Cryptocurrency Meets Bankruptcy Law: A Call for Creditor Status for Investors in Initial Coin Offerings

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CRYPTOCURRENCY MEETS BANKRUPTCY LAW: A CALL FOR CREDITOR STATUS FOR INVESTORS IN INITIAL COIN OFFERINGS

Miriam R. Albert & J. Scott Colesanti

ABSTRACT

In 1973, experts Homer Kripke and John J. Slain published a seminal study titled The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer’s Creditors. That lengthy analysis, contributed by, respectively, a former Securities and Exchange Commission official and a professor of law, examined the status quo and concluded that investors were receiving unfair priority vis-à-vis creditors in bankruptcy proceedings administered under the federal Bankruptcy Code. Focusing on the traditional “absolute priority rule,” the study pointed out that the Securities and Exchange Commission support for the investor priority was unfounded and urged deference to the notion of general creditors coming first.

Since then, a host of developments complicated both the analysis and the traditional view of Kripke and Slain. First, the pivotal determination of “rescinding shareholder” has been made complex by, among other things, an expanded notion of “sophisticated investor” occasioned by phenomena such as “crowdfunding.” Second, stock swaps, hedges, repurchase agreements, and other hybrid responses to financier discomfort have clouded the definition of “investor.” Finally, the explosive growth of cryptocurrencies (and

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the ventures that would sell, distribute, trade, or package them) highlighted the need for a new, softer line between creditor and investor.

Accordingly, the present authors revisit the absolute priority rule with a view towards historic SEC involvement with bankruptcy law and contemporary classification of some cryptocurrency-related entities as securities issuers. The article concludes that in light of the existing provisions and interpretations, the “absolute priority rule” examined through the lens of today’s innovative securities should be rethought to give investors in initial coin offerings creditor status. Whether the reader agrees or not is likely subordinated to the need for a conversation on the most egalitarian response—under both the securities laws and the Bankruptcy Code—to the investor’s claim for in pari passu treatment normally reserved for creditors, and likewise the general creditors’ opposition to sharing a legally enforceable priority.

INTRODUCTION

A. Crypto Among Us

In March 2019, close to $200 million worth of cryptocurrency was lost when the owner of a cryptocurrency trading platform died in sole possession of its digital key.1 The debacle foisted the trading platform into court protection, prompting calls for national legislation by the Canadian Securities Administrators.2

Indeed, such security problems are not unexpected. At year-end 2017, the meteoric rise of the price of Bitcoin (e.g., $17,900) posed a regulatory challenge to courts and government agencies alike.3

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2. Id. (noting that “[c]rypto assets with a value of almost $1 billion were stolen in 2018 from platforms around the world”).
Moreover, the first and largest Bitcoin exchange, Mt. Gox, remains protected by Japanese bankruptcy laws.\footnote{See Tim Allman, MtGox Bitcoin Exchange Files for Bankruptcy, BBC (Mar. 1, 2014), https://www.bbc.com/news/business-26394986/mtgox-bitcoin-exchange-fee...[https://perma.cc/5YZB-PBYX]. As of March 2019, a class action against the Mt. Gox owner and a third-party bank remains on the docket for the Northern District of Illinois. Fourth Amended Class Action Complaint at 1, Greene v. Mizuho Bank, Ltd., 206 F. Supp. 3d 1362 (N.D. Ill. 2017) (No. 1:14-cv-01437). That action—effectively stayed by the Japanese bankruptcy action—alleges, among other things, conversion, consumer fraud, and negligence. Id. at 21; see infra Section III.A. for a discussion of the Mt. Gox debacle.} These regulatory challenges are rife with difficulties, often chief among them the battle for prioritized status between creditors and depositors—investors—if such are even identifiable as distinct classes.\footnote{See, e.g., NATHANIEL POPPER, DIGITAL GOLD: BITCOIN AND THE INSIDE STORY OF THE MISFITS AND MILLIONAIRES TRYING TO REINVENT MONEY 317 (2015) ("An academic study in 2013 had found that 45% of the Bitcoin exchanges that had taken money had gone under, several taking the money of their customers with them."); David Meyer, After Bitcoin Spike, Mt. Gox Creditors Want to Yank the Failed Exchange Out of Bankruptcy, FORTUNE (Dec. 13, 2017), http://fortune.com/2017/12/13/bitcoin-mtgox-bankruptcy-creditors/ [https://perma.cc/93M3-ZGK9].}

A spinoff of the volatile, virtual investment craze arrived in recent years in the form of initial coin offerings (ICOs).\footnote{Jake Frankenfeld, Initial Coin Offering (ICO), INVESTOPEDIA (Nov. 4, 2019), https://www.investopedia.com/terms/i/initial-coin-offering-ico.asp [https://perma.cc/A97L-ATG7].} In such ventures, fledgling companies with grandiose plans exchange future “tokens”...
in a unique digital enterprise for investment. These enterprises state plausible cases for securities law coverage, particularly in light of the great many federal court holdings urging expansion of the securities laws in favor of investor protection. For example, a company promising partial ownership of a purely cyberspace enterprise may accord digital tokens on a pro rata scale tied to the level of investment. Such tokens only carry value in the accompanying “blockchain” (i.e., digital ledger created by the enterprise).

Compounding the regulatory challenge are the myriad definitional hesitancies: the United States (U.S.) Department of the Treasury has not declared Bitcoin or similar creations the equivalent of fiat currencies, instead simply insisting that cash exchanges for cryptocurrencies satisfy currency transaction requirements. The Internal Revenue Service (IRS) formally identified Bitcoin as “property,” gains on which must be taxed like all other gains on properties. And via a 2015 disciplinary decision, the U.S. Commodity Futures Trading Commission (CFTC) proclaimed Bitcoin a “commodity,” thus making the instrument subject to regulations promulgated under the Commodity Futures

9. “Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.” To that end, it enacted a broad definition of “security,” sufficient “to encompass virtually any instruments that might be sold as an investment.” Id. (quoting Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)).
11. See Kevin Drawbaugh & Patrick Temple-West, Bitcoins Are Property, Not Currency, IRS Says Regarding Taxes, REUTERS (Mar. 25, 2014, 2:37 PM), https://www.reuters.com/article/us-bitcoin-irs/bitcoins-are-property-not-currency-irs-says-regarding-taxes-idUSBREA2O1LR20140325 [https://perma.cc/9KCN-9ETE]. The article also related that the IRS statement clarified that “virtual currency is not to be treated as legal-tender currency to determine if a transaction causes a foreign currency gain or loss under U.S. tax law.” Id.
Modernization Act of 2000. The U.S. Securities and Exchange Commission (SEC) acknowledged the CFTC classification in December 2017; however, there still has been overlapping jurisdiction, as the SEC has taken repeated disciplinary actions against companies determined to invest in Bitcoin or other forms of cryptocurrency for misleading disclosures to shareholders. However, relatively unaddressed is the issue of classifying a Bitcoin investment (or any other cryptocurrency) for purposes of the federal securities laws enacted over seventy-five years before the advent of virtual and cryptocurrencies.

B. Brief History of the Federal Securities Laws

The federal securities laws of 1933 and 1934 were a drastic reaction to the Wall Street folly that almost bankrupted the nation. President Franklin D. Roosevelt and Congress were eager to restore investor confidence and reacted to profligate speculation by creating remedial laws with expansive reach. The purpose of these laws was to provide investor protection through mandatory disclosure and anti-


13. See discussion infra Section II.B.2.

14. Promptly after his inauguration, President Roosevelt began to push for securities reform, based on the idea that disclosing adequate information to investors would lessen or eliminate the specter of fraud. The idea was not to have the federal government sign off on the soundness of any particular investment, but rather to require issuers to provide investors with necessary and material information upon which to make investment decisions. In his message to Congress on March 29, 1933, President Roosevelt said:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

H.R. REP. NO. 73-85, at 2 (1933). As has been noted, even before President Roosevelt worked to repeal Prohibition and reward voters with a drink of alcohol, he worked to revamp the oversight of the stock exchanges. See J. SCOTT COLESANTI, FAIRNESS, INC.: THE ORIGINS (AND BILLION-DOLLAR Bonuses) OF RULE 10b-5 AS AMERICA’S INSIDER TRADING PROHIBITION 4 (2018).
fraud provisions. The first of these laws, the Securities Act of 1933 (1933 Act), is known as the “truth in securities” law and has two primary goals: to make sure investors have material information about possible investments and to prevent fraud in the purchase and sale of securities. Neither the 1933 Act nor the Securities Exchange Act of 1934 (1934 Act) was intended to provide a broad federal remedy for all fraud. Instead, these statutes apply only to those investments that are within their broad statutory definition of “security.” Courts often reference a need for flexibility in applying the definition of security.

Cognizant of the remedial goals of the 1933 Act, Congress tried to craft a broad definition that would “meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” Thus, Congress included (but failed to define) in the list of kinds of securities the catchall phrase

15. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946). According to the Supreme Court, the statutory purpose of the securities laws is “compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’” Id. (quoting H.R. REP. NO. 73-85, at 11 (1933)); see also SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (holding that the primary purpose of the federal securities laws is to “substitute a philosophy of full disclosure for the philosophy of caveat emptor”). Moreover, “[o]ne of [the 1934 Act’s] central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . . .” Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Thus, the design of the statute was to “protect investors by promoting full disclosure of information thought necessary to informed investment decisions.” SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (citing A.C. Frost & Co. v. Coeur D’Alene Mines Corp., 312 U.S. 38, 40 (1941)). “[T]he Court repeatedly has described the ‘fundamental purpose’ of the Act as implementing a ‘philosophy of full disclosure . . . .’” Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977) (quoting Capital Gains, 375 U.S. at 186).


18. 15 U.S.C. §§ 77b(a)(1), 78c (2018). Both statutes provide a laundry list of categories and examples of “securities,” including “any interest or instrument commonly known as a ‘security,’” to sweep in the varied types of instruments Congress predicted would (or should) fall within the term. §§ 77b(a)(1), 78c(10).

19. See, e.g., SEC v. Mut. Benefis Corp., 323 F. Supp. 2d 1337, 1339 (S.D. Fla. 2004), aff’d, 408 F.3d 737 (11th Cir. 2005) (stating that “[f]irst and foremost, the federal securities laws were drafted and have consistently been interpreted from the perspective that flexibility in the law’s applicability is paramount”).

