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Digital assets and DAOs: new theories of liability

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Decentralized autonomous organizations (or "DAOs") are often seen as a critical component of a truly decentralized digital asset project. While there is no single definition for a DAO, the term typically refers to a system of project governance where holders of "governance tokens" can make and vote on proposals relating to governance of a digital asset protocol.

A recent and developing legal theory posits that persons holding governance tokens in a DAO can be considered "partners" in a "general partnership" or "unincorporated association." Under this theory, those token holders are subject to joint and several liability as partners for any legal violations committed by the DAO and other participants on behalf of the DAO.

The question of whether DAOs are legally cognizable entities, including partnerships, is a novel one that is currently working its way through the courts and has been the subject of certain state legislation. The answer could potentially deter individuals and entities from participating in DAOs, and therefore significantly impact the viability of decentralized governance structures.

DAO liability

The earliest case to contend with theories of DAO liability was *Commodity Futures Trading Commission v. Ooki DAO*. In ruling on the CFTC's motion for alternative service, a judge in the U.S. District Court for the Northern District of California analyzed whether Ooki DAO had the capacity to be sued under the Federal Rules of Civil Procedure and whether it was a "person" subject to suit under the Commodity Exchange Act.

The CFTC argued that Ooki DAO could be sued because it was an "unincorporated association" comprised of token holders who used their tokens to vote on governance proposals during a particular time period.

The court agreed with the CFTC and arguably went one step further: In determining whether Ooki DAO could be sued, the court explained that it did not matter whether token holders voted or gave away their voting rights during the time period in question. Thus, for the purpose of the CFTC's service motion (as to which the Ooki DAO did not appear or contest) the court held that the CFTC sufficiently alleged that Ooki DAO was an unincorporated association under California law. The court subsequently entered a default judgment against Ooki DAO after it failed to appear.

Since then, private plaintiffs have begun asserting securities and other claims against DAOs premised on the idea that DAOs are partnerships. In *Sarcuni v. bZx DAO*, filed in the U.S. District Court for the Southern District of California, the plaintiffs brought a class action against the DAO for the bZx Protocol and token holders who participated in creating the protocol.

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The plaintiffs alleged that the defendants were negligent in operating the protocol when the plaintiffs lost millions of dollars in cryptocurrency following a hack. According to the plaintiffs, bZx DAO was a general partnership, all persons holding BZRX tokens were its partners, and each partner was jointly and severally liable for the DAO's alleged negligence. In ruling on the defendants' motion to dismiss, the court assessed whether the plaintiffs adequately pleaded the existence of a partnership under California law.

Accepting the plaintiffs' allegations as true, as the court was required to do at the pleading stage, the court held that the complaint adequately alleged that bZx DAO was an association of token holders that generates profits; that token holders possessed governance rights over the DAO because they could suggest and vote on governance proposals; and that token holders shared in the DAO's profits because they could vote to distribute assets from the DAO's treasury among themselves and through their receipt of an interest-generating token.

As a result, the court denied the defendants' motion to dismiss and allowed the case to proceed. It later settled.

In *Houghton v. Leshner*, the plaintiffs brought a class action in the U.S. District Court for the Northern District of California against Compound DAO and certain other defendants, asserting a claim under Section 12(a)(1) of the Securities Act of 1933 for the alleged sale of unregistered securities.

The complaint alleged that Compound DAO sold or solicited the plaintiffs' purchase of COMP tokens, the governance token of the Compound DAO. The plaintiffs also alleged that Compound DAO is a general partnership under California law, and that, because the defendants owned more than 50% of the outstanding COMP and actively participated in governance proposals for the DAO, they were its partners. The defendants maintained that Compound DAO is not a juridical entity capable of being sued and that none of the alleged "partners" could be liable for any securities violations by Compound DAO. The authors' firm represents one of the non-DAO defendants in this case.

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On Sept. 20, 2023, the court denied the moving defendants' motion to dismiss and permitted the action to proceed, explaining that the "exact contours of liability, whether it flows from the acts of 'Compound DAO' or flows from the acts of one or more [defendants], cannot be determined at this juncture." Compound DAO has neither appeared nor been found to have been served in the action.

