LLC.*, 5 Cal. App. 5th 154, 186 (Cal. Ct. App. 2d Dist. 2016) (internal citation omitted). And otherwise lawful actions may also be deemed "unfair" where those actions contravene a public policy that is

"closely tied" to an existing statute. *Id.* (citing *Cel-Tech Coms, Inc. v. Los Angeles Cellular Telephone Co.*, (20 Cal. 4th 163, 180 (1999)). As one appellate court held, to recover under the UCL for otherwise lawful conduct, the public policy at issue must be "'tethered' to specific constitutional, statutory, or regulatory provisions." *Gregory v. Albertson's, Inc.*, 104 Cal. App. 4th 845, 854 (Cal. Ct. App. 1st Dist. 2002).

[14] Case No. 9:17-cv-81370 (S.D. Fla.).

[15] Case No. 3:17-cv-6850 (N.D. Cal.).

[16] *SEC v. W.J. Howey*, 328 U.S. 293, 298–299 (1946).

[17] 15 U.S.C. § 77q(a); 17 C.F.R. § 240.10b-5.

[18] Fla. Stat. § 501.203(3).

[19] Cal. Bus. & Prof. Code § 17204.

[20] Technically, pursuant to Fla. Stat. § 517.191(5), the attorney general may enforce the Securities and Investor Protection Act, but only if the Office of Financial Regulation provides prior written approval.

[21] Fla. Stat. § 501.207(3).

[22] *Id.* § 501.2077.

[23] *Id.*

[24] *Id.* § 501.2075.

[25] Cal. Bus. & Prof. Code § 17206.

[26] *Id.*

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