Legal considerations
of “unwrapped” DAOs

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May 2, 2023
Legal Considerations of DAOs

Today’s Agenda:

- **Unwrapped DAOs** and their standing within the scope of global legal orders (focus on US)
- **Legal challenges** of unwrapped DAOs and how those are dealt with in practice
- **Ooki DAO cases** (with Rodrigo Seira)
Recap: DAOs

In the last classes, we looked at:

- different types of DAOs,
- technical underpinnings,
- governance structures and practices,
- securities regulation and current regulatory concerns.
Defining DAOs

Based on the last classes, there are many ways to define DAOs, but what we could perhaps agree on so far is:

- an online group consisting of a multiplicity of actors that coordinate towards some common purpose(s),
- using some smart contract code deployed on a permissionless blockchain,
- whereby the smart contract code implements governance rules, usually involving a token model and an incentive structure.
DAOs and corporate form

Our definition says nothing about DAOs’ legal characterisation or standing.

Legislation and case law globally do not say a lot about DAOs (though this is changing).
Cambrian explosion of DAOs + legal troubles?

DAOs are everywhere and nowhere
- at least legally.

Cool fact:
As of December 2021, 200 DAOs were listed on deepdao.io
Today, more than 12,000
“Codeslaw”

Code is law (as understood by past crypto ideologues):

The law applicable to DAOs is hardcoded and enforced by the software code of the DAO and its underlying blockchain network, rather than by external state authorities and their legal systems.

Nation state legal systems, including the US legal systems, see DAOs within the scope of their laws.
Code != law

I asked Midjourney what “Code is Law” looks like.
Short primer on entity establishment

Creating a corporate entity usually requires filing documents with relevant government authorities and involves:

1. **Choosing** a unique name
2. **Filing** articles of incorporation (setting out basic details: name, registered office, share structure, owners)
3. **Paying** registration fees or similar
4. **Holding** organizational **meeting**: electing directors, appointing officers, adopting bylaws

→ a corporate entity is considered established and can begin operating.
Main benefits of a corporate entity

Depending on the organisation form, a corporate entity benefits, among other things, from certainty about:

1. Legal personhood/personality (legal rights and obligations similar to a natural person)
2. Limited liability for the partners

To be sure to benefit from legal personhood and limited liability, some DAOs register as legal entities.

(We will cover in more detail on May 4, 2023)
Wrapped DAOs <> Unwrapped DAOs

For simplicity, DAOs can be distinguished roughly by their corporate form/lack thereof:

Wrapped DAOs: take the legal form(s) of their wrapper(s) (e.g. LLC, foundation company etc.)
Wrapped DAOs <> Unwrapped DAOs

The classification of unwrapped DAOs, or anything unincorporated:

(1) **is in the eye of the beholder**, and
(2) **depends on their matter of fact structure and function.**

Potentially:

- Unincorporated association, general partnership
- Foreign law structures: GbR, Islamic Waqf, trust structures
Wrapped DAOs ≠ Unwrapped DAOs

The existence of a DAO wrapper does not render a DAO lawful.

The absence of DAO wrapper(s) does not render DAOs beyond the scope of the law.
Legal Challenges of Unwrapped DAOs

1. Lack or uncertainty of legal personality (note general partnership provide legal personhood in US, but not in England):
   a. Inability to own off-chain property
   b. Inability to enter into legal contracts
   c. Inability to sue and be sued

2. Legal liability concern:
   a. DAO’s assets potentially not separate from that of owners/beneficiaries
   b. Lack of limited liability for DAO participants
   c. Potential joint & several liability of DAO participants

3. Uncertainty on applicable laws: which laws to comply with?

4. Uncertainty as to tax treatment: how to comply with tax obligations?
Characterisation of Unwrapped DAOs

In the US, DAOs that operate without any formal legal structure could be legally categorized as:

- general partnership (if for-profit)

- unincorporated [non-profit] association (if not-for-profit)
Unwrapped DAOs general partnership

When 2+ persons go into business together with the goal of earning a profit, a general partnership exists by default.

Cal. Corp. Code § 16202(a):

[T]he “association of two or more persons to carry on as coowners of a business for profit forms a partnership, whether or not the persons intend to form a partnership.”

Some consequences of finding that a partnership between persons exist:

- partners are jointly and severally liable for the conduct and torts committed by any one of the other partners or the partnership (Black v. Sullivan (1975) 48 Cal. App.3d 557, 569).
- fiduciary duties
Unwrapped DAOs as general partnerships

However:

“It is essential, however, to the existence of a partnership that there be a community of interest and an agreement to share jointly in the profits and losses resulting from the enterprise.”

