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Court Declines To Dismiss Securities Class Action Alleging That DraftKings NFTs Are 'Securities'

Securities litigation arising from the purchase or sale of digital products such as cryptocurrencies, nonfungible tokens (NFTs) and security tokens has proliferated in recent years. A gating question in these cases is whether the digital product purchased is a "security" subject to federal or state securities laws.

On July 2, 2024, Judge Denise Casper of the U.S. District Court for the District of Massachusetts held in *Dufoe v. DraftKings, Inc.* that the plaintiff had adequately alleged that transactions in DraftKings NFTs were investment contracts and thus "securities" under the U.S. Supreme Court's seminal test set forth in *Howey*.

The district court predicated this holding on allegations, accepted as true at the pleading stage, that DraftKings NFT sales reflected:

- A "**common enterprise**" through horizontal commonality because (i) DraftKings allegedly pooled assets through reinvestment of revenue generated by the sale of the NFTs into its NFT business, and (ii) NFT purchasers allegedly shared profits and risks because DraftKings controlled the online "marketplace" through which the NFTs traded.
- A "**reasonable expectation of profits solely from the efforts of others**" based on alleged DraftKings promotional statements about the investment prospects presented by the NFTs and because the value of the NFTs allegedly depended on the success of DraftKings' "marketplace."

Dufoe marks just the second case in which a court has addressed whether sales of NFTs may constitute securities under the rubric of *Howey*. In 2023, Judge Victor Marrero of the U.S. District Court for the Southern District of New York held in *Friel v. Dapper Labs, Inc.* that a complaint adequately alleged that the sale of National Basketball Association (NBA) Top Shot Moments NFTs constituted investment contracts. The Friel court acknowledged that this conclusion was a "close call."

Although *Dufoe* and *Friel* provide a framework for analyzing NFT transactions under *Howey*, neither decision preordains a result in future cases — or even in the cases before the courts on a full factual record.[1] To the contrary, both courts made clear that their respective holdings were narrow, fact-dependent and driven by specific allegations that could be controverted on summary judgment or at trial.

Background

DraftKings is a digital sports entertainment and gaming company. In August 2021, DraftKings began to sell NFTs through the DraftKings Marketplace (the Marketplace),

[1] The parties in *Friel* entered into a settlement agreement before the completion of discovery and summary judgment briefing. The settlement is subject to final court approval.

an online platform owned and operated by DraftKings. In February 2022, DraftKings launched so-called "gamified NFTs." Owners of gamified NFTs could use their NFTs in "Reignmakers" contests to earn cash prizes. The DraftKings NFTs were minted, or created, on the Polygon blockchain that exists independently of DraftKings.

Owners of DraftKings NFTs could resell their NFTs in the DraftKings Marketplace. Owners could also potentially sell their NFTs outside the Marketplace. But to make an off-Marketplace sale, the owner must first transfer the NFT from the Marketplace to the owner's personal digital wallet, and DraftKings allegedly retained the "sole discretion" to allow or prohibit such a transfer.

DraftKings allegedly promoted the NFTs, including through an online chatroom and on social media.

The plaintiff, an alleged purchaser of DraftKings NFTs, asserted a putative class action against DraftKings and several of its officers alleging that (i) the DraftKings NFTs constituted unregistered securities and (ii) the defendants operated an unregistered securities exchange. The plaintiff asserted claims for alleged violations of Sections 5, 12(a)(1) and 15 of the Securities Act of 1933; Sections 5, 15(a)(1), 20 and 29(b) of the Securities Exchange Act of 1934; and Chapter 110A, Sections 201(a) and 301 of the Massachusetts General Laws.

The Court's Decision

The defendants moved to dismiss the complaint in its entirety on the ground that the DraftKings NFTs are not "securities" subject to federal or Massachusetts securities laws. The court denied the motion, holding that the plaintiff adequately pleaded that the DraftKings NFTs were "securities" under *Howey* based on the facts alleged in the complaint, accepted as true for purposes of the motion.

The court applied the standard established in *Howey* more than 75 years ago to evaluate whether a transaction constitutes an investment contract and thus a "security" subject to the federal securities laws and requirements. Under *Howey*, an investment contract exists where a person (i) "invests his money" (ii) "in a common enterprise" and (iii) "is led to expect profits solely from the efforts of the promoter or a third party."

