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Holdings in *Commodity Futures Trading Commission v. Ooki DAO* and other recent cases are finding that participants in DAOs are subject to the court's jurisdiction and are liable for each other's actions

Not So *Fast*

DECENTRALIZED AUTONOMOUS ORGANIZATIONS (DAOS) have become increasingly popular among those who operate in the blockchain and cryptocurrency space as the "go-to" organizational structure for projects desiring to operate in a decentralized manner.[1] In 2021, participants in DAOs grew from 13,000 to 1.7 million people, many of whom are entrepreneurs and investors adopting this new form of organizational structure to facilitate collaborations for their work in the digital space.[2] Many projects begin as peer-to-peer

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collaborations between like-minded individuals on social media and mature into full-fledged protocols with complex hierarchies that allow global collaborations between individuals who might never meet or know each other's true identities.[3]

While DAOs come in many shapes and sizes, often having DAO-specific coding governance rules, one characteristic they all share is their desire to be decentralized, i.e., DAOs want to be controlled by their users rather than a centralized entity or individual. By operating in a decentralized manner, DAOs enable their members to pool capital and code rules for how the capital will be allocated, allowing governance to become automated by code and preventing individual members from tampering with the established rules.[4] The decentralized and transparent governance structure of DAOs enables trust among members and allows anyone with an Internet connection to participate in any protocol without fear of censorship or bias, leading to the formation of more inclusive and innovative organizations.[5]

Notably, the decentralized nature of DAOs has additional benefits. In the payments space, for example, decentralized cryptocurrencies permit the transfer of digital payments between individuals without the supervision or, some might say, interference of banks, and they can do so much faster and at a fraction of the cost of a bank wire or ACH transfer. However, these innovative benefits are sometimes associated with regulatory risks and considerations.[6]

Although many DAOs and their members merely want to operate in a decentralized manner to further the ethos of crypto, some intentionally operate decentralized organizations to enable their protocols to avoid regulatory scrutiny. If no individual or entity is in charge, the theory goes, there is no individual or entity that can be held responsible for regulatory compliance or, for that matter, liabilities that might arise from operations. For many years DAOs have operated with relative impunity because DAOs were small enough to fly under the radar of regulators and law enforcement, there was uncertainty regarding whether regulators could file suit against a DAO as an organization, and regulators were uncertain how to serve process on a quasi-entity with no address and no centralized control. Recent court holdings, however, suggest that the days of DAOs' being able to avoid regulatory risks and considerations are over, as courts have concluded that DAOs and their members are subject to suit as unincorporated organizations,[7] can constitute partnerships under the law,[8] and can be served process in novel ways.[9]

Legal Liability

Generally, DAOs had envisioned it would be possible to skirt legal liability and difficult to drag them into court because of their purely online and amorphous structure. For years, however, most attorneys advised DAOs and their members that in the United States under the law of corporations, courts would likely treat this novel organizational structure as a not-so-novel legal entity—a general partnership. If treated as such, every participant in a DAO, i.e., a partner, is subject to liability for the actions or inactions of other DAO participants. Such potential liability is an obvious setback when DAO participants in many cases do not even know their fellow DAO members' names, much less where they are from or whether they have ethical standards. Recently, courts issued rulings that confirm DAOs' legal personhood, ultimately confirming that DAOs and their members can be subject to legal liability. Notably, a determination of whether an entity has capacity to be sued (based on the law of the state where the court is located) is important because it determines whether any judgment issued by a court will be binding on the party such that the lawsuit can be resolved conclusively.[10]

California law permits an unincorporated association to "sue or be sued in the name it has assumed or by which it is known."[11] Section18035(a) of the California Corporations Code defines an unincorporated association as 1) an unincorporated group of two or more persons, 2) joined by mutual consent, 3) for a common lawful purpose whether organized for profit or not.[12] Case law adds a fourth requirement that the association function under a common name in which fairness requires the group be recognized as a legal entity, including situations where persons dealing with the association contend their legal rights have been violated.[13]