20. Id. at 1341 (quoting Howey, 328 U.S. at 299). “Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.” Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).
“investment contract” to give the courts flexibility in interpreting this important and far-reaching definition. The U.S. Supreme Court availed itself of that flexibility, aggrandizing jurisdiction in crafting a case law test that has come to be known as the “Howey test.” The resulting common law standard (like so much of securities law) results in case-by-case determinations of the threshold question to any dispute.

21. Reves, 494 U.S. at 64. “Throughout the history of struggling for an appropriate definition, courts have been mindful of the fact that the bottom-line question is whether the particular investment or instrument involved is one that needs or demands the investor protection of the federal (or state) securities laws.” THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 30–31 (3d ed. 1996).

22. Howey, 328 U.S. at 293 (1946). The first U.S. Supreme Court case to interpret the definition of investment contract in the 1933 Act was SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). Joiner involved the offer and sale of assignments in oil leases, coupled with the promoter’s promise to drill test wells. Joiner, 320 U.S. 345–46. The Court, in finding such offers to constitute investment contracts, adopted a broad reading of the term investment contract. Id. at 351. In determining whether a given investment was an investment contract, the Joiner court looked to “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.” Id. at 352–53. Three years later, the Court refined the definition of investment contract in the seminal case of SEC v. W.J. Howey, 328 U.S. 293 (1946). In Howey, the Supreme Court held that if “a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party,” the investment scheme is an investment contract for purposes of the Securities Act. Howey, 328 U.S. at 299. The Howey definition of investment contract “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’” Id. (citing H.R. REP. NO. 73-85, at 11 (1933)). Additional support for this idea comes from Tcherepnin v. Knight, where the Court stated that “[i]n searching for the meaning and scope of the word ‘security’ in the Act, form should be disregarded for substance and the emphasis should be on economic reality.” 389 U.S. 332, 336 (1967) (citing Howey, 328 U.S. at 298). The Court’s statement in Howey has been refined in the last half-century, with little substantive change, into the test used by courts today to determine whether an investment scheme is a security for purposes of the Securities Act. “After half a century, Howey still states the test for determining the existence of an investment contract. In the intervening years, litigation has not focused on the correctness of the test, but rather on the precise meaning of one or more of its parts.” LARRY D. SODERQUIST, SECURITIES REGULATION § 5:2.2, at 5-4 (3d ed. 1994). For a more detailed history of the Howey test, see Miriam R. Albert, The Howey Test Turns 64: Are the Courts Grading This Test on a Curve?, 2 WM. & MARY BUS. L. REV. 1 (2011).

23. The lack of a statutory definition creates opportunities as well as limitations: Conceptually, the lack of a statutory definition provides an opportunity for progress on both the disclosure and anti-fraud fronts. Courts have the flexibility to bring within the reach of the securities laws those interests that would not otherwise constitute securities, but nonetheless are the kind of investments that trigger a need for investor protection through mandatory, accurate disclosure. This flexibility also creates the opportunity for inconsistent or unsound interpretations of the definition, potentially triggering instability for the investing public.

Albert, supra note 22, at 11.
Conversely, the U.S. Bankruptcy Code (the Code), adopted in its current form in 1978, contains statutory definitions of a much more definite character. Section 101(49) largely mirrors the securities law legislative definition, though § 1145 expressly exempts certain arrangements from those set categories (e.g., “note”). The Code focuses on much more conventional securities products; moreover, a lack of certainty in discharging the debtor is the chief ill to be avoided.

I. Statutory and Common Law Approaches to Defining a Security

A. The Securities Act of 1933

From its inception, § 2(a)(1) of the 1933 Act contained a veritable laundry list of arrangements that arise under American securities laws. In its current form, the statutory definition of security reads as follows:

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security[,]” or any certificate of

interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.\(^\text{26}\)

None of these examples expressly touch on bankruptcy estate assets. Of the definition’s myriad possibilities, the SEC seized upon investment contract as a catchall, as explained below.\(^\text{27}\)

**B. The Howey Test**

Although the SEC has rarely shied from an opportunity to expand its jurisdiction,\(^\text{28}\) the investing public can remain calm because any overreaching by the SEC would arguably be tempered by the modest remedy sought of registration under § 5 of the 1933 Act.\(^\text{29}\) A primary means of such expansion by the SEC is via an ever-expanding notion of an investment contract, a term included but not defined in the seminal securities laws.\(^\text{30}\) From 1946 through the present, a common


\(^{28}\) In its effort to further investor protection, the SEC has maintained, with varying degrees of success, that the concept of investment contract includes many financial schemes not specifically mentioned by the federal securities laws, thereby honoring the Supreme Court’s instruction that, “in searching for the meaning and scope of the word ‘security’ . . . form should be disregarded for substance and the emphasis should be on economic reality.” Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

\(^{29}\) Colesanti, supra note 27, at 37.

\(^{30}\) The lack of a statutory definition creates opportunities as well as limitations: Conceptually, the lack of a statutory definition provides an opportunity for progress on both the disclosure and anti-fraud fronts. Courts have the flexibility to bring within the reach of the securities laws those interests that would not otherwise constitute securities, but nonetheless are the kind of investments that trigger a need for investor protection through mandatory, accurate disclosure. This flexibility also creates the opportunity for inconsistent or unsound interpretations of the definition, potentially triggering instability for the investing public.

Albert, supra note 22, at 11. Further, one commentator explained:

The term was included in the definitional section of the Federal Securities Act of
law test has been employed in justifying the actions of an agency formed in 1934 to combat Wall Street fraudsters, successfully reaching Ponzi schemers, foreign defendants, and novel forms of enterprise such as viatical settlements.31 And in recent years, this intentionally flexible common law test has been applied to the robust number of innovative financing schemes in the area of digital currencies.32

1. The Howey Test Before Cryptocurrencies

The Howey test fleshes out what constitutes an investment contract for purposes of the federal securities laws.33 The term had no standard meaning in any commercial context, although it appeared in several states’ blue sky laws before the 1933 Act.34 The test seeks to identify transactions in which investors are relying on others to manage the enterprise that will produce financial returns on their

1933, 15 U.S.C. § 77b, as well as many state securities laws for a particular reason: the drafters of these statutes realized that, at one point in time, they could not predict all the various investment products the ingenuity of participants in the securities business could concoct. In effect then, the term investment contract can be analogized to an expansion joint as it provides flexibility and adds a universal quality to the definition of investment security. This is especially true in the federal domain, and in particular, the Securities Act of 1933, 15 U.S.C. §§ 77a et seq. It was because the courts imposed an expansive construction of federal securities law that a definition evolved for the term investment contract. For, standing alone, the term would be meaningless.


33. Colesanti, supra note 27, at 27–28 (“[T]he Howey decision of 1946 began a ceaseless period of brashly applying the Securities Acts to nonconventional securities—an ever-growing list of investments the First Circuit has coined ‘a kaleidoscopic assortment of pecuniary arrangements that defy categorization.’ This expansive reading of the statute is buttressed by court decisions noting the lack of other regulatory remedies—the Supreme Court has even expressly tilted the scales in favor of finding a security when the instruments in question ‘would escape federal regulation entirely if the [Securities] Acts were held not to apply.’”) (citations omitted).

These investors are deemed to be more vulnerable without the disclosure that would come from registration under the federal securities laws than investors who are participating in the management of the enterprise. Under Howey, any interest that “involves an investment of money in a common enterprise with profits to come solely from the efforts of others” is an investment contract, thereby included within the definition of security and subject to the rules and regulations of the federal securities laws.

The Supreme Court’s definition of investment contract in Howey is intentionally flexible, and thus consistent with the congressional approach to defining the broader concept of what constitutes a security. Although the Court has said that when analyzing whether an investment opportunity is a security, “form should be disregarded for substance” and the emphasis should be on “the economic realities underlying a transaction, and not on the name appended thereto,” the choice of a flexible definition has led “to complex and fact-intensive judicial inquiries in the application” of the test, allowing for inconsistent results across “courts engaging in such inquiries, creating the possibility of similarly-situated litigants winding up with dissimilar outcomes.”

The Howey test is typically described as having four prongs. The first prong requires an investment of money. Courts have held that cash is not the only form of contribution or investment that will

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36. Id.
38. Howey, 328 U.S. at 299. This definition embodies a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” Id. The test “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’” Id.
42. See Albert, supra note 22, at 8–9, 11, 16–19 for a discussion of the specter of inconsistent interpretation or application by the lower courts threatening to undermine the utility of the Howey test itself as a trigger for investor protection.
43. See, e.g., Albert, supra note 22, at 15.
satisfy this prong.\textsuperscript{45} This prong has been interpreted to include cash, promissory notes,\textsuperscript{46} and bartered-for goods and services.\textsuperscript{47} The investment of money element is met when an investor parts with consideration with the hope of some future return.\textsuperscript{48} And as one commentator aptly noted, “It appears that any nuanced reading of the first element is subsumed in subsequent [t]est factors.”\textsuperscript{49}

The second prong requires that the investment of money be in a common enterprise.\textsuperscript{50} The Supreme Court in \textit{Howey} made a showing of fact to support a finding of commonality but failed to define the contours of this required commonality, leaving it to the lower courts to flesh out.\textsuperscript{51} Two tests have developed to satisfy the requirement of commonality. First, this prong can be satisfied in some circuits through “horizontal commonality,” which focuses on the connection between and among the investors (i.e., looking for investors sharing the risk of the enterprise by sharing profits and losses proportionately).\textsuperscript{52} The alternate approach taken by some circuits is known as “vertical commonality,” focusing on the connection between the promoter and investors and looking to see if “the fortunes of the investor are interwoven with and dependent upon the

\begin{itemize}
\item \textsuperscript{45} \textit{Uselton v. Commercial Lovelace Motor Freight, Inc.}, 940 F.2d 564, 574 (10th Cir. 1991).
\item \textsuperscript{46} \textit{Hector v. Wiens}, 533 F.2d 429, 432–33 (9th Cir. 1976).
\item \textsuperscript{47} \textit{Int'l Bhd. of Teamsters v. Daniel}, 439 U.S. 551, 560–61 (1979). \textit{But see United States v. Jones}, 450 F.2d 523, 525 (5th Cir. 1971) (finding airline ticket vouchers were not securities due to purposes set out in 18 U.S.C. § 2311 on the prohibition against carriage of forged instruments, even where such provision—which largely echoed the 1933 Act and 1934 Act definitional sections—specifically included “evidence of indebtedness”).
\item \textsuperscript{48} \textit{See BROWN, supra} note 34, § 5:2.2A, at 5–5.
\item \textsuperscript{49} \textit{Colesanti, supra} note 27, at 32.
\item \textsuperscript{50} \textit{SEC v. W.J. Howey Co.}, 328 U.S. 293, 301 (1946).
\item \textsuperscript{51} \textit{Christopher L. Borsani, A “Common” Problem: Examining the Need for Common Ground in the “Common Enterprise” Element of the Howey Test}, 10 DUQ. BUS. L.J. 1, 4 (2008); see also \textit{Jonathan E. Shook, Note, The Common Enterprise Test: Getting Horizontal or Going Vertical in Wals v. Fox Hills Development Corp.}, 30 TULSA L. REV. 727, 732–33 (1995) (citing Shawn Hill Crook, \textit{Comment, What is a Common Enterprise? Horizontal and Vertical Commonality in an Investment Contract Analysis}, 19 CUMB. L. REV. 323, 325 (1989) (“Unfortunately, because neither the Court in \textit{Howey} nor any subsequent Supreme Court decision has defined the ‘common enterprise’ prong of the \textit{Howey} test, the federal courts have been left to disagree.”)).
\item \textsuperscript{52} \textit{Albert, supra} note 22, at 16–17.
\end{itemize}
efforts and success of those seeking the investment or of third parties.”

