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The Challenge Of Suing A Defunct Virtual Currency Exchange

By Scott H. Kimpel

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To date, virtual currency exchanges in the United States have structured their operations so as to avoid being required to register as an exchange with either the U.S. Securities and Exchange Commission or the U.S. Commodity Futures Trading Commission. While these efforts may be entirely legal, without the regulatory protections of exchange registration, they could create enhanced risks for customers, particularly in the case of an exchange's insolvency or collapse.

A recent federal case, *Shaw v. Vircorex*,¹ highlights these risks and provides guidance for asserting personal jurisdiction over a virtual currency exchange.

The Court's Ruling

Timothy Shaw, the plaintiff in the case, was a Colorado resident who sought to bring a class action in federal district court for the District of Colorado against the operators of a defunct online digital currency exchange, after it froze customer funds while descending into insolvency. As a result, he was unable to withdraw his bitcoin, and Shaw asserted state law claims for breach of contract, conversion, constructive fraud and unjust enrichment.

Neither the exchange nor any of the other named defendants responded to the plaintiff's complaint or otherwise made an appearance before the court, so the plaintiff moved to enforce a default judgment against them. Before the court could rule on that motion, however, it first had to consider the fundamental due process question as to whether the court had personal jurisdiction over the defendants.

It is axiomatic that personal jurisdiction comports with the constitutional guarantee of due process when a defendant has minimum contacts with the forum state (here, Colorado), and when those contacts are such that assuming jurisdiction does not offend "traditional notions of fair play and substantial justice." Minimum contacts may be established under the familiar doctrines of general jurisdiction and specific jurisdiction.

Where general jurisdiction is asserted over a nonresident defendant who has not consented to suit in the forum, minimum contacts exist if the plaintiff demonstrates that the defendant maintains "continuous and systematic general business contacts" in the state. Because Shaw did not argue that the defendants were subject to general jurisdiction in Colorado, the court limited its discussion to the issue of specific jurisdiction.

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Specific jurisdiction exists only if a lawsuit arises out of or relates to the defendant's contacts with a particular forum. First, the court was required to determine whether a defendant has such minimum contacts with Colorado that the defendant "should reasonably anticipate being haled into court" there. Specifically, the court must determine whether the defendant purposefully directed its activities at residents of the forum, and whether plaintiff's claim arises out of or results from actions by the defendant that create a substantial connection with the forum state.

Second, if the defendant's actions create sufficient minimum contacts, the court must consider whether the exercise of personal jurisdiction over defendant offends "traditional notions of fair play and substantial justice," *i.e.*, whether the court's exercise of personal jurisdiction over the defendant is reasonable in light of the circumstances of the case. To satisfy this latter test, the court followed Tenth Circuit precedent to consider whether the defendants' conduct indicated any continuing relationship with forum state residents, deliberately exploited the forum state's market or suggested intentional conduct that targeted and had substantial harmful effects in the forum state.

In this case, the plaintiff merely alleged that he created an online account with the exchange. According to the court, he did not identify what this process included, what information defendants collected about account holders, or whether the exchange even knew he was in Colorado. Assuming that Shaw entered into a contract with the exchange, the court stressed that this fact alone is insufficient to establish a continuing relationship.

The court also found that the plaintiff's complaint offered no evidence that the account creation process involved any negotiations, or that the parties contemplated any future consequences. Shaw did not provide the terms of any contract between the parties. He did not indicate that the defendants engaged in any solicitation or direct communication that would show a course of dealing among them.

Furthermore, the plaintiff failed to show that the defendants purposefully directed their activities at Colorado or knew that the brunt of the plaintiff's injury would be felt there. Drawing an analogy to older cases involving other types of internet-based businesses, the court remarked that the emphasis is on "the internet user or site intentionally directing his/her/its activity or operation at the forum state rather than just having the activity or operation accessible there."

Ultimately, the court determined that it did not have personal jurisdiction over the defendants, and dismissed the case without prejudice. It is possible that the court would have ruled differently had the plaintiff pleaded additional facts to show greater interaction in Colorado, and by dismissing without prejudice, it left the door ajar for him to do just that. It is also possible that Shaw could find another more appropriate forum, either elsewhere in the United States or abroad; the court was unable to find such a forum in Colorado due to the paucity of the pleadings.

Impact for Cryptocurrency Investors

While Vircurex does not necessarily blaze a new trail in personal jurisdiction jurisprudence, it underscores the difficulty of pursuing litigation against virtual currency exchanges — many of which are decentralized and operate on the basis of algorithmic programming, do not engage in traditional marketing activities and have no traditional physical presence anywhere. Even were a court to enter a default judgment against a defunct exchange, collecting on that judgment poses its own separate challenges when customer assets have dissipated and responsible parties reside outside the United States.

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For investors in the frothy cryptocurrency market, this case further bespeaks caution. When an exchange registers with the SEC or CFTC, it becomes subject to a myriad of regulations and capital requirements intended to protect customers in the very kind of situation that the unregistered exchange faced here.

To be fair, the SEC has on numerous occasions announced that neither bitcoin nor Ether is a security (and thus beyond its jurisdiction), while reserving judgment on all other cryptocurrencies. The CFTC takes a contrary position, and does assert jurisdiction over bitcoin as a kind of commodity, but it is not clear that Vircorex would have been required to register with the CFTC on the basis of its business activities.

Although some crypto exchanges are registered as money transmitters in certain states, and thereby subject to a state consumer protection regime, there is no evidence that Vircorex was so registered. New York state has a comprehensive regulatory regime for holders of a BitLicense that is very favorable to consumers, but many crypto exchanges attempt to avoid doing business in New York state, and it would have been little help to a Colorado resident like Shaw in any case.

Registration as a federal money service business subjects a party to compliance with various anti-money laundering regulations, but provides little in the way of consumer protection. In any event, Vircorex was not registered as an MSB. This situation leaves customers like Shaw with little recourse other than litigation.

Many commentators have likened the cryptocurrency marketplace to the Wild West, though that analogy may be inapt: there is no Judge Roy Bean for operators of crypto exchanges. It has been nearly five years since the flame-out of the Mt. Gox exchange, and stories of crypto exchanges or other intermediaries either losing track of customer assets or going bust outright are becoming increasingly common.

While many in the crypto community advocate in favor of a lighter regulatory touch, experiences like Shaw's are more likely to push regulators and policymakers in the opposite direction. In the meantime, buyer beware.

Notes

¹ *Shaw v. Vircorex*, Civ. No. 18-cv-00067-PAB-SKC (D. Col., Feb. 20, 2019).

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