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LUNA and UST Crash

The crash of the cryptocurrency LUNA and its associated algorithmic stablecoin UST has sent shockwaves through the cryptocurrency market. It has affected countless investors in Singapore and overseas, be they institutional investors, sophisticated investors or retail investors, who have seen the value of their entire investment be reduced to almost zero.

The question on the tip of everyone's tongue is – is there any recourse in respect of my losses? While significant fact finding is still ongoing in respect of the events leading up to and during the crash, this client update will generally explore potential causes of action available to a disgruntled investor against various actors, so as to give one a starting point to explore potential recourse.

Background

A key feature of UST was that it aimed to be pegged at a 1:1 ratio with the US dollar at all times *i.e* a stablecoin that could be traded like the US dollar. This purportedly protected users of UST from the volatility that is typically seen in other cryptocurrencies.

Typically, stablecoins are backed by cash and/or cash equivalents. However, UST was an algorithmic stablecoin which was balanced by a counterweight cryptocurrency – LUNA. The ecosystem was undergirded by an algorithm which facilitated the conversion of UST to LUNA and vice versa at a fixed price of \$1/unit of the currency. This was regardless of the market price of either token.

Collectively, the entire ecosystem sought to regulate the supply of UST by incentivising users to swap between UST and LUNA, thereby ensuring that UST would always be pegged at a 1:1 ratio with the US dollar by way of arbitrage. The operation of this system is briefly summarised as follows.

- (a) Where demand for UST increased such that its market price rises above US\$1, there was an imbalance in the ecosystem where holders of LUNA were able to purchase UST at a price lower than that in the market.
- (b) This arbitrage created an incentive for LUNA holders to profit by swapping US\$1 of LUNA to create one UST token and then selling the said token on the market for a higher price. Consequently, the supply of existing UST in circulation would increase and the price would be reduced.
- (c) This process would repeat until the supply of UST was sufficiently diluted to bring the value of UST back to US\$1.
- (d) The converse would be true if the market price of UST fell below US\$1 – UST holders would be incentivised to swap UST for Luna, which would reduce the supply of UST until the value was brought back to US\$1.

These tokens appeared attractive to investors because:

- (a) Investors could use their UST to provide collateralised loans that earned up to 19.5% interest per annum. One such popular loan platform was the Anchor Protocol.
- (b) The price of LUNA had also been steadily appreciating and reached an all-time high of US\$115 earlier this year. Further, the Luna Foundation Guard (“LFG”), an entity related to the founders of the Tera Ecosystem, had accumulated over 80,000 of reserves in Bitcoin as a further commitment to defend the peg.

However, on 7 May 2022, over US\$2 billion of UST was unstaked *i.e* taken out of the Anchor protocol, and hundreds of millions of UST were sold.

The sheer volume of such sudden sales pushed the price of UST down to 91 cents. Traders then sought to take advantage of the arbitrage opportunity – but there was an issue – only US\$100m of UST can be burned to mint LUNA in a single day. It therefore became immensely difficult for the ecosystem to bring the price of UST back up to US\$1.

The above resulted in a cascading effect as investors who were already spooked by recent market downturns dumped their UST. This led to massive hyper-inflation as the algorithm minted significant amounts of LUNA to attempt to bring the UST peg back to US\$1. The massive dilutions led to further sell-offs and a complete crash in the price of both UST and LUNA – both are worth a fraction of a cent today, a stark contrast to LUNA's all-time high of US\$115 earlier this year.

The LFG purportedly deployed almost the entirety of its Bitcoin reserves to the Binance and Gemini exchanges to buy back UST to defend the peg – but failed.

Investors who invested in UST and/or LUNA and who retained them up to this point saw the value of their investment go to almost zero.

Potential recourse for affected investors

Many investors burnt by the crash would naturally want to explore the possibility of seeking civil recourse.

To start, we emphasize that significant fact-finding remains ongoing regarding events leading up to and during the crash – for example, whether the initial sell-off was a malicious attack and whether the Bitcoin reserves were properly deployed and utilised by LFG.

In the absence of clear evidence to the contrary, the LUNA and UST crash was in essence a bank run. The LUNA / UST system functioned as intended, with unfortunate catastrophic results during this black swan event. It is ordinarily very difficult for investors to seek civil recourse arising from such market events – all market participants take on inherent risk when investing in cryptocurrency, even with stablecoins.

There are also allegations that the Anchor protocol was a Ponzi scheme as it could not continue paying out 19.5% p.a returns on UST indefinitely, without new investors coming in and feeding the returns of older investors. However, the Anchor protocol does not fit established definitions of a Ponzi scheme (be it financial or legal) as it sought to generate its yields through lending – and any shortfall would be made up by reserves. Further, the 19.5% yield was not fixed or guaranteed – before the crash, there was a proposal to cut the yield to 4%.

Nevertheless, the complaint of most investors, especially retail investors, is that misrepresentations were made to them about the risks of investing, and they relied on such misrepresentations when investing. The counterparties would typically fall into, but not be limited to, these parties:

- (a) The founder, Do Kwon and the company behind the Terra ecosystem, Terraform Labs (which is incorporated in Singapore).
- (b) Exchanges or other third-parties offering yield on UST deposits;
- (c) Third-parties who promoted UST for financial incentive e.g influencers / financial advisors; and/or
- (d) Third-parties e.g funds / startups which purported to provide safe and stable returns on investment, but in truth invested in UST.