The defendants did not dispute the first prong — investment of money — at the pleading stage. The court held that the plaintiff had adequately pleaded facts to support the remaining two prongs:

Common enterprise. A plaintiff may plead a common enterprise through "horizontal commonality," or a pooling of assets from multiple investors in such a manner that all share in the profits and risks of the enterprise. The court acknowledged that, with respect to NFTs — in contrast with other forms of digital products — "it is less obvious that risks and profits are shared across all investors because each NFT is definitionally unique or non-fungible." The court nonetheless held that the plaintiff adequately pleaded that all DraftKings NFT purchasers shared in the risks and profits of the "enterprise." The court relied on allegations that DraftKings reinvested revenue generated by the sale of DraftKings NFTs into its business, including for purposes of promoting the Marketplace controlled by DraftKings on which the NFTs traded. Moreover, the value of the NFTs was allegedly dependent on the Marketplace. The court noted: "if DraftKings shut down the Marketplace or interest in the Marketplace evaporated, the value of the NFTs would plausibly drop to zero."

Reasonable expectation of profits solely from the efforts of others. To plead a reasonable expectation of profits solely from the efforts of others, a plaintiff must allege facts to support two independent requirements.

First, a plaintiff must allege a reasonable expectation of profits. The court held that the plaintiff met this standard based on statements made by DraftKings and the individual defendants about the NFTs. These statements included, for example, details regarding the transaction histories for DraftKings NFTs, news about "biggest risers and fallers" within the Marketplace and proclamations that buyers would "keep the open market profit of your cards." The court also relied on allegations that the public viewed DraftKings NFTs as an investment, such as through correspondence in chatrooms comparing the Marketplace to the stock market and discussing ways to make money by trading DraftKings NFTs.

Second, a plaintiff must allege that a purchaser's expectation of profits is dependent on the efforts of others. The court accepted the plaintiff's allegations that the NFTs were dependent on the success of the Marketplace and thus on DraftKings even though the NFTs were not minted on a proprietary DraftKings blockchain. The court reasoned that "it is plausible that users did not, and possibly could not, withdraw their NFTs from DraftKings' system and place them in their own wallets." Moreover, DraftKings allegedly undertook substantial effort to promote the Marketplace and the NFTs.

Practical Implications

Dufoe largely tracks the reasoning of *Friel* but with a twist: In *Friel*, the defendant, Dapper Labs, was alleged to control the "Flow Blockchain" on which the NBA Top Shot Moments NFTs traded. That allegation was at the heart of the court's determination that the plaintiff had adequately pleaded horizontal commonality and a reasonable expectation of profits from the efforts of others.

In *Dufoe*, by contrast, the DraftKings NFTs traded on the Polygon blockchain that "exists independently of DraftKings" and that is not controlled by DraftKings. The *Dufoe* court held that this was a distinction without a difference for purposes of *Howey* because the plaintiff plausibly alleged that all trading took place through the Marketplace and that DraftKings could prohibit transactions outside the Marketplace at its sole discretion.

Dufoe and *Friel* are not the last word on whether NFT sales constitute securities subject to the securities laws. Both are appealable district court decisions. Further, the decisions turn on case-specific factual allegations that could be rebutted on summary judgment or at trial.

Indeed, the court in *Dufoe* began its analysis by observing that it "need not decide whether any and all NFT transactions should be considered an investment contract." Rather, the court "evaluate[d] only whether Dufoe has plausibly alleged that DraftKings NFTs in the context of the Marketplace are securities." The court in *Friel* likewise tethered its decision to the facts alleged and noted that each NFT project "must be assessed on a case-by-case basis."

Dufoe also catalogued factual disputes that it could not resolve at the pleading stage and that could alter the *Howey* analysis on a full factual record, such as the defendants' contentions that:

- DraftKings co-mingled NFT funds with its "vast trove of other revenues," undercutting the plaintiff's contention that there was a pooling of assets sufficient to establish horizontal commonality.
- DraftKings NFT prices did not move in tandem and instead depended on other factors specific to a given NFT, refuting the plaintiff's contention that all users shared the risks and profits of the enterprise sufficient to establish horizontal commonality. The court observed that "[a]t a later stage of litigation, DraftKings will have the opportunity to present evidence that investors 'could make profits or sustain losses independent of the fortunes of other purchasers' and thus negate horizontal commonality."
- The defendants did not in fact control the primary and secondary market for its NFTs because users could trade outside the Marketplace.
- The plaintiff's expectations of profit were unreasonable or they were motivated by consumptive intent (*e.g.*, participation in Reignmakers contests). The court acknowledged that DraftKings lowered the price of NFTs over time, contradicting an expectation of profit, and that the complaint alleged "at least a mixed consumptive and speculative motive by NFT buyers." But the court concluded that "these questions are not suited for resolution on a motion to dismiss, where all plausible inferences are drawn in favor of [the plaintiff]."