In a case of first impression, the U.S. District Court for the Northern District of California found that Ooki DAO, as an unincorporated association, had capacity to be sued in California courts.[14] In *Commodity Futures Trading Commission v. Ooki DAO*, the Commodity Futures Trading Commission (CFTC) sued a DAO, alleging it was operating an "exchange" for commodity derivatives and permitting its members to engage in retail commodity transactions without complying with the Commodity Exchange Act (CEA).[15] The CFTC alleged Ooki DAO failed to register its "exchange" platform with the CFTC, failed to conduct standard customer due diligence to protect against fraud, money laundering, and terrorist activities, and failed to comply with other regulatory requirements mandated by the CEA.[16]

Because Ooki DAO was comprised of individual token holders, the court reasoned that the DAO met the initial "two or more persons" requirement under Section 18035(a).[17] Second, the court found that token holders joined Ooki DAO "by mutual consent."[18] If they did not consent, the court found they could sell or give away their tokens. Third, the court found that the DAO was formed for a "common lawful purpose," reasoning that governing the DAO, including voting on its governance decisions, pausing or suspending trading, rewriting the software protocol, using and distributing funds from the DAO's common treasury, and rebranding the DAO all constituted a lawful purpose.[19] The court found operating a retail commodity exchange via a DAO was not illegal as long as the DAO complied with all federal laws, distinguishing that the purpose of the DAO was not illegal, but the structure used was illegal because it attempted to avoid regulation by the CFTC.[20] Finally, neither party disputed that Ooki DAO operated under the common name, Ooki DAO.[21] Therefore, the court found that fairness required recognizing Ooki DAO as a legal entity because it was operating an illegal trading platform, in violation of federal law.

The district court thus ruled that Ooki DAO, organized as an unincorporated association, had capacity to be sued in the name of the DAO in federal court. The court cautioned that even though Ooki DAO had capacity to be sued, it did not imply the DAO met the requirements of an unincorporated association such that it could be liable under the CEA. Although this case involved preliminary issues of whether Ooki DAO was properly before the court in terms of capacity to be sued and service of process of the lawsuit, the decision did not include a discussion of the merits of the case and Ooki DAO's alleged violations of federal law.

In 2023, in another case of first impression, the District Court in Northern California addressed whether a DAO could be held liable as a partnership under California law for losses incurred by token

holders. In *Sarcuni v. bZx DAO*, token holders filed a class action lawsuit against the former founders and current DAO BZRX token holders, alleging they collectively lost $1.7 million because of the defendants' negligence.[22] The plaintiffs alleged bZx operated a DAO on a blockchain platform called the bZx Protocol, which offered cryptocurrency margin trading and lending in various cryptocurrencies. It had two products, Fulcrum and Torque, to conduct margin lending and trading as well as to make fixed interest rate loans, respectively. The bZx Protocol operated on the Ethereum, Polygon, and BNB Smart Chain blockchain platforms.

The bZx Protocol and products were created and controlled by the two founders, who then transitioned control of the Protocol and assets of their limited liability companies to the bZx DAO. The bZx DAO and Protocol were from then on controlled by BZRX token holders, who held tokens issued by the DAO. Notably, the bZx Protocol had $80 million in assets, and the bZx DAO was now responsible for managing the Protocol, developing new products, managing the community, and governing and making decisions for the DAO.

Unfortunately, hackers breached the DAO's protocol and stole $55 million in cryptocurrency during a successful phishing attack on a developer working for the DAO, allegedly causing plaintiffs' losses. In the class action, the plaintiffs alleged the defendants owed them a duty of care to keep the funds deposited on the bZx Protocol safe and to ensure proper procedures against cyber theft and hacking. The plaintiffs argued that because of the defendants' negligence in failing to do so, they should be held liable as general partners of the DAO for the losses the plaintiffs suffered. The plaintiffs further alleged the defendants were general partners of bZx DAO and jointly and severally liable for their injuries.

