Michael E. Mariani
+1-212-474-1007
mmariani@cravath.com

D. Scott Bennett
+1-212-474-1132
sbennett@cravath.com

David J. Kappos
+1-212-474-1168
dkappos@cravath.com

Jennifer S. Leete
+1-212-474-1222
jleete@cravath.com

Kevin J. Orsini
+1-212-474-1596
korsini@cravath.com

Evan Norris
+1-212-474-1524
enorris@cravath.com

SEC v. LBRY, Inc.: Federal Court Rules Cryptotoken Distribution Was an Unregistered Securities Offering

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On November 7, 2022, the U.S. District Court for the District of New Hampshire (the "District Court") granted summary judgment in favor of the U.S. Securities and Exchange Commission ("SEC") in its enforcement action against New Hampshire-based LBRY, Inc. ("LBRY").[1] Specifically, the District Court found that LBRY's offer and sale of its cryptotokens (LBRY Credits or "LBC") constituted an unregistered securities offering, and, as a result, a violation of Section 5 of the Securities Act.

LBRY had contended that LBC constituted a utility token rather than a security because it facilitated Web3 video and image sharing without the need for a centralized provider such as YouTube. LBC rewarded "miners" on the LBRY network and could be spent to publish media onto the LBRY blockchain, purchase paywall content, and "tip" creators, amongst other uses. Despite recognizing these uses of the token, the District Court stated that there is no contradiction between a token having some consumptive utility and such token also constituting a security,[2] for example, by virtue of its speculative characteristics. The District Court focused on (i) a number of statements made by LBRY to potential investors, including emails and other correspondence, that would lead those investors to reasonably expect that the LBC token would grow in value due to the ongoing efforts of the LBRY team, and (ii) the "objective economic realities" of the transaction over its form.

The District Court's decision draws further contours as to how courts may interpret what constitutes a "promoter or third party" under the test for evaluating investment contract securities developed in *SEC v. W.J. Howey Co.* and its progeny.[3] Specifically, the LBRY court's decision holds that when token creators retain a significant stake in their issued and outstanding tokens, potential purchasers might reasonably purchase such tokens thinking that those creators will exert efforts to benefit that retained stake. To this point, the District Court emphasized that LBRY may have communicated its intention to generate value even if it had made no explicit statement of such intention to investors. Notably, 400 million LBC tokens were pre-mined by LBRY prior to public launch. LBRY used certain amounts of these pre-mined tokens to fund operations and sustain the LBRY network. The District Court found that, by holding a large number of LBC, LBRY communicated a strong or decisive indicator to purchasers of its intended ongoing efforts to generate value:

> The problem for LBRY is not just that a reasonable purchaser of LBC would understand that the tokens being offered represented investment opportunities – even if LBRY never said a word about it. It is that, by retaining hundreds of millions of LBC for itself, LBRY also signaled that it was motivated to work tirelessly to improve the value of its blockchain for itself and any LBC purchasers. This structure, which any reasonable purchaser would understand, would lead purchasers of LBC to expect that they too would profit from their holdings of LBC as a result of LBRY's assiduous efforts. **Simply put, by intertwining LBRY's financial fate with the commercial success of LBC, LBRY made it obvious to its investors that it would work diligently to develop the Network so that LBC would increase in value.**[4]

LBRY also argued it did not receive fair notice that its offering violated securities laws, claiming SEC precedent and guidance targeted initial coin offerings. The District Court rejected this claim and concluded that the SEC's enforcement action was not brought on a novel interpretation of a rule or change in interpretation. Instead, the District Court concluded that the claim was brought based on a factual application of the long established *Howey* analysis.[5]

The LBRY decision, though subject to possible appeal and not necessarily binding on other courts or on matters in other circuits, has the potential to influence the resolution of other major enforcement actions.[6] Issuers of cryptotokens should carefully consider whether their statements and the economic reality of their operations, including the presence of large tokenholders who are contributing to a project, communicate to purchasers a "reasonable expectation of profits" generated by the "efforts of others."

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[1] *SEC v. LBRY, Inc.*, No. 1:21-cv-00260-PB (D.N.H. Nov. 7, 2022).

[2] *Id*. at 18.

[3] Namely, an investment contract exists where there is investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. *See Securities and Exchange Commission v. W.J. Howey Co*., 328 U.S. 293 (1946). *See also United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. Glenn W. Turner Enter., Inc.,* 474 F.2d 476, 482 (9th Cir.), *cert. denied,* 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

[4] *LBRY, Inc.*, No. 1:21-cv-00260-PB at 16 (emphasis added).

[5] *LBRY, Inc.*, No. 1:21-cv-00260-PB at 21.

[6] *See, e.g., SEC v. Ripple Labs Inc.*, No. 1:20-cv-10832 (S.D.N.Y. filed Dec. 22, 2020).

New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com