The third prong requires that the investment be undertaken with the expectation of profits. This expectation cannot be of additional contributions, and the return on investment must be the principal motivation for the investment. This prong is often “synonymous with the marketing of the financial arrangement[s]” particular to the given investment and is often demonstrated by a promoter’s “wistful statements or advertising of successful commercial activities.”

The fourth prong requires the expectation of profits to be from the efforts of others. Recall the goal of the federal securities laws is to provide investor protection through mandatory disclosure and anti-fraud regulations. Here, the passive investor is in much greater need of these protections than an investor involved in running the investment. This prong has seen significant movement since Howey was decided. The original language in Howey required that the investment of money in this common enterprise be undertaken with the expectation of profits solely from the efforts of others. The limitations inherent in prohibiting the expectation of profits by the investor would exclude any investment that involved even the most minimal effort from the investors from the protection of the securities.
laws—arguably defeating the goals of the securities laws themselves.\textsuperscript{60} The Supreme Court began to walk back the “solely” language in \textit{United Housing Foundation v. Forman}, with its comment that the “touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”\textsuperscript{61}

The \textit{Howey} test, for better or for worse, is what courts and investors are left with to determine whether a given opportunity is an investment contract and thus within the reach of the federal securities laws, specifically the registration and prospectus delivery requirements of § 5. As Professor Colesanti previously noted:

Overall, despite some hiccups, \textit{Howey} transformed the 1933 Act and 1934 Act into dynamic statutes that would forever value the dual promises of section 5 (i.e., registration and prospectus delivery). Moreover, the federal bench has continued to uphold \textit{Howey}’s promise of protection for [i]nvestors in securities traditional or otherwise; such continued protection is laudable for, among other reasons, the vulnerability and political nature of agency-made law in general.\textsuperscript{62}

2. The SEC’s Response to Cryptocurrencies

The SEC has not been shy about using the \textit{Howey} test to attempt to rein in “the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”\textsuperscript{63} The world of cryptocurrency is fertile ground for SEC intervention. Commentators have debated whether and how cryptocurrencies

\begin{footnotes}
\item[60] Robinson v. Glynn, 349 F.3d 166, 170 (4th Cir. 2003).
\item[62] Colesanti, \textit{supra} note 27 (citing THOMAS LEE HAZEN, \textit{PRINCIPLES OF SECURITIES REGULATION} 328–29 (2d. ed. 2006); then citing WILLIAM F. FOX, \textit{UNDERSTANDING ADMINISTRATIVE LAW} 54–57 (6th ed. 2012)) (noting that the federal agencies’ “administrators are totally subject to Presidential control”).
\item[63] Howey, 328 U.S. at 299.
\end{footnotes}
should be regulated, with the debate clearly illustrating that any path to regulation was not self-evident from the language of the 1933 and 1934 Acts. Under certain circumstances, the SEC has declared that both vehicles purchasing cryptocurrency and ICOs themselves constitute sales of securities warranting formal registration with the agency (and related public disclosures). The first relevant holding was in 2013.

- SEC v. Shavers

One of the SEC’s earliest actions in this area was SEC v. Shavers, in which the SEC delved into whether a fund designed to trade Bitcoin constituted an investment contract under Howey, specifically finding that the use of Bitcoin satisfied the first prong of the Howey test. Trendon Shavers, the founder and operator of Bitcoin Savings and Trust (BTCST), solicited lenders to invest in Bitcoin-related opportunities, and “[t]he SEC assert[ed] that Shavers made a number of misrepresentations to investors . . . and . . . defrauded investors.” Shavers challenged the court’s subject matter jurisdiction, arguing that the BTCST investments are not securities because Bitcoin is not “money.”

67. SEC v. Shavers, No. 4:13-CV-416, 2014 WL 12622292, at *4 (E.D. Tex. Aug. 26, 2014) (order granting in part and denying in part defendants’ motion for reconsideration). Bitcoin was such a new phenomenon that the court needed to find a viable definition and description. This led to one ground for appeal by Mr. Shavers, who argued that the court had improperly relied “upon a second-year law student’s law review article.” Id. The court notes that it did rely on the article by Derek A. Dion, I’ll Glady Trade You Two Bits on Tuesday for a Byte Today: Bitcoin, Regulating Fraud in the E-Conomy of Hacker-Cash, 2013 U. ILL. J.L. TECH. & POL’Y 165, 167 (2013), but only for a definition and description of Bitcoin. Id.
69. Id.
70. Id.
Unsurprisingly, the SEC disagreed and argued “that the BTCST investments are both investment contracts and notes, and thus, are securities.”\textsuperscript{71} The U.S. District Court for the Eastern District of Texas agreed, finding that the BTCST investments were in fact investments of money because Bitcoin could be used as money to purchase goods and services and could be exchanged for “conventional” currencies.\textsuperscript{72} Accordingly, the court found that “Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money.”\textsuperscript{73}

Next, the court applied the Fifth Circuit’s vertical commonality test requiring “interdependence between the investors and the promotor” and found that the investors were dependent on Shavers’s expertise in Bitcoin markets and his local connections.\textsuperscript{74} Finally, the court found that any investors participating in the BTCST investments were expecting profits from Shavers’s efforts.\textsuperscript{75} Accordingly, the investments sold by Shavers were deemed investment contracts and thus securities.\textsuperscript{76}

\textit{b. The DAO Report}

Whether cryptocurrencies are investment contracts and thus securities is the subject of an SEC release entitled “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO” (the DAO Report).\textsuperscript{77} The DAO Report reiterates the fundamental principles of the federal securities laws

\begin{footnotes}
\footnotetext{71}{Id.}
\footnotetext{72}{Id. at *2.}
\footnotetext{73}{Id.}
\footnotetext{74}{Shavers, 2013 WL 4028182, at *2.}
\footnotetext{75}{Id. The court noted that “Shavers began advertising that he was in the business of ‘selling Bitcoin to a group of local people’ and offered investors up to 1% interest daily ‘until either you withdraw the funds or my local dealings dry up and I can no longer be profitable.’” Id. at *1. The court found this sufficient to demonstrate an expectation of profits from his efforts. Id. at *2.}
\footnotetext{76}{Id. at *2.}
\footnotetext{77}{Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO at 1, Exchange Act Release No. 81207, 117 SEC Docket 745 (July 25, 2017) [hereinafter DAO Report]. “The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a ‘virtual’ organization embodied in computer code and executed on a distributed ledger or blockchain.” Id. at 1.}
\end{footnotes}
and “describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities.” The DAO Report concludes that DAO Tokens are in fact securities, and so the SEC provides typical cautionary language stressing issuers’ obligations to comply with the federal securities laws:

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as “Initial Coin Offerings” or “Token Sales.” Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale.

In the DAO Report, the SEC, although deciding against enforcement action, declared that Slock.it, a German cyberspace corporation holding “a corpus of assets through the sale of DAO Tokens to investors,” had sold securities under American securities laws. In less than one month during the spring of 2016, Slock.it sold over 1 billion DAO Tokens. The SEC did not bring an enforcement action against Slock.it because a hacker stole

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78. Id. at 2.
79. Id. at 3.
80. Id. at 10.
81. See generally id.
82. DAO Report, supra note 77, at 5. The DAO’s intended purpose was to “blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code.” Id.
approximately one-third of the DAO’s assets after the DAO Tokens were sold but before the DAO was able to begin financing the project.83

In applying the Howey test to DAO Tokens, the SEC first concluded that the investors in DAO Tokens did invest money, although no traditional currency changed hands.84 Money would typically connote currency, but the case law supports the idea that cash is not the only form of contribution or investment needed for the finding of an investment contract.85 The SEC found that DAO Tokens investors used Ether (ETH), a virtual currency used on a decentralized platform that runs smart contracts, known as the Ethereum Blockchain, to make their investments.86 Each investor tendered ETH in exchange for DAO Tokens. Despite the lack of traditional currency to satisfy Howey’s “investment of money” prong, the SEC concluded that the investment in DAO Tokens “is the type of contribution of value that can create an investment contract under Howey.”87

The SEC combined discussion of the commonality prong of the Howey test with the DAO Tokens in its discussion of the “reasonable expectation of profits” prong of the Howey test.88 The only reference to the commonality requirement is the SEC’s unsupported conclusion that DAO Token investors were investing in a common enterprise.89 The SEC devoted more analysis to the expectation of profits prong.

83. Id. at 1.
84. Id. at 11.
85. Id. (citing Uselton v. Comm. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) (citations omitted)); see also Munchee Order, supra note 65. (“Munchee offered and sold MUN tokens in a general solicitation that included potential investors in the United States. Investors paid Ether or Bitcoin to purchase their MUN tokens. Such investment is the type of contribution of value that can create an investment contract.”). See supra Section II.B.2.a. for a discussion of SEC v. Shavers.
86. DAO Report, supra note 77, at 11.
87. Uselton, 940 F.2d at 574 (“[T]he ‘investment’ may take the form of ‘goods and services,’ or some other ‘exchange of value.’”); DAO Report, supra note 77, at 11 (citing SEC v. Shavers, No. 4:13-CV-416, 2014 WL 12622292, at *1 (E.D. Tex. Aug. 26, 2014) (order granting in part and denying in part defendants’ motion for reconsideration) (finding that an investment of Bitcoin, a virtual currency, meets the first prong of Howey)).
88. DAO Report, supra note 77, at 11.
89. Id.
and noted that for purposes of the *Howey* test, profits can include “dividends, other periodic payments, or the increased value of the investment.” The DAO was a for-profit enterprise with the stated objective to fund projects in exchange for a return on investment. Because DAO Token holders had the possibility of sharing in potential profits from the various contracts funded, the SEC concluded that “a reasonable investor would have been motivated, at least in part, by the prospects of profits on their investment of ETH in the DAO.”

