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Delaware Court Issues Novel Ruling Clarifying Treatment of Cryptocurrency Assets When Evaluating Contract Damages

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Judge Paul Wallace of the Delaware Superior Court issued a recent opinion in *Diamond Fortress Technologies, Inc. v. EverID, Inc.*, clarifying the treatment of cryptocurrency assets when calculating damages.^[1] The opinion also lays a framework for analyzing the treatment of cryptocurrency assets in future actions and provides useful guidance in interpreting recent legislation.

Plaintiffs Diamond Fortress Technologies, Inc., and its CEO Charles Hatcher II (plaintiffs), contracted with defendant EverID, Inc. (EverID) to provide EverID digital ID verification services. EverID created cryptocurrency “ID Tokens” and developed a related blockchain-based financial platform. As a part of this, EverID sought to use Diamond Fortress’s ONYX software for identity verification. The ONYX software allows for touchless verification of a user’s identity by scanning the user’s fingerprint with a phone’s camera. EverID also retained Hatcher as a consultant, and the agreements prohibited Diamond Fortress or Hatcher from working with other blockchain providers.

Rather than pay them in traditional currency, EverID agreed to compensate the plaintiffs through distributions of ID Tokens at the initial coin offering (ICO) and later at regular token distribution events (TDEs). EverID held an ICO for the ID Tokens on February 8, 2021 but did not distribute them to Diamond Fortress or Hatcher. The plaintiffs thereafter made informal and formal demands for the contractually agreed upon token distributions without response from EverID before sending a final communication on March 4, 2021, declaring the plaintiffs’ intent to treat the contracts as breached. Shortly after delivering that final communication, the plaintiffs filed suit. EverID failed to answer the complaint. The plaintiffs moved for default judgment.

Because EverID’s liability was not at issue, the only question before the court was the proper measure of damages. Since the plaintiffs were to be paid in cryptocurrency with a fluctuating value pursuant to the contract, the court had to determine how to compensate the plaintiffs for their loss, which required two steps: “First, the Court must find a reliable cryptocurrency valuation source to ensure the proper input of values. Then the Court must ascertain the proper method for calculating damages.”^[2] The court utilized CoinMarketCap, a website posting daily cryptocurrency pricing data, as its valuation source, noting other courts had done so, and Congress had expressed approval of the website in legislation.^[3]

More significantly, the court also determined that the ID Tokens offered by EverID were securities because they were “investment contracts” subject to regulation under the Securities Act of 1933 and the Exchange Act of 1934. Damages therefore should be calculated under Delaware’s existing precedent dealing with failure to deliver

pursuant to contracts for the sale of securities. The court first examined whether cryptocurrency constitutes a security or a commodity, noting that both the CFTC and the SEC have claimed jurisdiction over regulation of cryptocurrency. The court looked to legislation introduced in July 2021 in the House of Representatives by Donald S. Beyer, Jr. (D-VA) — the Digital Asset Market Structure and Investment Protection Act[4] — to create a test that analyzes whether a cryptocurrency constitutes an asset or security based on “a cryptocurrency’s characteristics at a given time.”[5]

To make this determination, the court applied the *Howey* test[6] to ID Tokens and determined that, at the time that the plaintiffs incurred damages, the ID tokens constituted a security. First, the court found the plaintiffs’ commitment to provide software and consulting services in exchange for cryptocurrency constituted an investment of money. Second, the court found the Token ID cryptocurrency amounted to a common enterprise because, both pre- and post-ICO, the value of the ID tokens was inextricably linked to the performance of EverID’s blockchain and platform as a whole. Third, the court found that the plaintiffs expected their profits to be derived from the efforts of others because the plaintiffs could not be reimbursed until after the ICO was complete. As the court noted, “[t]he Plaintiffs’ overall investment into the platform was based on their expectation to be paid in eventual distributions of ID Tokens after the ICO. This expectation is no different than that of a traditional investment contract entered into before an IPO, and thus, ID Tokens is in this circumstance like a security.”[7]

After determining the ID Tokens constituted securities owed to the plaintiffs under the relevant agreements, the court applied existing Delaware law governing damages calculations for failure to deliver securities. Applying the New York rule, which Delaware courts have adopted, the court found the highest value for ID Tokens in the three months after EverID’s failure to deliver and calculated damages based on that, ultimately awarding Diamond Fortress more than \$20,000,000 and Hatcher more than \$5,000,000.[8]

The court’s opinion lays out a useful analytical framework for determining how cryptocurrency assets may be classified, while acknowledging that some cryptocurrencies — as they gain widespread adoption — may shift from being classified as securities to commodities. But early-stage cryptocurrencies whose use is tied to a specific platform may constitute securities, at least under the analytical framework laid out by this court. In essence, the court’s test asks whether the purchase of a cryptocurrency is based on a belief in the value of the token itself or the blockchain platform underlying the token in question. Here, the court found Diamond Fortress and Hatcher agreed to receive payment in ID Tokens not because of a belief in the intrinsic value of the ID Token, but because of a belief that the ID Token’s value would rise as EverID’s blockchain platform was adopted on a wider scale.

Critical to the court’s analysis in this case was the fact that the plaintiffs reached their agreement with EverID before the ID Token ICO, meaning that the plaintiffs’ “investment” was necessarily speculative based on future performance, akin to the purchase of a security, and not the purchase of an existing commodity. Under the court’s framework, pre-ICO agreements to purchase cryptocurrency may more likely than not be properly classified as securities. Even post-ICO purchases, however, may constitute securities under this court’s framework where the value of the cryptocurrency itself is heavily tied to the performance of a larger product using the cryptocurrency’s blockchain. If the value of cryptocurrency rises and falls with the performance of a product utilizing a proprietary blockchain, the purchase of cryptocurrency represents an investment in the larger product, and thus likely constitutes a purchase of securities.

Under this court’s analysis, as a cryptocurrency grows and reaches widespread adoption, however, it can

transition from a security to an asset. While the court in this case did not delineate exactly when such a transition occurs, the independent use of the currency as a unit of exchange is likely a good indicator. Under the court's framework, there is a clear difference between bitcoin or ethereum — currencies that are accepted by some vendors and serve as a unit of exchange with widely-adopted blockchain platforms — as compared to currencies tied to the performance of a specific application or enterprise with its own blockchain, such as the ID Tokens in this case. While the largest and most utilized cryptocurrencies may classify as assets, smaller tokens created by startups are more likely to be securities, especially when purchased at the pre-ICO stage.

Cryptocurrency issuers and companies considering ICO events should take note of this court's ruling and be mindful that other courts and regulators may not categorically classify cryptocurrencies as assets or securities but may instead look at the individual circumstances of each case along with the possibility of a fluid evolution. Companies wishing to achieve a certain classification should take efforts to demonstrate their cryptocurrency is or is not a security under the court's framework. At the same time, investors should utilize the court's framework to evaluate potential cryptocurrency investments and the protections available to them. The court's opinion provides vital clarification in the otherwise murky realm of cryptocurrencies, while still acknowledging that cryptocurrencies are novel, evolving, and resistant to categorical classification.

[1] — A.3d —, C.A. No. N21C-05-048, 2022 WL 1127217 (Del. Super. Ct. Apr. 14, 2022).

[2] *Id.* at *13.

[3] *Id.*

[4] H.R. 4741, 117th Cong. (2021).

[5] 2022 WL 1127217, at *6-7 (emphasis in original).

[6] *Id.* at *7 ("an investment contract is 'a contract, transaction or scheme whereby 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.'") (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)).

[7] *Id.* at *11.

[8] *Id.* at *15.

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