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One Manhattan West
New York, NY 10001
212.735.3000

Suit Alleging NBA 'Top Shot' NFTs Were Securities Survives Motion To Dismiss

On February 22, 2023, Judge Victor Marrero of the U.S. District Court for the Southern District of New York issued an order in *Friel v. Dapper Labs, Inc.*, denying Dapper Labs and its CEO's motion to dismiss a putative securities class action. The court held that, at the pleading stage and accepting all allegations as true, plaintiffs adequately alleged that Dapper Labs violated Sections 5 and 12(a)(1) of the Securities Act of 1933 (Securities Act) by offering National Basketball Association (NBA) Top Shot Moments non-fungible tokens (Moments) without a registration statement. The court also held that plaintiffs adequately alleged control person liability against Dapper Labs's CEO under Section 15 of the Securities Act.

While the decision represents a first-of-its-kind application of the so-called *Howey* test to the offer and sale of NFTs, the court itself acknowledged that the facts presented a "close call" and stated that its decision is narrow and based on the specific facts before it.

Background

In 2020, Dapper Labs began offering and selling Moments, each of which featured a digital video clip of influential moments in past NBA games with a unique serial number. Moments were offered and sold on the NBA Top Shot platform, a platform allegedly owned and operated by Dapper Labs. Plaintiffs alleged that prior to the launch of Moments, Dapper Labs developed a private blockchain (Flow Blockchain) to, among other things, offer technological support for the Moment NFTs by hosting the NBA Top Shot platform, recording transactions that occurred on a secondary marketplace that was part of the NBA Top Shot platform (Marketplace), and facilitating the validation of Marketplace transactions. In connection with the Flow Blockchain, plaintiffs alleged that Dapper Labs created 1.25 billion tokens (Flow Tokens) that holders could stake in order to validate transactions on the Flow Blockchain.

On May 12, 2021, plaintiff Jeeun Friel filed a putative class action against Dapper Labs and its CEO, Roham Gharegozlou, alleging that Moments were securities under the federal securities laws. On August 31, 2022, defendants filed a Rule 12(b)(6) motion to dismiss for failure to state a claim, leading to the court's February 22, 2023, decision.

Ruling

Before the court was the question of whether Moments were investment contracts and therefore securities, which the court analyzed under the *Howey* test, which examines

whether (i) there is an investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profit derived solely by the promotional or managerial efforts of others.[1] At both the outset and the conclusion of its decision, the court emphasized the significance of the Flow Blockchain and Flow Tokens to the *Howey* analysis. Although Moments were the instruments being analyzed under *Howey*, the court observed that the private blockchain was nevertheless part of the "economic realities" because it "significantly, if not entirely, dictated Moments' use and value."

The court then addressed the *Howey* elements in turn:

Investment of Money

This element was not in dispute, so the court found it adequately pled.

Common Enterprise[2]

Horizontal commonality. The court held that plaintiffs adequately pled horizontal commonality because there was a pooling of funds that was tied to the success of the overall venture.

The court began by explaining that the pooling of funds could be inferred from plaintiffs' allegations that: (1) the sale of Moments and the transaction fees on the Marketplace generated revenue used to support the growth of the Flow Blockchain, (2) purchasers' capital was held in Dapper Labs-controlled wallets, and (3) Dapper Labs retained cash after withdrawals were requested in order to raise capital.

In drawing this conclusion, the court rejected defendants' argument that, unlike in cases involving initial coin offerings, here there was no pooling in advance of the construction of the Flow ecosystem. The court stated that there is no "temporal requirement" when it comes to pooling because that "would inappropriately limit the scope of investment contracts to pre-development initial offerings."

The court went on to conclude that plaintiffs adequately pled that the fortunes of each purchaser was tied to Dapper Labs's overall success because Dapper Labs controlled the Flow Blockchain upon which Moments sat, and once Moments were purchased they could only be sold on the Marketplace that Dapper Labs controlled. Additionally, the court commented that plaintiffs plausibly alleged that "all that Moments purchasers own is, essentially, the line of code recorded on the Flow Blockchain, as no other rights to use or display the image are transferred," and the terms of use provided that Moments have no value outside the Flow Blockchain. Thus, as the court explained, if Dapper Labs hypothetically went out of business, Moments would be worthless. According to the court, this makes them distinct from rare collectibles (and case law applying Howey to these collectables) or cardboard basketball cards.

Strict vertical commonality. The court also analyzed vertical commonality, explaining it was not persuaded by plaintiffs' argument that Dapper Labs' collection of a 5% fee on every transaction in the Marketplace was "sufficient to establish strict vertical commonality as a matter of pleading or law." In drawing this conclusion, the court distinguished case law, in part, because Dapper Labs's transaction fees were collected regardless of the success of Moments on the Marketplace, *i.e.*, they were collected regardless of whether Moment's value went up or down.

Expectation of Profits

The court next held that plaintiffs adequately alleged that defendants' public statements and marketing materials led purchasers to expect profits, pointing to, among other statements, tweets recounting statistics of market performance of Moments with rocket ship, money bag and stock chart emojis, which, as the court put it, "objectively mean one thing: a financial return on investment."

The court rejected defendants' argument that dismissal was warranted because Moments had consumptive uses which, under *United Housing Foundation, Inc. v. Forman*, might defeat the contention that they were securities. 421 U.S. 837 (1975). The court concluded that this raised factual questions that were inappropriate given the procedural posture of the decision. Notwithstanding that conclusion, the court offered a view that plaintiffs adequately alleged that Moments had no utility other than the ability to view them and seek out certain players, and that other consumptive uses were only speculative and unavailable when Moments were first offered to purchasers.