The district court began by stating that, in California, 1) an association of two or more persons, 2) carrying on as co-owners, 3) a business for profit, forms a partnership irrespective of whether the parties' intent was to do so or not.[23] Unless persons doing business together establish a formal entity (e.g., a corporation), the association is deemed a partnership regardless of the parties' intent.[24] Additionally, the ability to participate in the management of a business is another key element in determining whether a partnership exists.[25] Significantly, profit sharing among partners is evidence of a partnership but is not a required element.[26]

As to the first element, the court found the complaint against bZx DAO sufficiently alleged the DAO was an association of two or more persons because it was comprised of the token holders and investors. Further, the DAO operated a business for profit because it generated revenue through its margin trading and lending products, Fulcrum and Torque.

As to the second element, the court also found the token holders were carrying on as co-owners of the DAO. The plaintiffs alleged that bZeroX LLC transitioned millions of dollars and control of the protocol to the bZx DAO. When the transition was completed, bZeroX LLC ceased to exist and the DAO took its place. The bZx DAO was now controlled by the holders of the BZRX token, who had the rights to govern the DAO and make decisions concerning the bZx platform. Specifically, if a proposal received the required number of votes, the DAO or Protocol could vote on governance proposals, spend treasury funds to hire people, change organizational goals and policies, and even distribute treasury assets to token holders—similarly to how corporations authorize and issue dividends to shareholders. The BZRX token holders attempted to argue that they were not a partnership because they had limited rights to govern the Protocol. However, the court found limited governance rights do not negate the existence of a partnership, reasoning that a partnership can still exist even when individual partners are not vested with complete control of parts of the venture because partners can agree that one or more partners will control all or parts of the enterprise.[27]

As to the third element, the CFTC's Order Instituting Proceedings against the DAO had found that token holders could share in the DAO's profits either by voting to distribute treasury assets among themselves or via an interest-generating token. Since some token holders were entitled to receive distributions, the court found that profit sharing supported the existence of a partnership. The fact that profits and losses were not shared equally among token holders did not indicate the absence of a partnership.[28] Defendants also argued that there was no agreement they would bear any losses suffered by a partnership. However, the court found an agreement to divide profits implies an agreement to divide losses, unless otherwise expressly stated.[29]

Under these circumstances, the court found plaintiffs had sufficiently stated facts to allege a general partnership existed among the BZRX token holders, holding that the DAO was operating as a California general partnership. The court also found plaintiffs had sufficiently alleged that the individual defendants and former founders were partners of bZx DAO, reasoning that anyone holding a BZRX token was a partner in the partnership. The court reasoned that because the founders had the ability to participate in decision-making about the Protocol it could reasonably be inferred that they also held BZRX tokens.

In reaching their holding, the court noted that the founders consciously rejected registering the DAO as an LLC or other limited liability entity when they transferred control of the Protocol from their LLC to the DAO. The court concluded that this was done expressly to avoid regulatory oversight and compliance with U.S. law. The court found defendants' own actions could result in every BZRX token holder's plausibly being a co-owner of the DAO with management authority and personal liability for losses—a potentially striking and sweeping expansion of the law on partnership.

Ultimately, the holdings in *Ooki DAO* and *bZx DAO* should place DAOs and their counsel on notice that although DAOs had hoped to be outside such traditional business entity models because of their virtual and anonymous nature, organizing a DAO will not insulate the organization or its members from suit or protect the organization or its members from legal liability. These recent cases demonstrate that California courts are finding DAOs to be subject to the same governance and liability requirements of formal corporate structures. Additionally, these holdings may suggest a shift in how jurisdictions view DAOs, the legal personhood of DAOs, and whether DAOs fall within the purview of the traditional concepts of the law of corporations.