The final prong of the *Howey* test—that the profits be derived primarily from the managerial efforts of others—was met with DAO Tokens because the investors “relied on the managerial and entrepreneurial efforts of Slock.it, its co-founders, and the DAO’s Curators, to manage the DAO and put forth project proposals that could generate profits for the DAO’s investors.”

The SEC made it clear that the federal securities laws apply to any and all investments that fall within the statutory definition of security:

> The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger

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92. *Id.*
93. *Id.* at 12. The SEC was not troubled by the DAO Token holders’ voting rights, finding that these rights “did not provide them with meaningful control over the enterprise because (1) DAO Token holders’ ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.” *Id.* at 14.
technology.\textsuperscript{94}

This SEC’s clear precedent became an injunction action not much later.

c. The Munchee Stop Order

In 2017, the SEC halted an entrepreneurial offering commenced by Munchee Inc.\textsuperscript{95} Munchee, a California corporation, issued digital coins to budding restaurant critics for submitting a review of a local eatery.\textsuperscript{96} The SEC halted the offering on day two of its operation, which had been slated to earn $15 million from American purchasers.\textsuperscript{97} As the accompanying SEC settlement order stated:

Under Section 2(a)(1) of the Securities Act, a security includes “an investment contract.” An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. ['] The “touchstone” of an investment contract “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” ['] This definition embodies a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”\textsuperscript{98}

An “initial coin offering” or “ICO” is a recently developed form of fundraising event in which an entity offers participants a unique digital “coin” or “token” in exchange

\textsuperscript{94} Id. at 18.
\textsuperscript{95} Munchee Order, supra note 65, at 1.
\textsuperscript{96} Id.
\textsuperscript{97} Id. at 2.
\textsuperscript{98} Id. at 8 (citations omitted).
for consideration (most commonly Bitcoin, Ether, or fiat currency). The tokens are issued and distributed on a “blockchain” or cryptographically-secured ledger. Tokens often are also listed and traded on online platforms, typically called virtual currency exchanges, and they usually trade for other digital assets or fiat currencies. Often, tokens are listed and tradeable immediately after they are issued.99

That same month, the SEC Chair issued a warning to all potential ICO issuers that the securities laws would presumably apply to their deals:

A key question for all ICO market participants: “Is the coin or token a security?” As securities law practitioners know well, the answer depends on the facts. For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club’s operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books[,] and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value—with the ability to lock in those increases by reselling the tokens on a secondary market—or to otherwise profit from the tokens based on the efforts of others. These are key

99. Id. at 3 n.1.
hallmarks of a security and a securities offering.\textsuperscript{100}

The Chair’s warning to investment professionals concurrently acknowledged a presumption that related parties would, where appropriate, be subject to the securities laws:

I also caution market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. \textit{Selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of “scalping,” “pump and dump[,]” and other manipulations and frauds.} Similarly, I also caution those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker–dealers that are in violation of the Securities Exchange Act of 1934.\textsuperscript{101}

To the extent the weight of the SEC’s vaunted Division of Enforcement was not readily comprehended, the Chair continued:

On cryptocurrencies, I want to emphasize two points. First, while there are cryptocurrencies that do not appear to be securities, simply calling something a “currency” or a currency-based product does not mean that it is not a security. Before launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must either (1) be able to demonstrate that the currency or product is not a security or (2) comply with applicable registration and other requirements under our

\begin{footnotesize}
\textsuperscript{100} Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017) [hereinafter Clayton Statement].
\textsuperscript{101} \textit{Id.}.
\end{footnotesize}
securities laws.102

d. The Khaled and Mayweather Cases

Approximately a year after the Munchee Order and the Chair’s warnings, the SEC made good on its advertised presumption that coins issued via ICOs are securities.103 Significantly, in accepting $900,000 to promote three ICOs on his Instagram, Twitter, and Facebook accounts, champion boxer Floyd Mayweather was found to have violated Section 17(b) of the Securities Act.104 In a much-publicized settlement with the boxer, the SEC imposed discipline upon Mayweather—an ordinary citizen, not a securities professional—for his paid endorsement of digital tokens.105 That SEC Order (Mayweather Order) tersely held, “Mayweather violated Section 17(b) of the Securities Act by touting three ICOs that involved the offer and sale of securities on his social media accounts without disclosing that he received compensation from an issuer for doing so, or the amount of the consideration.”106

The Mayweather Order did not explain the application of § 5 or the Howey test to the ICOs in issue.107 The conclusion seems to be presumed, as it was in a companion settlement Order concluded with celebrity Khaled Mohamed Khaled, better known as DJ Khaled.108 Mayweather consented to pay $600,000 in satisfaction of a fine and

102. Id.
105. Mayweather Order, supra note 103, at 5.
106. Id. at 4.
107. See id.
disgorgement, as well as the undertaking to refrain from further violations\(^{109}\) and Khaled agreed, for a two-year period, to:

> [F]orgo receiving or agreeing to receive any form of compensation or consideration, directly or indirectly, from any issuer, underwriter, or dealer, for directly or indirectly publishing, giving publicity to, or circulating any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security, digital or otherwise, for sale, describes such security.\(^{110}\)

Thus, between 2017 and the present, the SEC, in word and deed, expanded the scope of the securities laws to include ICOs. The SEC now benefits from unchallenged agency support, precedent in the form of SEC Orders, and a wealth of case law expanding application of the Howey test for over seventy years.\(^{111}\) Such branding accords the ICO depositor–investor, at first blush, an unsecured claim placed a distant second to secured creditors. The next Section traces the treatment of securities under the Bankruptcy Code through that storied law’s various incarnations.\(^{112}\)

\(^{109}\) Mayweather Order, supra note 103, at 4.

\(^{110}\) Khaled Order, supra note 108, at 3. Of note is the SEC No-Action Letter of early April 2019, which permitted an ICO to move forward without registration of tokens representing air charter discounts where the issuer, among other things, did not emphasize the “potential for the increase in the market value of the Token” and the Token was limited to an immovable price of $1. See TurnKey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019).


C. The Bankruptcy Code On Securities and Section 510(b)
   “Subordination”

   1. Traditionally

   In one sense, the contrast between the respective definitions of
security residing within securities and bankruptcy law tells a story of
statutory versus common law construction. However, the history
behind the Bankruptcy Code reveals that the SEC was never truly
distant from each generation’s notion of a level playing field for both
creditors and investors. It is axiomatic that bankruptcy reorganization
plans need to evaluate such practicalities as stock swaps, stock
registration, and anti-fraud laws. Such investments as real estate
partnerships, Bitcoin arrangements, LLCs, and commercial paper
holdings beg for certainty before a plan can be confirmed.

   Significantly, congressional authority over bankruptcy proceedings
is more clearly defined by the U.S. Constitution than many of its
other powers. Specifically, Article I enables the federal legislature
to “establish uniform Laws on the subject of Bankruptcies throughout
the United States.” In the nineteenth century, three acts of
Congress alternatively granted and rescinded an individual’s right to
voluntary bankruptcy. The aim of marshaling property for
redistribution gradually succumbed to that of debtor relief—often
with strong opposition.

   The Bankruptcy Act of 1898 was the first permanent federal
statute designed to provide American companies with relief from
creditors. That seminal legislation was centered on banks,

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merchants, and farmers. As one scholar explains, “In striking contrast to the tough, administrative British framework that emerged at the same time, American bankruptcy would have a minimalist administrative structure and comparatively generous provisions for the treatment and discharge of debtors.”

2. **The Chandler Act of 1938**

In 1938, Congress, via the Chandler Act, tilted the balance even more in favor of the debtor, as the Supreme Court memorialized in *Local Loan Co. v. Hunt*:

One of the primary purposes of the Bankruptcy Act is to “relieve the honest debtor from the weight of oppressive indebtedness[] and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.” This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt. The various provisions of the Bankruptcy Act were adopted in the light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act. Local rules subversive of that result cannot be accepted as controlling the action of a federal court.

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118. *Id.* at 336.
Concurrently, the Chandler Act prioritized customers over general creditors in claims against a “single and separate fund.”\textsuperscript{120} Thus \textit{Local Loan}, a case deciding a $300 debt, would wind up impacting billions of dollars.\textsuperscript{121}

Since 2005, laws enacted and contemplated have targeted abuse by the debtor.\textsuperscript{122} However, the interplay of securities law and the Code remains a common law tangle.\textsuperscript{123}

Interestingly, the SEC was accorded administrative authority over bankruptcy filings by the 1938 Act.\textsuperscript{124} Separately, alarming brokerage house failures of the late 1960s prompted Congress to adopt the Securities Investor Protection Act of 1970 (SIPA).\textsuperscript{125} Though seemingly extricating issues of investor status from the Bankruptcy Code, SIPA actually only supplants the Code when a registered brokerage firm becomes insolvent and its customers are left with empty accounts (i.e., it does not affect depositor–investors who have parted with money in favor of issuers, online or otherwise).\textsuperscript{126}