First, institutional investors or seed investors with a direct contractual relationship with the founder and/or the company may have contractual causes of action against them depending on amongst others the representations and warranties set out in the relevant agreements. However, much would depend on the exact contractual terms.

For investors without a direct contractual relationship, claims against the founder and company could arise if it can be established that a fraudulent misrepresentation was made and/or the tort of deceit was committed, which requires:

- (a) A representation was made by the defendant;

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- (b) The representation was made with the intention that it should be acted upon by the plaintiff, or by a class of persons, which includes the plaintiff;
 - (c) The representation was false or untrue and made with knowledge that it is false, or without genuine belief in its truth, or recklessly as to whether it is true or false; and
 - (d) The claimant was induced by and/or relied on the representation to his detriment and suffered loss.

As seen from the Court of Appeal's decision in *JTrust Asia Pte Ltd v Group Lease Holdings Pte Ltd and others* [2020] 2 SLR 1256, it is possible to maintain a claim under the tort of deceit on the basis of representations made in public financial statements to a class of persons or even the general public at large.

However, much would turn on the exact circumstances of each representation in question.

In the present case, the founder Do Kwon was well-known for making several statements on his Twitter account and other social media on the Terra ecosystem. Insofar as some of these statements diverged from the mechanics set out in LUNA's White Paper, downplayed the inherent risks of the ecosystem and/or gave investors the impression that UST was stable and returns were guaranteed, these could amount to actionable misrepresentations. We however do not unequivocally opine that all such social media statements are actionable, as much would depend on the exact words, circumstances, and impact upon individual investors.

Second, apart from the Anchor protocol itself, there were many exchanges and other third-parties offering their own yield on UST deposits – as they could earn a spread by subsequently investing on Anchor or other staking mechanisms.

In some cases, representations were made that UST was a very safe investment as it was a stablecoin, and would not fluctuate like other cryptocurrencies – without sufficient disclosure of the mechanics of an algorithmic stablecoin and the inherent risks involved.

In such cases, if an investor can show that he was induced by the abovementioned representations to purchase UST and deposit it with the relevant exchange or third-party entity, the investor could have a cause of action against the exchange / third-party entity for misrepresentation or deceit. The investor would also have entered into a user agreement under which explicit terms, including but not limited to representations or warranties, could have been breached.

Do note that user agreements with exchanges and other third-party entities may contain arbitration clauses which preclude a lawsuit in the Singapore Courts, or even an exclusive jurisdiction clause which precludes legal action in Singapore. Legal advice should be sought on such clauses and whether there is nevertheless a possibility of commencing an action in Singapore.

Separately, for investors who have suffered major losses and/or believe they have a cause of action against the founders, it could be possible to obtain third-party discovery orders against relevant exchanges for information on how the LFG's Bitcoin reserves were ultimately deployed – this is because public blockchain information on the reserves could only be tracked to the point of it entering exchange wallets.

Third, LUNA and UST were continually promoted by influencers and self-styled financial advisors on the internet, in particular social media platforms. Again, many of these parties may have made representations to the effect that UST was 100% safe as it was a stablecoin and that returns from the Anchor protocol were safe and guaranteed.

In such cases, it is possible for a claim in fraudulent misrepresentation and/or in tort of deceit to be made even if there was no direct contractual relationship between these influencers / advisors and the investor in question – see the section on the founder and company above. Again, much would turn on the exact words used in the representations, the circumstances, and the impact upon the investor.

Further, if the influencer or advisor obtained a financial benefit from promoting LUNA and UST on behalf of a third-party such as an exchange or fund, the influencer or advisor could be deemed to be an agent of the third-party – and the third-party could be held vicariously liable.

Fourth, there were many funds and other combinator start-ups which purported to provide safe and stable returns of 10-15% p.a because they were assisting investors to invest through the Anchor protocol. In some cases these entities may not have even disclosed that their investment strategy was simply putting investors' monies into the Anchor protocol, but represented that investments were safe, diversified and guaranteed.

For example, according to a US\$44m class action lawsuit¹ filed in the US against Y Combinator-backed start-up, Stablegains, it promised a 15% p.a yield. The lawsuit alleges that in truth it simply invested all its investors' funds into UST and the Anchor protocol, and skimmed 3-4% off the yield as their cut.

Similar causes of action may lie against other funds or start-ups which operated in a similar manner for misrepresentation, deceit and breach/es of the investment agreement/s.

Closing note

While this client update provides an overview of the potential civil recourse available to investors, much will turn on the exact circumstances and any relevant contractual documents. Further fact-finding is also still ongoing and may unveil or close off other angles of recourse.

In the premises, any affected investor, or conversely any party which may be concerned about potential civil liability in respect of offering or promoting investments in LUNA and UST, would be best served seeking specific legal advice from counsel with experience with and/or industry knowledge about cryptocurrency investments.

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¹ <https://www.theverge.com/2022/5/20/23131647/terra-luna-do-kwon-stablecoin-anchor>; <https://cryptobriefing.com/yield-app-stablegains-faces-lawsuit-after-losing-44m-on-ust/>