Due Process Principles

Since July 2017 when the Securities and Exchange Commission published The DAO Report, the public has been on notice that the use of a DAO entity does not protect individuals from government action.[30] Meanwhile, and despite the SEC's admonition, only recently have plaintiffs devised clever ways to serve entities with no address and that are associated with no particular known individual. Prior to that, DAOs had hoped to avoid the legal formalities and restrictions of brick-and-mortar businesses by creating

virtual and anonymous structures.

However, in addition to holding that DAOs are capable of being sued and that DAOs can constitute a general partnership, California courts are further expanding traditional due process principles to exercise jurisdiction over DAOs, thereby continuing to erode the features that made them so popular. For example, in *Ooki DAO*, the district court ruled that a summons and complaint against a DAO may properly be served through the "chat box" and "discussion forum" features on the DAO's platform.[31] In *Ooki DAO*, the CFTC tried to serve Ooki DAO but was frustrated in efforts to do so because of the virtual and anonymous structure of the DAO. Unable to use traditional methods of serving legal papers at a business address or to an officer of the business (in person, by mail, or a combination of both), the CFTC served Ooki DAO via the chat box and discussion forum features on its platform. The court permitted the CFTC to serve the summons and complaint on Ooki DAO in this manner.

First, the court reasoned that the structure of the DAO made identifying DAO members impossible. Additionally, the DAO had no website, no email address, and no physical address. Further, numerous attempts to serve the DAO via traditional methods of service had failed because the DAO had neither a registered place of business nor a publicly identified person associated with it. Finally, the chat box and discussion forum features were the only online methods Ooki DAO created for the public to contact it. The court noted that the token holders actively discussed the receipt of the lawsuit and the next steps in the online chat box and discussion forum, confirming that service had been properly effected.

The court resorted to infrequently used principles of law to arrive at this conclusion. Where traditional methods of service on a party defendant under federal law are not practicable, courts can resort to a lesser known power that enables the judge handling the case to decide the best mode of service based on the facts of the case.[32] Federal judges have discretion to determine the nature and sufficiency of service.[33] Judges have permitted a host of alternate methods of service when defendants were either hard to find or deliberately evading service, e.g., service via email on an international defendant, service via Facebook chat where the defendant was mainly found on Facebook, or service via website only for a business that preferred communication through its website. Considering all these factors, the court ruled that service through the chat box and discussion forum features on Ooki DAO's platform met due process standards. Interestingly, the court also directed the CFTC to serve the two former founders of the company on the grounds the CFTC should serve the last known physical address for the company. Thus, the founders' goal of eliminating their liability by transferring the business to the DAO also proved not to be a foolproof way of avoiding the long arm of the law.

With respect to the cases discussed above, there are thousands of fully operational DAOs currently in existence whose members, knowingly or unknowingly, may be subject to the court's jurisdiction and to liability for each other's actions.[34]

Looking Forward

DAOs are increasingly popular organizational structures to use for various innovative purposes including investing, contributing to charitable causes, fundraising, or making payments in a decentralized manner, allowing the organizations to operate independently from regulatory oversight by a centralized entity or individual.[35] Nevertheless, recent California court decisions have helped crystalize the legal landscape surrounding DAOs, suggesting that these organizations and their members will be subject to the same governance and liability requirements of formal corporate structures. These rulings suggest that courts will apply traditional legal principles in novel ways to prevent DAOs and their members from escaping liability and the reach of local laws, thus providing notice to DAOs and their members that although DAOs desire to operate in a decentralized manner, continuing to operate in that way without protections provided by a legal "wrapper"[36] carries significant risk of legal liability for the DAO and its members. It is in the best interest of DAOs to consult with legal counsel to discuss the benefits and considerations regarding forming a legal corporate entity to protect the DAO and its members from unexpected legal liability, and a best practice for counsel of DAO clients is to proactively advise their clients on the legal risks and consequences of operating a DAO without establishing a legal wrapper as a protective mechanism. ■

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[1] Geoffrey See et al., *Are 'Decentralized Autonomous Organizations' the Business Structure of the Future?*, World Econ. F. (June 23, 2023), https://www.weforum.org/agenda/2022/06/are-dao-the-business-structures-of-the-future/#:~:text=1%20Decentralized%20Autonomous%20Organizations%20%28DAO%29%20can%20replace%20the,true%20digital%20revolution%2C%20unlocking%20the%20potential%20of%20web3.

