June 1, 2022

Not Your Keys…Still Your Crypto?

Coinbase seeks dismissal of a SDNY putative class action based on its terms of service

Douglas J Pepe

Underwood v. Coinbase Global, Inc., et al., is a closely-followed putative class action in the Southern District of New York against Coinbase. The plaintiffs in *Underwood* claim that Coinbase sells 79 securities on its platform in violation of the securities laws because Coinbase is not a registered exchange or broker-dealer.

In its recent Motion to Dismiss—an early legal filing that takes all allegations as true and tests the legal merit of the alleged claims on their face—Coinbase raised a number of anticipated arguments, including: (1) the absence of direct solicitation under Section 12(a)(1) of the Securities Act; (2) the absence of an implied private right of action supporting Plaintiffs' Exchange Act claims under Sections 5 and 15; (3) the absence of an unlawful contract (as opposed to an unlawful transaction pursuant to a lawful contract) under Exchange Act Section 29(b); and (4) sundry other arguments including statute of limitations, group pleading, and the absence of control person liability.

Despite recent press reports suggesting otherwise, the Coinbase motion does not attempt to strike at the heart of the Complaint by arguing substantively that the 79 blockchain assets at issue were not securities. As a litigator, this is what I would expect. That question is fraught with factual issues, requiring an in-depth analysis of the application of *Howey* to each one to determine whether the asset is an "Investment Contract"—i.e., a "scheme" involving an "investment of money in a common enterprise with profits to come solely from the efforts of others"—or more akin to the purchase and sale of a traditional commodity (in *Howey* parlance, the land, trees, and fruit). To the extent the Complaint survives a motion to dismiss, we can expect this issue to be front-and-center in the discovery and summary judgment phases of the case.

But what is most interesting about Coinbase's motion is its principal argument—that it is not a statutory seller and lacks privity with its customers, absolving it of liability under Securities Act Section 12(a)(1) and Exchange Act Section 29(b).

Why is this interesting? Because the basis for Coinbase's motion is its user agreement, which specifically states that when users buy or sell assets on the Coinbase site, they are not buying or selling them "from Coinbase."

It does say that. But is it correct?

Any seasoned crypto user knows the old saw, "not your keys, not your crypto." When using a custodial exchange, the exchange holds the keys, not the user. The exchange and user may have a contractual relationship in which the exchange agrees, upon request, to transfer crypto from its own wallet (keypair)

to the user's, but this relationship is in the nature of an unsecured obligation. In general, until such time as the transfer actually occurs, the user does not "own" the crypto - the exchange does.

Coinbase recently acknowledged this fact in the risk disclosures of its May 2022 10-Q filing:

> *Moreover, because custodially held crypto assets may be considered to be the property of a bankruptcy estate, in the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors.*

This begs the question: can an exchange really disclaim that it holds and transfers title in its user agreement, when the technical and legal reality is that the exchange exclusively possesses the keys at the time of the exchange transaction, subsequently transferring the crypto to the user with whom it is in contractual privity?

This has significant potential implications for the statutory seller defense in the crypto context.

The *Underwood* case, however, may not be the best vehicle to answer this question, because the plaintiffs in *Underwood* may have pled themselves out of court with allegations acknowledging that exchange users transact with themselves through the exchange. Those allegations undercut the principal argument plaintiffs have to establish that Coinbase is a statutory seller—a significant foot fault similar to the one recently made by the plaintiffs against Binance. *See* 3/31/22 Opinion and Order, *Anderson v. Binance,* 1:20-cv-2803 (S.D.N.Y.)(ALC) ("Plaintiffs briefly argue as an alternative that Defendants are also statutory sellers because they passed title to Plaintiffs.... However, the cited paragraph does not support this assertion."). In securities cases, allegations matter.

Nevertheless, the Coinbase case presents an interesting question in the context of suits against crypto exchanges: can statutory seller liability be extinguished by a user agreement saying that customers are not transacting with the exchange, even though the exchange maintains the keys and controls the crypto at all times until it is transferred to the customer? How the court answers this question in light of the plaintiffs' conflicting allegations remains to be seen, but eventually, it is a question that the courts will need to grapple with.

The Authors:

Douglas J Pepe
Partner

+1 212 957 7605
Email Douglas

About Cohen & Gresser:

Cohen & Gresser is an international law firm with offices in New York, Paris, Washington, DC, and London. We have an outstanding record of success in high-stakes and high-profile corporate transactions, litigation, investigations, regulatory and government relations work for our clients, including major financial institutions and companies across the world. Our attorneys have superb credentials and are committed to providing the efficiency and personal service of a boutique law firm along with the quality and attention to detail that are the hallmarks of the best firms in the world. The firm has been recognized in a wide range of publications, including *Chambers* and *The Legal 500*.

New York | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+1 212 957 7600

View C&G's Profile