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\item \textsuperscript{120} \textit{A Brief History of Bankruptcy}, \textsc{BankruptcyData}, \url{https://www.bankruptcydata.com/a-history-of-bankruptcy} [https://perma.cc/DBM3-7YFM] (last visited Oct. 20, 2019).
\item \textsuperscript{121} \textit{See Local Loan}, 292 U.S. at 238, 245; \textit{A Brief History of Bankruptcy}, supra note 120.
\item \textsuperscript{123} Bankruptcy courts often show deference to the securities laws when evaluating investments engaged in by debtors. \textit{See In re Flanagan}, Nos. NV-13-1188-TaJuKi, NV-13-1189-TaJuKi, 2014 WL 764371, at *7 (B.A.P. 9th Cir. Feb. 26, 2014) (applying the \textit{Howey} test and finding “the bankruptcy court did not err in determining that the Agreement was not an ‘investment contract’ for the purposes of the Securities Act”); \textit{Williams v. Sato (In re Sato)}, 512 B.R. 241, 254 (Bankr. C.D. Cal. 2014) (applying the \textit{Howey} test and finding “the transaction between the parties constitutes an investment contract under the federal test”); \textit{Estate of Adler v. SunTrust Bank, N.A. (In re American Capital Corp.)}, 425 B.R. 714, 722 (Bankr. S.D. Fla. 2010) (applying the \textit{Howey} test and finding “the guaranty fee notes attached to the Amended Complaint in this case do not involve the investment of money by any of the insider Plaintiffs, and thus are not ‘securities’ for purposes of the securities laws”).
\item \textsuperscript{124} Bankruptcy Act of 1938 (Chandler Act), Pub. L. No. 75-696, 52 Stat. 840 (repealed 1978).
\item \textsuperscript{125} 15 U.S.C. § 78lll (2018).
\item \textsuperscript{126} \textit{See id.}
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3. **The Modern Bankruptcy Code**

The present Bankruptcy Code (Title 11) was adopted in 1978, with revisions to the appointment of Bankruptcy Court judges codified in 1984. Its fifteen chapters (spread over four titles) address, in turn, creditors, liquidation, reorganization, creditors, and readjustment of debts. The Code specifically defines security in a manner reminiscent of the 1933 Act:

**a. Definitions**

Definitions are positioned within Title 11. Security is defined as follows:

The term “security”—(A) includes—(i) note; (ii) stock; (iii) treasury stock; (iv) bond; (v) debenture; (vi) collateral trust certificate; (vii) pre-organization certificate or subscription; (viii) transferable share; (ix) voting-trust certificate; (x) certificate of deposit; (xi) certificate of deposit for security; (xii) investment contract or certificate of interest or participation in a profit-sharing agreement or in an oil, gas, or mineral royalty or lease, if such contract or interest is required to be the subject of a registration statement filed with the Securities and Exchange Commission under the provisions of the Securities Act of 1933, or is exempt under section 3(b) of such Act from the requirement to file such a statement; (xiii) interest of a limited partner in a limited partnership; (xiv) other claim or interest commonly known as “security”; and (xv) certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell,
Section 101(49) of the Code continues by expressly exempting a list of instruments from the definition of security. That list includes items that can be grouped into cash or its equivalents (e.g., a check, bank letter of credit), special instruments defined elsewhere in the Code (e.g., a “leverage transaction,” as defined in § 761), certain transactions not subject to SEC registration requirements, commodities–derivatives, or a debt for sold goods or services.

Conversely, the express exclusions are somewhat peculiar to the Code. These exclusions include:

(i) [c]urrency, check, draft, bill of exchange, or bank letter of credit; (ii) leverage transaction, as defined in section 761 of this title; (iii) commodity futures contract or forward contract; (iv) option, warrant, or right to subscribe to or purchase or sell a commodity futures contract; (v) option to purchase or sell a commodity; (vi) contract or certificate of a kind specified in subparagraph (A)(xii) of this paragraph that is not required to be the subject of a registration statement filed with the Securities and Exchange Commission and is not exempt under section 3(b) of the Securities Act of 1933 from the requirement to file such a statement; or (vii) debt or evidence of indebtedness for goods sold and delivered or services rendered.

Were it not for the overlapping jurisdiction between the SEC and CFTC over virtual currency arrangements, the Code might thus

130. Id. § 101(49).
131. Id. § 101(49)(i).
132. Id. § 101(49)(ii).
133. Id. § 101(49)(vi).
134. Id. § 101(49)(iii)-(v).
136. Id.
exclude all claims related to ICOs as “commodities.”

Accordingly, the investor–depositor faces the real problem of subordination under the Code, which is the subject of the next section.

\[\text{b. Section 510(b) of the Bankruptcy Code} \]

In both a Chapter 11 reorganization and a Chapter 7 liquidation, the shareholder of a corporation faces significant obstacles. In brief, the owner of debtor securities takes action upon the debtor’s filing for bankruptcy; at times, this action manifests itself as “rescission” of unregistered securities. At other times, the securities holder simply makes a claim, which is generally subordinated to creditors of both the secured and unsecured type. Thus, in varied situations, the Code consistently relegates the shareholder claim to a posterior position in the order of payout. Section 510(b) itself states as follows:

For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages

138. See supra Section II.B.2.
139. See infra Section II.C.3.b.
141. See generally discussion infra Section II.C.
arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.144

Investors in a business that file for bankruptcy can see their infusions dissipate or dry up before their claim is honored; conversely, creditors stand a better chance of recovery.

Generally, the bankruptcy courts have ruled on the relation of § 510(b) to securities in various contexts—and in the presence of various joined claims.145 The five cases summarized below provide examples of the contexts in which debtors have sought to subordinate claims in recent years.

(i) In re Lehman Bros. Inc.

In In re Lehman Bros. Inc.,146 the famed broker–dealer had been placed into liquidation under SIPA, which created the Securities Investor Protection Corporation (SIPC).147 The customer–claimant subsequently brought an action premised upon Lehman’s alleged failure to purchase Lehman Holding Company (LHI) bonds pursuant to a prime brokerage account agreement.148 The initial ruling

145. See infra Sections II.C.3.b(i–v).
147. JOHN DOWNES & JORDAN ELLIOT GOODMAN, BARRON’S BUSINESS GUIDES: DICTIONARY OF FINANCE AND INVESTMENT TERMS 672 (9th ed. 2014). SIPC, a nonprofit corporation, aims to parallel the Federal Deposit Insurance Corporation by “insur[ing] the securities and cash in the customer accounts of member brokerage firms against the failure of those firms.” Id. There are limits of, respectively, $100,000 for cash or cash equivalents, and $500,000 per customer account. Id.
sustained an objection by the trustee seeking to subordinate claims under § 510(b).\textsuperscript{149}

The claimant’s appeal centered on three arguments. First, a literal reading of § 510(b) should not apply in the absence of an actual purchase or sale.\textsuperscript{150} Second, it was asserted that the claim for damages should not be subordinated because it does not arise from the purchase or sale of the LHI bonds within the meaning of § 510(b).\textsuperscript{151} Third, the claimant maintained that subordination of its claim did not advance the statute’s purpose.\textsuperscript{152}

Regarding statutory interpretation, the court reasoned that the claim “[did] not require ‘arising from’ to be read nearly as broadly as permitted under the case law.”\textsuperscript{153} Irrespective of the nature of the claim, the statute “require[d] subordination of claims by security holders that seek to recover, as [claimant] does, for the loss in value of a security issued by the debtor or an affiliate.”\textsuperscript{154} Concurrently, “[n]either Section 510(b) nor SIPA suggests an exception for transactions involving broker–dealer debtors either purchasing or selling affiliate bonds.”\textsuperscript{155}

Further, pursuant to case law, the court found it well settled that § 510(b) applies even in the absence of an actual purchase or sale.\textsuperscript{156} The bench ruled that under Med Diversified\textsuperscript{157} and other case law, it had been well settled that § 510(b) applies in the absence of an actual

\begin{footnotesize}
\begin{enumerate}
\item[149.] In re Lehman Bros., 519 B.R. at 436.
\item[150.] Id. at 437.
\item[151.] Id. at 446.
\item[152.] Id. at 449.
\item[153.] Id. at 446.
\item[154.] Id.
\item[155.] In re Lehman Bros., 519 B.R. at 446.
\item[156.] Rombro v. Dufrayne (In re Med Diversified, Inc.), 461 F.3d 251, 252 (2d Cir. 2006). By comparison, the application of famed SEC Rule 10b-5—the measure which is used to punish insider trading and other securities fraud—often evaluates the actual purchase or sale of a security. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 724 (1975) (dismissing a claim by parties dissuaded from purchasing the relevant securities). Such analysis is deemed mandated by the parting words of the provision: “in connection with the purchase or sale of a security.” Id. But see SEC v. Zandford, 535 U.S. 813, 824 (2002) (finding a stockbroker liable for a Rule 10b-5 violation where monies were filched but no clearly related securities transactions noted).
\item[157.] In re Med Diversified, Inc., 461 F.3d at 252.
\end{enumerate}
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purchase or sale.\textsuperscript{158} \textquote{[G]iven \lq\lq[t]he weight of precedent favoring subordination’ even where no purchase or sale has occurred, ‘and the absence of persuasive precedent upholding the contrary position, the ambiguity \textit{vel non} of the statutory text’\rq\rq was held to be inconsequential.\textsuperscript{159} Thus, the claim remained subordinated.

Finally, in evaluating policy considerations, the \textit{Lehman Bros.} court found that the \textquote{risk-allocation} rationale supported subordination of the claim.\textsuperscript{160} Though the claimant argued that this rationale did not apply because Lehman Brothers had agreed to pay a fixed sum of cash for the LHI bonds, the court noted the key distinction between case law and the present context: the fact that, in contrast to \textit{Med Diversified}\textsuperscript{161} and other cases where the claimant contracted to acquire more stock, the present claimant sought to \textit{dispose} of the LHI Bonds, thereby \textquote{terminating its right to share in any appreciation in price,}\textsuperscript{162} In this vein, the court noted that the claimant still held the LHI bonds as of the petition date, and its claim was based in part on the diminished value of those bonds.\textsuperscript{163}

This policy analysis is not uncommon. One leading practitioner firm described the trend as such:

Many courts have decided cases under section 510(b) by reviewing the traditional allocation of risk between a company’s shareholders and its creditors. Under this policy-based analysis, shareholders are deemed to expect more risk in exchange for the potential to participate in the profits of the company, whereas creditors can expect only repayment of their fixed debts. Accordingly shareholders, and not creditors, assume the risk of a wrongful or unlawful

\begin{footnotes}
\item[158] See sources cited \textit{supra} note 156 and accompanying text.
\item[159] \textit{In re} Lehman Bros., 519 B.R. at 446.
\item[160] \textit{Id.} at 447.
\item[161] \textit{Id.} at 447–48.
\item[162] \textit{Id.} at 447.
\item[163] \textit{Id.} at 447.
\end{footnotes}
purchase or sale of securities . . . . 164

(ii) Marro v. General Maritime Corp.

