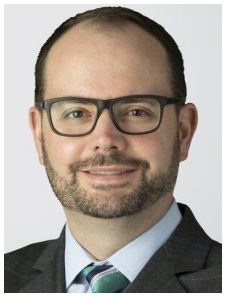
Issues To Watch In Decentralized Autonomous Org Case

By Andrew Balthazor and Ashley Shively (May 24, 2022)



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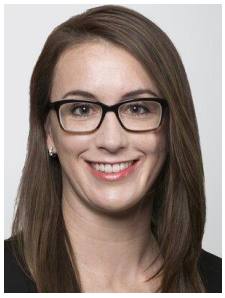

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On May 2, users of decentralized finance platform bZx filed a novel putative **class action** against the decentralized autonomous organization, or DAO, governing the DeFi platform and related entities, seeking to hold those entities legally responsible for cyber hackers' theft of about $55 million worth of virtual assets from the platform.

The case, Sarcuni v. bZx DAO in the U.S. District Court for the Southern District of California, presents novel questions of liability in the context of these relatively new organizations.

The term "DAO" is amorphous. Generically, DAOs are smart contract-based associations of investors who possess voting rights and thus control aspects of a DAO based on their token holdings — tokens purchased from the DAO. Token purchases fund the DAO's treasury and thus the DAO's operations.

There can be many variations on this model, including different methods of voting, suggesting proposals, distributing profits, determining ownership rights to underlying assets and implementing successfully accepted proposals. For example, the original DAO[1] only permitted token holders to vote on proposals curated by a third-party panel, itself selected by an entity over which the DAO token holders had no real control.

The bZx plaintiffs distinguish between the bZx protocol — a decentralized finance platform offering lending and interest-bearing products to users, via two different brands — and the bZx DAO that was ostensibly governing the bZx protocol. The plaintiffs were bZx protocol users, placing their virtual assets in the custody of the bZx protocol to earn interest.

The plaintiffs allege the bZx DAO became the controlling entity of the bZx protocol on or about August 2021. The bZx DAO was governed by the holders of the DAO's BZRX tokens.

Importantly, bZx protocol users were not necessarily bZx DAO token holders — and in such a case would have no control over the decentralized platform, the products being offered, the development of the bZx protocol, or the system's security.

On Nov. 5, 2021, a phishing attack against an unnamed bZx protocol developer successfully netted the private keys that permitted the hacker to drain a substantial portion of the customer funds entrusted to the bZx protocol as well as the DAO's BZRX governance tokens. And, per the complaint, this was only the latest and largest security breach of the protocol, which had suffered three prior hacks in 2020.

Shortly after discovering the hack, the bZx DAO token holders passed a plan to compensate victims of the hack — but in a way that prioritized bZx DAO token holders.

Specifically, holders of the BZRX tokens would be compensated in full, but bZx protocol users who lost funds would only be issued new debt tokens that would be purchased by the DAO from debt token holders over a period of "thousands of years," according to the

complaint. Payment for the debt tokens would come from revenue derived from the user transaction fees on the bZx protocol.

A month later, in December 2021, the bZx protocol encouraged users to transition to a new DeFi platform — Ooki, controlled by the newly created Ooki DAO. Certain amounts of Ooki DAO governance tokens were granted to BZRX token holders, and the plaintiffs allege the Ooki DAO is the direct successor of the bZx DAO.

If users transition to Ooki, it seems unlikely bZx users will ever be compensated under the bZx debt token plan — there will be less, if any, revenue generated by the bZx protocol as users move to Ooki.

The plaintiffs filed the class action on behalf of all bZx users, bringing a single claim of negligence against the bZx DAO, Ooki DAO and certain persons and entities alleged to be general partners in both organizations. The plaintiffs allege that the defendants failed to implement security measures reasonably necessary to prevent the hack and resulting damages to users.

DAOs lacking a formal business entity may expose stakeholders to unlimited liability.

Importantly, the bZx DAO and the successor Ooki DAO are not alleged to be formal business entities. Instead, the plaintiffs describe them as general partnerships: informal associations of co-owners carrying on a business for profit.

The plaintiffs employ this general partnership theory apparently to target the deep pockets of certain defendants who are bZx DAO and Ooki DAO token holders, and who, by implication, had an outsized amount of control and responsibility for the actions and security measures taken, or not taken, by the bZx DAO.

Although state partnership laws vary, typically general partnerships subject all partners to unlimited joint and several liabilities for the partnership's actions. Notably, certain jurisdictions like Wyoming and Vermont, have passed laws enabling DAOs to form formal business entities. California, the alleged forum where the bZx DAO was controlled from, is not one of those jurisdictions.

Under the plaintiffs' general partnership theory, all DAOs would ostensibly qualify as a general partnership unless they were formed within one of the handful of DAO-friendly jurisdictions. While this theory has not been embraced by a court, if it was, it could potentially expose stakeholders of all such DAOs to the various risks of being a general partner, including the possibility of unlimited personal liability.

DAOs can minimize the risk to their stakeholders of such exposure by ensuring they are formed within an appropriate business entity. Before becoming a DAO stakeholder, it would be prudent to determine how the DAO is organized before acquiring a potentially unpredictable amount of risk.

Fractionalization of DAO ownership may affect liability of de minimus DAO token holders.

Another legal issue is the amount of liability de minimus DAO token holders would have if a DAO is determined by a court to be a general partnership.

The U.S. Securities and Exchange Commission noted in its report of the original DAO that a general partnership selling tiny fractions of ownership to many people may result in those fractional ownership shares being effectively securities — analogous to shares in a corporation. It is an open question as to where or how a court would draw a line separating the two — liable general partners and nonliable de minimus token holders.

This question of de minimus token holder liability may well arise in the bZx action. The plaintiffs or members of the putative class may be bZx DAO token holders themselves — the complaint's class definition does not outright exclude holders of the BZRX tokens and at least one allegation implies that some of the named plaintiffs held at least some BZRX tokens. This, in turn, means some members of the defined class could also potentially be liable for the alleged harm caused.

The plaintiffs will likely need to resolve this potential conflict of interest at the class certification stage or earlier, as class members who could be liable to the class may be an obstacle to adequacy, or pose insurmountable individualized issues under Federal Rule of Civil Procedure 23.

Who owes what duties to whom in a DAO?

The action also raises questions as to what duties DAO partners or their agents owe to the DAO and to one another.

Someone has to implement proposals passed by DAO stakeholders. That person, stakeholder or not, may owe duties — possibly even fiduciary duties — to the DAO and its stakeholders. If DAOs are treated as general partnerships, then state law would define the parameters of those duties.

The $55 million theft in this case allegedly resulted from one point of failure — an unnamed developer of the bZx protocol. Someone selected that person and directed that person's duties vis-à-vis the bZx protocol.

As this action develops, there is the possibility that DAO partners may file cross-claims or third-party claims against parties alleged to have owed duties of care to the DAO's partners, potentially creating new law as to the scope of duties owed by different participants in the DAO context.

Formalizing a DAO as a legal entity would provide some certainty as to the extent of duties owed by DAO managers, developers, agents and stakeholders.

Indeed, if this action becomes a model for litigation against DAOs, DAO stakeholders have a substantial financial incentive to regularize such an entity within an appropriate legal structure to provide conventional liability protections to these unconventional innovations of the blockchain era.

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as legal advice.

[1] https://www.sec.gov/litigation/investreport/34-81207.pdf.