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] Ian Kane, *Unlocking the Future: 5 Ways DAOs Are Revolutionizing Business Models*, Newsweek, Oct. 20, 2023, *available at* https://www.newsweek.com/unlocking-future-5-ways-daos-are-revolutionizing-business-models-1836214.

[6] Amy Matsuo, *Ten Key Regulatory Challenges of 2023*, KPMG (2023), https://kpmg.com/kpmg-us/content/dam/kpmg/pdf/2022/ten-key-financial-services-regulatory-challenges-2023.pdf.

[7] Commodity Futures Trading Comm'n v. Ooki DAO, No. 22-cv-5416, 2022 WL 17822445 (N.D. Cal. Dec. 20, 2022).

[8] Sarcuni v. bZx DAO, No. 22-cv-618-LAB-DEB, 2023 WL 2657633 (S.D. Cal. Mar. 27, 2023).

[9] Ooki DAO, 2022 WL 17822445.

[10] Fed. R. Civ. P. 17(b).

[11] Code Civ. Proc. §369.5(a).

[12] Corp. Code §18035(a).

[13] Church Mut. Ins. Co., S.I. v. GuideOne Specialty Mut. Ins. Co., 72 Cal. App. 5th 1042, 1059 (2021), *as modified on denial of reh'g* (2022).

[14] Ooki DAO, 2022 WL 17822445.

[15] *Id.* at *2.

[16] *Id.* at *3.

[17] *Id.* at *6.

[18] *Id.*

[19] *Id.* at *7.

[20] *Id.*

[21] *Id.* at *8.

[22] Sarcuni v. bZx DAO, No. 22-cv-618-LAB-DEB, 2023 WL 2657633, at *2-3 (S.D. Cal. Mar. 27, 2023).

[23] Corp. Code §16202(a).

[24] *See* Jones v. Goodman, 57 Cal. App. 5th 521, 538 n.19 (2020); *see also* Corp. Code §16202(b).

[25] Dickenson v. Samples, 104 Cal. App. 2d 311, 315 (1951).

[26] *See* Corp. Code §16202(c)(3). "The ability to share profits is not a determining factor in whether a partnership existed between the parties." Holmes v. Lerner, 74 Cal. App. 4th 442, 454 (1999).

[27] *See* Singleton v. Fuller, 118 Cal. App. 2d 733, 741 (1953).

[28] Constans v. Ross, 106 Cal. App. 2d 381, 389 (1951).

[29] National Bank of Commerce in Pasadena v. Thompson Adver. Co., 114 Cal. App. 327, 329-30 (1931).

[30] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), *available at* https://www.sec.gov/files/litigation/investreport/34-81207.pdf.

[31] Commodity Futures Trading Comm'n v. Ooki DAO, No. 22-cv-5416, 2022 WL 17822445, at *10-11 (N.D. Cal. Dec. 20, 2022).

[32] Fed. R. Civ. P. 4(e)(h).

[33] *Id.*

[34] *Top DAOs Projects in 2023*, Ctr. Fin. Tech. Entrepreneurship (Mar. 7, 2023), https://blog.cfte.education/top-daos-projects-2023.

[35] Cathy Hackl, *What Are DAOs and Why You Should Pay Attention*, Forbes, June 1, 2021, *available at* https://www.forbes.com/sites/cathyhackl/2021/06/01/what-are-daos-and-why-you-should-pay-attention/?sh=7978f1c37305.

[36] Dennis Post & Jeff Wong, *The Right Legal Wrapper Can Protect a DAO and Its Members*, Bloomberg (July 31, 2023), https://news.bloomberglaw.com/us-law-week/the-right-legal-wrapper-can-protect-a-dao-and-its-members.