Finally, in *True Return Systems LLC v. MakerDAO*, the plaintiff filed a patent infringement action in the U.S. District Court for the Southern District of New York against MakerDAO, which it alleged is a partnership under New York law. The plaintiff alleged that the holders of MKR Tokens jointly control MakerDAO's governance and that MakerDAO shares its profits with MKR token holders.

In its motion to dismiss, MakerDAO argues that it cannot be sued under Rule 17 of the Federal Rules of Civil Procedure because it is not a partnership or unincorporated association under New York or federal law. Among other things, MakerDAO highlighted New York law that provides that partnerships dissolve with every admission or withdrawal of a partner. Thus, any "partnership" would be dissolved by each transfer of MKR on secondary platforms, which occurs thousands of times per day. The motion to dismiss remains pending.

Considerations

The legal liability of DAOs and their token holders represents uncharted waters. Although certain of the cases above survived the defendants' motions to dismiss, no court affirmatively endorsed the plaintiffs' theories of liability against DAOs. The only case to meaningfully progress beyond the motion-to-dismiss stage was the *Ooki DAO* case. But there, the defendant did not appear, so the court entered a default judgment, where, like at the motion-to-dismiss stage, the allegations were accepted as true.

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At the outset, given that most DAOs have no real jurisdictional nexus, it will be difficult to determine which jurisdiction's partnership laws apply. This is critical, as the tests for determining the existence of a partnership or unincorporated association vary among jurisdictions. Some state laws may make pleading the existence of a partnership more difficult. For instance, California law provides that a person may become a partner only with the unanimous consent of all other partners. Many states also require sufficient allegations of mutual consent among the partners to jointly run a business.

Even where pleaded with enough detail to satisfy pleading standards, these elements may ultimately be difficult to prove. Indeed, many DAOs consist of thousands of globally dispersed token holders. As the Securities and Exchange Commission noted in its "DAO Report," this reality makes it unlikely that token holders know each other, much less meaningfully communicate with one another and/or agree to jointly run a business. U.S. Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017), https://bit.ly/3X2ned0.

Moreover, the scope and contours of this theory have not been fully articulated and, in many instances, may lead to absurd results. If the DAO is a "partnership," who, exactly, are its partners? All token holders? At what point in time? Many governance tokens are traded on exchanges thousands of times per day — does this mean a new "partnership" forms from each transaction? If so, individual token holders would be "partners" as well, and thus face significant obstacles to suing other "partners" for the DAO's alleged wrongdoing.

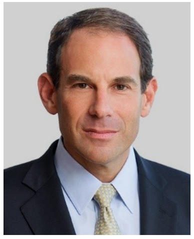
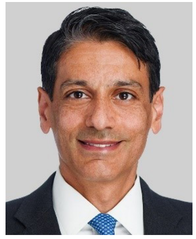
If only some subset of token holders can be considered "partners," how is that determined? If the partnership consists of only those token holders who voted in governance proposals, are those token holders liable as partners if the proposals they voted on have nothing to do with the alleged violations at issue? And what if the token holder voted *against* a proposal that led to the alleged violations? These questions remain unanswered by the pending litigations.

States like Wyoming have passed laws that recognize DAOs as legal entities while limiting the *in terrorem* effect of potentially open-ended liability of DAO participants. Miles Jennings and David Kerr, "The DUNA: An Oasis for DAOs," a16z Crypto (Mar. 8, 2024), https://bit.ly/454YTFC.

It remains uncertain whether and to what extent decentralized projects will embrace these new laws. Nevertheless, as courts continue to grapple with how to adjudicate allegations brought against DAOs, companies and individuals contemplating holding and utilizing governance tokens should consider the potential legal implications of these theories and consult with experienced counsel.

Alex Drylewski is a regular contributing columnist on Web3 and digital assets for Reuters Legal News and Westlaw Today.

About the authors

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