In 2014, the same year as Lehman Bros., the U.S. District Court for the Southern District of New York held that parties holding $50,000 worth of “Senior Notes” issued by a debtor seeking Chapter 11 bankruptcy protection could not recover monies attributed to principal and lost opportunities. Specifically, in Marro v. General Maritime Corp., the court found § 510(b) inapplicable under the reorganization plan, which called for the debtors to distribute cash, equity, and warrants to the Senior Notes Indenture Trustee. Then, noteholders would receive these distributions as full satisfaction of their claims. Significantly, although the noteholder acknowledged receiving his distribution from the Trustee, he filed an additional proof of claim totaling $81,250—$50,000 for the principal amount of the notes and $31,250 for opportunity costs and other damages, which were attributed to fraudulent inducement, fraudulent retention, breach of contract for the bond indenture, and breach of fiduciary duty by the debtors.

The court held that although not every breach of contract claim is subject to mandatory subordination, the key is “whether the requisite nexus is present to tie the specific claim at issue to the claimant’s initial purchase of his securities.” Here, the noteholder himself described his claim as “a hybrid of fraudulent inducement, fraudulent retention[,] and breach of contract.” The court further held that on

166. Id. at *2.
167. Id.
168. Id. at *2–3.
169. Id. at *10–11.
170. Id. at *11 (citation omitted).
its face, § 510(b) applied to any such claim because fraudulent inducement, by definition, describes misconduct occurring at the time of a security’s purchase.\textsuperscript{171} The court then found that the remaining theories of recovery—fraudulent retention, breach of fiduciary duty, and breach of contract—pertained to the debtor’s post-acquisition conduct.\textsuperscript{172} However, under § 501(b) the outcome was the same.\textsuperscript{173}

\textit{(iii) Templeton v. O’Cheskey}

In 2015, the Fifth Circuit in \textit{Templeton v. O’Cheskey} ruled that unsecured claims of both the liquidated and unliquidated variety should be subordinated.\textsuperscript{174} Templeton’s liquidated claim was submitted for reimbursement, although its unliquidated claim asserted fraud and breach of fiduciary duties in relation to those investments.\textsuperscript{175} The debtor’s Trustee commenced an adversary proceeding by filing a complaint that objected to Templeton’s claim.\textsuperscript{176}

Templeton invested in certain limited partnerships formed under the guaranty of the debtor, American Housing Foundation (AHF), who ultimately filed for Chapter 11 bankruptcy.\textsuperscript{177} Templeton asserted claims based on the guaranties against AHF, arguing that its claims should fall within “General Unsecured Claims”—for which the estimated recovery fell between 20\% and 40\% of the claim value.\textsuperscript{178} The Trustee argued instead that Templeton’s claims fell within “Allowed Subordinated Claims”—a class with a 0\% estimated recovery.\textsuperscript{179} The decision was affirmed concerning the Trustee’s suggested subordination.\textsuperscript{180} The court expressly held that “all of

\begin{flushright}
172. \textit{Id.}
173. \textit{Id.}
175. \textit{Id.}
176. \textit{Id.} at 150.
177. \textit{Id.} at 146.
178. \textit{Id.} at 146, 149.
179. \textit{Id.} at 152.
180. \textit{In re Am. Hous. Found.}, 785 F.3d at 165.
\end{flushright}
Templeton’s claims [were] claims ‘for damages arising from the purchase or sale of’ a ‘security . . . of an affiliate of [AHF]”’ and must, therefore, be subordinated.\textsuperscript{181} In turn, the court described its step-by-step analysis of this provision.\textsuperscript{182}

First, regarding the unliquidated claims—fraud and breach of fiduciary duties—Templeton sought damages based on the injuries that resulted from these torts.\textsuperscript{183} Moreover, Templeton’s liquidated claims, which sought reimbursement under AHF’s guaranties, also constituted claims for damages.\textsuperscript{184} Although Templeton was suing for the breach of the guaranties of limited partnership (LP) interests (rather than for repayment of his equity investments in the LPs), such proposed treatment was held to be exactly the “elevation of form over substance that § 510(b) seeks to avoid—by subordinating claims that functionally seek to ‘recover a portion of claimants’ equity investments.’”\textsuperscript{185}

By means of elaboration, the court found that Templeton’s claims arose from the purchase of securities.\textsuperscript{186} To arise from the purchase or sale of a security, the claim must have some causal relationship with the sale.\textsuperscript{187} Templeton itself clarified that the tort claims stemmed directly from the LP investments.\textsuperscript{188} Furthermore, those LP interests were securities of an affiliate\textsuperscript{189} of AHF as directly referenced by the statute.\textsuperscript{190} The Bankruptcy Code defines “affiliate,” in relevant part, as a “person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the

\textsuperscript{181} Id. at 153.
\textsuperscript{182} Id.
\textsuperscript{183} Id.
\textsuperscript{184} Id. at 154.
\textsuperscript{185} Id. at 155.
\textsuperscript{186} In re Am. Hous. Found., 785 F.3d at 157.
\textsuperscript{187} Id. at 155 (citations omitted).
\textsuperscript{188} Id. at 155.
\textsuperscript{190} Id. § 510(b).
debtor.”\footnote{Id. \textsection 101(2)(c).} The Templeton court thus had little tolerance for creative, alternative pleading in light of the plain language of the statute.

\textbf{(iv) \ Murphy v. Madden}

In 2016, the Sixth Circuit in \textit{Murphy v. Madden} held that a shareholder of Energy Conversion Devices (ECD) could not effectively convert a securities claim to a novel tort action premised upon a surprise bankruptcy filing.\footnote{Murphy v. Madden \textit{(In re Energy Conversion Devices, Inc.)}, No. 15-1734, 2016 U.S. App. LEXIS 4414, at *1–6, *9 (6th Cir. Feb. 19, 2016).} ECD and a related entity, United Solar Ovonic LLC, filed a Chapter 11 bankruptcy petition.\footnote{Id. at *1.} Murphy was a shareholder of ECD, holding 116,950 shares of ECD stock.\footnote{Id. at *2.} The bankruptcy court authorized ECD’s liquidation sale through the auction of nearly all of its assets.\footnote{Id.} Murphy filed a claim for breach of performance and violations of fiduciary responsibility to shareholders.\footnote{Id. at *2–3.} Because ECD’s actions in filing the petition and subsequent liquidation sale substantially reduced the value of his stock, Murphy claimed that he was owed $136,890, representing the value of his shares of stock on the morning before the formal commencing of the bankruptcy.\footnote{In re Energy Conversion Devices, Inc., 2016 U.S. App. LEXIS 4414, at *2.}

The liquidation trustee concluded that Murphy merely had an equity interest in EDC and that under \textsection 510(b), his breach of fiduciary duty claim still required subordination to the ECD’s creditors’ claims.\footnote{Id. at *1.} Murphy countered that the section did not apply because his claim originated from his \textit{ownership} of ECD stock rather than from his actual purchase of the stock.\footnote{Id. at *2–3.} Murphy argued that judicial estoppel prohibited the application of \textsection 510(b) to his claim because ECD’s Bankruptcy Plan did not contemplate the section’s

\footnote{Id. at *3–4 (emphasis added).}
application to noteholders who, like Murphy, merely owned ECD securities. 200

The Sixth Circuit affirmed the Trustee’s Order, concluding that Murphy’s claim required subordination under § 510(b).201 The court held that, for purposes of the section, there is no distinction between fraud committed when the securities were purchased and fraud committed after the purchase that adversely affects one’s ability to sell those securities.202 Thus, the claim still arises from the purchase or sale of such a security when an investor’s claim for damages is caused by fraud either at the time of the purchase or post-purchase.203 The court further held that Murphy’s judicial estoppel argument was misplaced because unlike Murphy, who merely held an equity interest in ECD, the noteholders held debt interest in ECD.204 Accordingly, unlike Murphy’s equity interests, the noteholders were unsecured creditors with claims against ECD not subject to subordination under § 510(b).205

(v) Liquidating Trust Communication of the Del Biaggio Liquidating Trust v. Freeman

Finally, the Ninth Circuit weighed in via Liquidating Trust Communication of the Del Biaggio Liquidating Trust v. Freeman.206 In Liquidating Trust, “the entity charged with prosecuting claims [during the] Del Biaggio’s bankruptcy” received an objection from David Freeman, an investor in Predators Holdings, LLC.207 The case has somewhat of a story behind it.

200. Id. at *4.
201. Id.
202. Id. at *4-5 (citations omitted).
204. Id. at *5.
205. Id.
206. Liquidating Tr. Comm’n of the Del Biaggio Liquidating Tr. v. Freeman (In re Del Biaggio), 834 F.3d 1003, 1006 (9th Cir. 2016).
207. Id. at 1006–07.
The Nashville Predators are a National Hockey League team based in Nashville, Tennessee that in 2007 was owned by Craig Leipold. In 2007, after David Freeman learned that Leipold intended to sell the Predators to a third party who would move the team out of Tennessee, Freeman began organizing a group of Nashville investors to buy the team to avoid the potential move. Ultimately, Freeman and his group of investors reached an agreement to purchase the Predators from Leipold for $193 million. The sale of the Predators to Freeman and his group of investors, including William Del Biaggio III, closed on December 7, 2007. After the sale, Nashville Hockey Club Limited wholly owned and operated the Predators. In turn, Predators Holdings, LLC (Holdings) wholly owned the Nashville Hockey Club Limited.

After a few months, Freeman discovered that Del Biaggio never had the necessary funds to support his guarantees. Del Biaggio then filed for Chapter 11, giving rise to the proceeding that ultimately went before the Ninth Circuit with Freeman filing a general unsecured claim against Del Biaggio’s bankruptcy estate seeking damages from Del Biaggio’s fraud in the Holdings transaction. In response, the Liquidating Trust Committee filed a counterclaim against Freeman seeking summary judgment on the issues of subordination and disallowance of Freeman’s claim based on § 510(b).