Importantly in the court's analysis, the court found it plausible that Moments' value was derived from the continued operation by Dapper Labs of the Flow Blockchain, stating that "[w]ithout Dapper Labs's continued maintenance of the Flow Blockchain and the 'token that powers it all,'" plaintiffs "plausibly allege[d] that Moments would have no value." While recognizing outside

[1] *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

[2] A common enterprise can be established in either two ways: horizontal commonality, *i.e.,* a pooling of funds whereby the fortunes of the each investor of the pool are tied to the success of the overall venture, or vertical commonality. *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994). Some circuits find vertical commonality can be "broad" such that the "fortunes of investors are tied to the efforts of the promoter," while other circuits, including the Second Circuit, only accept "strict vertical commonality" whereby the "fortunes of investors" must be "tied to the fortunes of the promoter." *Id.* The court only analyzed strict vertical commonality.

market forces like player popularity might influence a Moment's value, the court explained that plaintiffs adequately alleged that Moments could only be traded on the Marketplace that Dapper Labs controlled, and therefore Dapper Labs's efforts were "crucial" to Moments retaining value.

In further support, the court explained that plaintiffs plausibly alleged that Moments' value on the Marketplace depended on Dapper Labs's ability to generate hype and that Dapper Labs made an "implicit promise" to purchasers to maintain the Flow Blockchain and facilitate trades on the Marketplace.

Finally, the court rejected defendants' argument that, because purchasers controlled their NFT portfolio and the rights that come along with ownership, there was no expectation of profits based on the efforts of Dapper Labs. In doing so, the court relied on the allegations that: (i) Moments' values dropped when Dapper Labs had halted trading on the Marketplace; (ii) Dapper Labs' and the NBA and NBA Players Association held control over the intellectual property of Moments; and (iii) Dapper Labs controlled the Marketplace.

Key Takeaways

It is important to keep in mind the procedural posture: a decision on a motion to dismiss where plaintiffs only needed to state a claim that was "plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). Thus, the court did not make any determinations as to the ultimate merits of the questions presented, but instead ruled on whether the allegations, which if accepted as true, are sufficient to warrant that the action proceed to discovery. Indeed, the court expressly did not engage with Moments' consumptive uses for this very reason, explaining that whether purchasers bought Moments for consumptive or investment purposes was an "important factual question" that was "ill-suited for resolution on a motion to dismiss."

Notwithstanding the preliminary posture, the court went out of its way to highlight that its holding was "narrow." As the court explained, *Howey* analyses are often fact- and circumstance-specific, and each NFT project "must be assessed on a case-by-case basis." Thus, much of the court's holding turned on the unique factual allegations regarding Moments and the underlying blockchain supporting them.

Moreover, essential to the court's reasoning was the allegation that Dapper Labs controlled the Marketplace where Moments could be bought and sold, which the court emphasized "significantly, if not entirely, dictate[d] Moments' use and value."

This reasoning is an extension of the *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc*. line of cases, where the creation and maintenance of a secondary marketplace may be viewed as evidence of an expectation of profits based on the ongoing efforts of the promoters. 756 F.2d 230, 237 (2d Cir. 1985). This aspect of the court's ruling highlights the potential regulatory risks of a "walled garden" business model where the NFT issuer creates its own marketplace that serves as the only place for buyers and sellers to trade.

Other points are also worthy of emphasis. For example, despite finding that horizontal commonality was adequately alleged, the court held that the presence of seller royalties not directionally linked to an NFT holder's profits or losses is insufficient, by itself, to establish vertical commonality between the promoter and purchasers — a ruling that could have broader ramifications given the near-ubiquity of royalties in the NFT market.

Additionally, while the court pointed to the lack of intellectual property rights as indicia that Moments were purchased with an intent to invest (and not consumptive intent), the opposite argument could — and likely will — also be made at later stages of the litigation.

Due to its procedural posture and the specific allegations at issue, the court held that there existed questions of fact regarding what the unique nature of the NFTs means for horizontal commonality. Only able to consider the allegations made by plaintiffs, the court concluded that they adequately alleged that "the value of Moments is 'causally related to the profitability of [Dapper Labs] as a whole' because their value depend[ed] on the success of the Flow Blockchain." To be determined, likely through discovery, is whether there is, in fact, such a causal relationship and whether other factors that are not common to all NFT holders drove individual values. Also, by its emphasis on the defendants' private blockchain, the court's ruling here does not speak to whether there may be horizontal commonality for other NFT projects that are based on Ethereum or other non-proprietary blockchains.

The court also considered tweets and subjective statements by observers and purchasers, which were very likely cherry-picked by plaintiffs for their pleading. This underscores the need for defendants in similar cases to examine and contextualize both pre- and post-offer events and statements, including analyzing how digital asset prices would react to these statements and whether those price reactions were tied to the promoters' efforts.

Contacts

Alexander C. Drylewski
Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Stuart D. Levi
Partner / New York
212.735.2750
stuart.levi@skadden.com

Daniel Michael
Partner / New York
212.735.2200
daniel.michael@skadden.com

Samantha P. Kaplan
Associate / New York
212.735.2366
samantha.kaplan@skadden.com

Shireen Lankarani
Associate / New York
212.735.2456
shireen.lankarani@skadden.com