Freeman lost, but on appeal he argued the bankruptcy court and district court erred in applying § 510(b) to his claim against Del Biaggio, contending his claim did not arise from the purchase or sale of Holdings. Freeman further contended there was no privity

208. Id. at 1006.
209. Id.
210. Id.
211. Id.
212. In re Del Biaggio, 834 F.3d at 1006.
213. Id.
214. Id. at 1006–07.
215. Id. at 1007.
216. Id.
217. Id. at 1008.
because he purchased the Holdings securities from Leipold—not Del Biaggio.\textsuperscript{218} Freeman also sought to avoid § 510(b)’s language by arguing that even if its text pointed towards subordination, its purposes did not.\textsuperscript{219}

The circuit court denied all of Freeman’s objections.\textsuperscript{220} The Ninth Circuit began by looking at the statute’s plain text, observing that § 510(b)’s “arising from” language reached broadly to subordinate damage claims involving qualifying securities.\textsuperscript{221} Citing to a 2015 case, the bench held that:

> The phrase “arising from” as employed in [the section] “connotes, in ordinary usage, something broader than causation” and is instead “ordinarily understood to mean ‘originating from,’ ‘having its origin in,’ ‘growing out of,’ or ‘flowing from’ or in short, ‘incident to, or having connection with.’”\textsuperscript{222}

Additionally, the court found it irrelevant that Freeman purchased the securities from Leipold rather than from Del Biaggio.\textsuperscript{223} The court reasoned that the statute only said a damages claim must arise from the purchase of securities “of an affiliate of the debtor,” not from the debtor himself.\textsuperscript{224} Accordingly, the lack of privity was irrelevant.

In general, the 	extit{Freeman} court reminded that there are “two main rationales for mandatory subordination: (1) the dissimilar risk and return expectations of shareholders and creditors; and (2) the reliance of creditors on the equity cushion provided by shareholder investment.”\textsuperscript{225} As he admitted, Freeman bargained for increased risk.

\textsuperscript{218} In re Del Biaggio, 834 F.3d at 1010.
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} Id. at 1009.
\textsuperscript{222} Id. at 1010 (citing Pensco Tr. Co. v. Tristar Esperanza Props., LLC (In re Tristar Esperanza Props., LLC), 782 F.3d 492, 497 (9th Cir. 2015)).
\textsuperscript{223} Id.
\textsuperscript{224} In re Del Biaggio, 834 F.3d at 1010.
\textsuperscript{225} Id.
in exchange for an expectation in the Holdings’s profits by investing in an affiliate of Del Biaggio. However, Del Biaggio’s creditors did not take this type of gamble. Thus, the court found that allowing Freeman to stand on par with Del Biaggio’s creditor would give Freeman the “best of both worlds—the right to share in profits if [Holdings] succeeded and the right to repayment as a creditor [of Del Biaggio] if it failed.”

Indeed, the “best of both worlds” rationale appears to permeate the case law of numerous circuits. To be sure, on various grounds in various settings, courts evaluating a security’s § 510(b) status have favored subordination. It is worth noting that all of the circuit court decisions noted above were unanimous. Interestingly, the emphasis on the actual purchase or sale of securities—a common question in securities cases—is evidenced.

The bootstrapping of fraud claims to contractual claims has been consistently frowned upon by bankruptcy courts. Further, a bankruptcy court may unquestionably recharacterize a claim as equity “within the Code’s confines.” Yet, the interface of securities and bankruptcy law can rationally be characterized as a reflection of the times facing investors. Indeed, the Kripke–Slain Hypothesis (the Hypothesis)—although amplifying creditor expectations to be paid before shareholders—nonetheless also posited that most claims arose from fraudulent conversion at or near the time of sale.

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226. *Id.* at 1011.
227. *Id.*
228. *Id.*
229. *Id.* at 1011–12.
230. *In re* Del Biaggio, 834 F.3d at 1011–12.
231. *FIN. ACTION TASK FORCE*, *supra* note 6.
Because the ICO investor–depositor can now trust the SEC to have prevented fraud ab initio (i.e., ICO warranting registration shall be so required), a model based upon shareholder rescission seems a bit out of date. Concomitantly, the recognition that fraud, if any, is more likely to occur after the ICO takes place provides a clear point of demarcation between speculation and expectation.

### c. A Modern Trend?

Securities law has long been thought to be policy influenced. The question thus becomes, whether policy considerations will unsettle Bankruptcy Code favoritism of debtors urging subordination when frauds become more readily apparent and separated in time from the initial purchase of stock. It is axiomatic that something more than creditor negligence is required to warrant equitable subordination under § 510(c) while statutory subordination is undergoing a period of review. ICOs, with their billion-dollar paydays and often inscrutable technical characteristics, can be said to present a ripe opportunity for a re-evaluation of both § 510(b) and the Hypothesis.

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235. See, e.g., Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm’n, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading (Feb. 27, 1998) (extolling the practicality of the Supreme Court’s O’Hagan decision, which utilized a new SEC theory to expand the insider trading ban to trading by corporate “outsiders”).

236. 11 U.S.C. § 510(c) reads in toto as follows:

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

1. under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
2. order that any lien securing such a subordinated claim be transferred to the estate.

II. Is a New Protocol Warranted by the Advent of Mass Investment in Digital Currencies?

In their 1973 article, The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer’s Creditors, experts Homer Kripke and John J. Slain examined the then-status-quo and concluded that investors were receiving unfair priority vis-à-vis creditors in bankruptcy proceedings administered under the federal Bankruptcy Code.\(^{237}\) Focusing on the traditional “absolute priority rule,” the study pointed out that the SEC support for the investor priority was unfounded and urged deference to the notion of general creditors coming first.\(^{238}\) Messrs. Kripke and Slain were pointed in their 1973 observation that the absolute priority rule was being averted.\(^{239}\) Does their rationale hold up in today’s complex markets?

A. The Mt. Gox Debacle

Mt. Gox was a Bitcoin exchange launched in 2010 based in Japan.\(^{240}\) By 2014, Mt. Gox was the largest Bitcoin exchange in the world, with over 70% of Bitcoin transactions.\(^{241}\) But all was not well with Mt. Gox; starting in 2011, Mt. Gox had experienced a series of hacks, totaling about 630,000 Bitcoin by 2013.\(^{242}\) In February 2014, Mt. Gox halted all Bitcoin withdrawals.\(^{243}\) The former CEO of Mt. Gox (who also owned approximately 88% of the failed exchange) continues to face a class action in Illinois.\(^{244}\) That action was brought

\(^{237}\) Slain & Kripke, supra note 234, at 298–99.
\(^{238}\) Id.
\(^{239}\) Id.
\(^{241}\) Id.
\(^{243}\) Id.
\(^{244}\) Brian Flood, Mt. Gox Chief Can’t Escape Suit over Crypto Exchange Collapse, BLOOMBERG L. (Mar. 13, 2019, 1:04 PM), https://news.bloomberglaw.com/class-action/mt-gox-chief-cant-escape-suit-
by owners of Bitcoin who were abruptly informed that all withdrawals were being halted for technical reasons, when in actuality, hackers had purloined hundreds of millions of dollars’ worth of assets.\textsuperscript{245} In February 2014, Mt. Gox filed for bankruptcy protection under Japanese law.\textsuperscript{246} The CEO was confined to the island nation while under investigation for theft, a process that did not resolve until March 2019.\textsuperscript{247}

In the five years since the Mt. Gox disaster, the following chronology has been revealed. The fledgling exchange, operating under Japanese law, successfully solicited over $1 million of Bitcoin.\textsuperscript{248} By 2013, allegedly, third-party banks were placing pressure on the unique exchange to settle accounts out of fear of its ties to money laundering.\textsuperscript{249} Consequentially, Mt. Gox users began to experience difficulties in withdrawing their funds from Mt. Gox accounts.\textsuperscript{250} Parties within and outside Mt. Gox were later alleged to have wrongfully continued to accept deposits from new Bitcoin purchasers, while behind the scenes operations were freezing up.\textsuperscript{251} When the Mt. Gox owner eventually shuttered the exchange and filed for bankruptcy protection under Japanese law in February 2014, liabilities were represented as exceeding $65 million, while the forsaken Bitcoins were valued at over $400 million (allegedly due to an unpreventable hacking).\textsuperscript{252}

In June 2014, a Texas bankruptcy court recognized the primacy of the Japanese bankruptcy proceeding and stayed all other litigation.\textsuperscript{253}
Though the Mt. Gox example continues to be sorted out and, incontrovertibly, visited irreparable woe upon creditor and investor– depositor alike, the case stands out foremost as a notorious initial chapter to the book of Bitcoin. The persisting domestic litigation concerns the actions of individuals and not any bankruptcy estate; truly, Mt. Gox is a curious tale of an exchange that either did or did not ever exist, thus simply exponentially increasing the losses due to a traditional shareholder rescission claim. Accordingly, to reevaluate the rights of the cryptocurrency shareholder more meaningfully, a court of repute was needed to upend traditional thought and refuse to subordinate the claim of the cryptoshareholder, who invested in a seemingly legitimate enterprise and was much later defrauded via conventional human theft. A California case with disturbing facts created such a chance in 2017.

**B. The Ninth Circuit Mini-Revolution in Khan**

During the first decade of this century, as markets swung volatily, commentators followed in earnest the saga of subordination. In one noteworthy case, the U.S. District Court for the Southern District of Texas subordinated over $2.7 million in debt in a Chapter 11 battle between limited partners of a sea diving company. Indeed, multiple circuits were said to subscribe to the trend of finding congressional intent for a broad concept of subordination of investments.

However, a minor revolution occurred in 2017 within the Ninth Circuit. In the *Khan* case, the appellate court, noting the dual obstacles awaiting shareholders alleging fraud, severed the timeline

254. See Khan v. Barton (*In re Khan*), 846 F.3d 1058, 1066 (9th Cir. 2017).
256. SeaQuest Diving, LP v. S & J Diving, Inc. (*In re SeaQuest Diving, LP*), 579 F.3d 411, 416 (5th Cir. 2009).
257. May, *supra* note 255.

1. The Khan Decision

The Khan case, a play told in three parts, was described by the highest court to hear the matter as “a saga of picaresque behavior.”\footnote{259}{In re Khan, 846 F.3d at 1066.} In In re Khan, a Chapter 13 bankruptcy action was brought in a Ninth Circuit Bankruptcy court.\footnote{260}{See generally id.} The bankruptcy court first converted a Chapter 13 action to a Chapter 7 proceeding and then decided against subordinating a creditor’s claims.\footnote{261}{Id. at 1061.}

The facts are as follows: in 2013, creditor Kenneth Barton succeeded in obtaining a state court judgment against a corporate debtor for conversion, fraud, and breach of fiduciary duty.\footnote{262}{Id.} Barton alleged that after he suffered a stroke in 2009 his cofounders converted his approximately 6,000,000 shares of common stock of the debtor (issued in 2001).\footnote{263}{Id.} The California Superior Court agreed that the Debtors had “fraudulently converted Barton’s stock” by means of “forged corporate resolutions.”\footnote{264}{Id.} Further, these parties had “misplaced or destroyed” the records of shareholder ownership.\footnote{265}{In re Khan, 846 F.3d at 1061.} The Superior Court, after additional hearings, awarded damages to Barton of approximately $3.8 million.\footnote{266}{Id.}

The Debtors quickly filed for Chapter 13 bankruptcy; that petition was converted to a Chapter 7 based upon a court finding of bad faith.\footnote{267}{Id. at 1062.} The bankruptcy court found that Barton’s claim was not subject to subordination because it stemmed from the Superior Court...
The Bankruptcy Appellate Panel affirmed the bankruptcy court ruling on simpler grounds: that § 510(b) cannot apply to debtors who are individuals. Finally, the United States Court of Appeals for the Ninth Circuit agreed with the refusal of the lower courts to subordinate, noting that the judgment creating Barton’s claim was based upon actions by the Debtors “many years later” in relation to the initial issuance of the company stock.

2. Khan and the SEC Actions Combined

Such a severed timeline spells relief for ICO investors who often watch purchases of cryptocurrency later disappear due to hacking or outright waste. And SEC action serves to bolster the shareholder claim by separating the registration (i.e., § 5) violation from the fraud (i.e., Rule 10b-5) violation, an approach evident in the Munchee Order, Mayweather Order, and other disciplinary cases to date.

In sum, the spate of SEC actions accord ICO purchasers investor status, and the distinctions drawn between initial purchase and subsequent fraud echo the Ninth Circuit’s attack on subordination. According the investor–creditor status could greatly increase the likelihood of salvaging a claim, thus making § 510(b)’s treatment of shareholders a new and pivotal issue in many hotly contested bankruptcy matters. That subordination issue was last addressed nearly fifty years ago, and given the vast amounts of online investments likely to be deemed securities, it is in dire need of updating.

268. Id.
269. Id.
270. Id. at 1063–64. The one Ninth Circuit case to cite Khan has not questioned its refusal to subordinate a shareholder’s claim of conversion temporally removed from the investment. See Moore v. Blue Earth, No. 17-cv-03905, 2018 WL 4378713, at *8 (N.D. Cal. Sept. 12, 2018) (noting that “Section 501(b)’s ‘arising from’ language ‘reaches broadly to subordinate damage claims involving qualifying securities’ and ‘requires that claims be subordinated “where there exists some nexus or causal relationship between the claim and the purchase of the securities”’”) (citation omitted).
271. See supra Section II.B.2.
272. May, supra note 255, at 1–2.
III. Elevated Status for Severable Crypto Investments

A. The Kripke–Slain Hypothetical

In their seminal article, the esteemed experts Kripke and Slain worked from the following example:

Assume that XYZ, Inc., having just been organized to engage in the widget business, requires an additional $300,000 of capital to start up. XYZ’s management, either directly or through investment bankers, searches for a group of substantial investors prepared to provide the $300,000 and accept equity risks. They locate one such investor, H, who has a personal investment portfolio of several million dollars. Prior to his retirement, H was employed as a portfolio manager for a financial business and is concededly a “sophisticated investor.” H meets the principals in XYZ . . . and purchases 30,000 shares of XYZ’s common stock for $180,000 . . . . Another 20,000 shares are sold for $120,000 to others less sophisticated, who are impressed by the information that the sophisticated Mr. H is participating.

XYZ begins operations and for six months after H’s stock purchase conducts an active business. The corporation quickly incurs $1,000,000 in liabilities to unsecured lenders. . . . [One month later the corporation files for bankruptcy.] In this proceeding, H asserts a claim for rescission of his $180,000 stock purchase, alleging that the issuer violated Section 5 of the Securities Act of 1933 . . . . XYZ’s trustee in bankruptcy attempts to show that the issue was exempted as a nonpublic offering under Section 4(2) of the Act, but fails when he is unable to

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273. The authors each were enrolled in graduate law courses taught by Professor Slain (1927–2014), a recognized expert in securities regulation.
demonstrate that all the persons to whom the $300,000 in stock had been offered were “sophisticated” . . . . [I]t is probable that H has a claim . . . to share pari passu with the claims of general creditors. 274

B. A More Modern Hypothetical

The hypothetical offered by Messrs. Kripke and Slain spoke strongly in support of the fairness of their interpretation. The following updated hypothetical highlights the problem caused for purchases of ICOs—either direct or indirect—by investors when the intermediary goes bankrupt:

Assume that online issuer XYZ, Inc., having just created a charter for a unique digital coin environment, requires an additional $5 million of capital to start up. XYZ’s management, either directly or through internet financiers, offers coins to provide $5 million. They locate a well-heeled investor, H, who has a personal investment portfolio numbering in the tens of millions of dollars.

Before his retirement, H was employed as a portfolio manager for a financial business and is concededly a “sophisticated investor.” He trades information online with the principals in XYZ and purchases 3,000 coins for $2.8 million. Another 2,000 coins are sold for $1.2 million to others less sophisticated, (I & J), who are impressed by the information that the sophisticated Mr. H is participating.

XYZ begins operations and for six months after H’s coin purchase conducts an active business. The corporation quickly incurs $1,000,000 in liabilities to unsecured lenders. Then, six months later, the company informs the

274. Slain & Kripke, supra note 234, at 263–65 (citations omitted).
public that all assets are gone due to hacking. The principals apologize for less than ideal safety procedures. One month later, XYZ corporation files for bankruptcy.

In this proceeding, H asserts a claim for rescission of his $2.8 million stock purchase, alleging that the issuer violated § 5 of the Securities Act of 1933 (to bring the action within the scope of the securities laws). That claim is subordinated.

Simultaneously, I and J assert claims for damages due to negligence. I and J would seem to have a severable claim, because (per Khan) the claims were due to the unforeseen theft by other individuals.

XYZ’s trustee in bankruptcy attempts to show that the issue was exempted as a nonpublic offering under § 4(2) of the Act, but fails when he is unable to demonstrate that all the persons to whom the $5 million in coins had been offered were sophisticated. It is probable that H has a claim to share pari passu with the claims of general creditors.

Yet, I and J would seem to make plausible arguments that their claims are on par with creditors, due to the rational reading of the timeline of the case.

As Khan educates, “[T]here is a limit to the reach of § 510(b), which stops short of encompassing every transaction that touches on or involves stock in a corporation.”

275 Khan v. Barton (In re Khan), 846 F.3d 1058, 1064 (9th Cir. 2017).
CONCLUSION: TIME FOR A NEW NORMAL?

A. A Pointed Summary

The current application of the absolute priority rule to investor claims is premised on a study that is over fifty years old.\(^\text{276}\) Although the Kripke–Slain Hypothesis is laudable, it is in need of updating for unconventional online investments. Simply put, those two outstanding scholars produced an interpretation of § 510(b) at a time when the thorniest investor–issuer disputes centered on varying share classes and interlocking partnership agreements. Today’s issues question: (1) the very existence of a security; (2) the point at which issuer wrongdoing (if any) transpired; (3) the ability of the bankruptcy estate to locate the funds being fought over; (4) whether there is a ceiling on financial assets contributed and gathered online; and (5) a novel interdependency of regulatory action, criminal charges, and class action litigation in the absence of timely statutory changes.\(^\text{277}\)

Further, recent efforts at updating the Code have centered on its possible abuse by debtors.\(^\text{278}\) Although such avoidance of judicial and economical waste is salutary, that focus forestalls or precludes amendment to § 510(b)—particularly at a time when neither Congress nor regulators have defined cryptocurrencies and their latest incarnation, the ICO.

Accordingly, to promulgate a working arrangement for victims of insolvent crypto-issuers, the present authors have offered the following syllogism:

1. As evidenced by over seventy years of successful

\(^{276}\) Slain & Kripke, \textit{supra} note 234, at 298–99.
\(^{277}\) \textit{See In re Khan}, 846 F.3d at 1064; Zack Christensen, \textit{The FAIR Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to the Creditors of a Bankrupt Debtor?}, 71 U. Ill. L. Rev 339, 339 (2005); Colesanti, \textit{supra} note 27, at 30; Hester Peirce, Comm’r, Sec. & Exch. Comm’n, Regulation: A View from Inside the Machine at University of Missouri School of Law (Feb. 6, 2019).
application, the *Howey* test broadly expands the securities laws to reach a great many (often unexpected) financial arrangements.

2. As evidenced by noteworthy actions by the chief securities markets regulator, ICOs, since late 2017, are often presumed securities.

3. As evidenced by the 1978 Bankruptcy Code, securities holders are subordinated to both secured and unsecured creditors.

4. As evidenced by several decisions since 2017, a severable claim may be brought by the securities holder.

5. Further, the Ninth Circuit has held that where the conversion is severable from the investment, an investor claim can overcome subordination.

6. ICOs—when they have been disciplined by the SEC—have been found to have commenced lawfully and later defrauded investor–depositors.

7. Thus, a valid argument can be made for allowing the ICO purchaser to elevate his severable claim to pari passu status with creditors.

Such a progression is more than just plausible; sharing the wealth appears the most equitable distribution of remaining estate proceeds given the uncertainties of ICOs that continue to puzzle market regulators.279 The biggest obstacle to a reorientation of the Kripke–Slain Hypothesis is the Hypothesis itself.

B. Final Thoughts

As a reminder, both the number of investor–depositors and the volume of their ICO contributions are staggering figures.280

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279. Compare Clayton Statement, *supra* note 100 with Peirce, *supra* note 277 (opining that *Howey* is not a good fit for many ICO deals).

280. See *supra* Section II.B.2.
Consequentially, regulators are racing to inform the public of the attendant risk of loss.\textsuperscript{281} To be sure, the elevation of claim advocated herein would create some new obstacles. For example, creditors would find themselves sharing a depleted trust with investor–purchasers who might already be better off financially. However, in the complicated world of recovery for securities fraud, creditors already face such competition. As far back as 2005, it was noted that SEC “FAIR Funds,” a creation of the Sarbanes–Oxley Act of 2002,\textsuperscript{282} prioritize recovered funds for defrauded investors.\textsuperscript{283}

\begin{thebibliography}{99}
\bibitem{283} See Christensen, \textit{supra} note 277. As Mr. Christensen argued: 
[T]he SEC and common stockholders may work an end-run around section 510(b) of the Bankruptcy Code and elevate the stockholders’ claims by resorting to the Fair Funds for Investors provision. Further, as corporate malfeasance increases public outrage, the SEC will face increasing pressure to divert funds to defrauded investors, leaving creditors to collect from a depleted bankruptcy estate.
\end{thebibliography}