Unwrapped DAOs

Reasons why some DAOs are unwrapped:

- Unsuitability of wrappers: incorporating a DAO in any jurisdiction is generally not straightforward and finding a viable and efficient connection between the legal entity and the governance expressed on-chain
- Some founders do not think about legal structure and the DAO is formed organically
- Legal structure appears unnecessary to the DAO collaborateurs
- Ideology: A wrapped DAO loses its extraterritorial and borderless nature and becomes an entity according to the law of a given jurisdiction and therefore objected to (e.g. anarchism, cypherpunks, libertarianism)
- Regulatory reasons (e.g. as a radical decentralization measures)
Unwrapped DAOs

Why is it important to look at unwrapped DAOs:

Even where corporations have been formed to represent part of a DAO, legal actions may assert that token holders, delegates etc or a subset of a DAO form a general partnership. This potentially allows regulators to circumvent the liability protections (corporate veil) created by wrapping the DAO.
Structuring Unwrapped DAOs: Private Ordering

Private Ordering Agreements / Participation Agreements / Constitutions / Bylaws

- to govern relationships within a DAO
- to signal DAO members’ understanding to external parties

Example:  
MakerDAO Constitution  
TracerDAO Participation Agreement  
CowDAO Participation Agreement

Section 16.3
"Each CowDAO Participant acknowledges and agrees that this Agreement does not constitute a partnership agreement of any kind. Despite this, in the event that a court or tribunal determines any aspect of this Agreement is found to constitute or cause a partnership to arise, each CowDAO Participant hereby waives any rights against each other partner in respect of the released Claims howsoever arising, including any obligation to account or account for any profit or loss or any other cause of action that a partner would have against another partner in the context of a partnership."
Structuring Unwrapped DAOs: Private Ordering

- Are private orderings legally binding?
- How to enforce those agreements?
  - On-chain mechanisms
  - Off-chain mechanisms
- Who has legal standing to file a claim & in which jurisdiction?
Structuring Unwrapped DAOs: contracting

“Contracting” (by ensuring key-signature neutrality):
- Bounties (e.g. MakerDAO bug bounty on Immunify)
- Agreements by way of proposal (offer) and acceptance (vote) (e.g. Gnosis Grant to Erigon, prior discussion in Gnosis forum)
- Gig working arrangements by way of proposal (e.g. Juicebox contributor payment)

Appointment of representatives (natural or juridical persons, sometimes on a task-by-task basis)
  (e.g. Curve Proposal discussion to appoint lawyers to protect IP; see payments reimbursement to contributor for paying Web2 players)

Usage of intermediaries (in particular for labour considerations though PEOs):

ØPOLIS TOKU
Structuring Unwrapped DAOs: contracting

Contracting

- Is there an existing legal relationship?
- How to resolve a dispute in case of non/improper performance?
  => Can I sue a DAO, can a DAO sue me? (Tracer DAO Service Agreement with Sigma, see also corresponding Snapshot vote)

Legal representation

- Can an “alegal” entity be represented?
- In case of a dispute, can the DAO sue the representative?
- What is the representative’s liability for the DAO’s actions?
- Can the representative sue the DAO?
Structuring Unwrapped DAOs: property

How to own off-chain property

- On trust by natural or juridical persons, e.g.:
  - Without explicit trust deed: individual members of the DAO without explicit trust deed
  - With explicit trust arrangement: Guernsey Purpose Trust for DyDx Grants Program (see also Trust Agreement) DASH DAO Irrevocable Trust
Structuring Unwrapped DAOs: property

**Without an explicit trust deed**

The individual member of the DAO has all legal rights over the property.

**With an explicit trust deed**

If the DAO is the beneficiary, who has legal standing to sue the trustee in case of a dispute?

- The DAO?
- Individual members of the DAO?
- No one?
Structuring Unwrapped DAOs: IP

How to hold IP rights?

- Members/participants/contractors retain IP rights
- IP generators assign IP to third party (e.g. Dyne)
- Agreements/constitutions profess to the DAO holding the IP (even though this may not hold in many jurisdictions, e.g. see CoW DAO Participation Agreement:)

“The CowDAO Participants and Service Providers agree that if the CowDAO decides by Governance Mechanism to incorporate or register, as the case may be, as a company, association, foundation or other corporate entity (‘Wrapped DAO’), any and all Intellectual Property Rights that would have accrued (or would have accrued but for lack of corporate form) to the CowDAO under agreements with Service Providers, third parties or otherwise shall be assigned to the Wrapped DAO.”
Structuring Unwrapped DAOs: IP

Members/participants/contractors retain IP rights
  - the DAO doesn’t own any IP
  - scattered ownership of IP rights

IP generators assign IP to third party
  - the DAO depends on a third party to fight against IP infringements

Agreements/constitutions profess to the DAO holding the IP
  - does the DAO have legal standing to fight against IP infringements?
Structuring Unwrapped DAOs: Disputes

Unwrapped DAOs usually seek a *dispute-resistant design* that prevents [legacy] legal system capture:

- Constitutions/bylaws specify how intra-DAO + extra-DAO disputes are decided
- Bylaws make processes mandatory that disincentive resort by members and third parties to nation state legal systems
- Strong focus on informal negotiations between parties
- By putting the dispute before the DAO to be decided
- By allowing members to refer the dispute to third party on-chain dispute resolution mechanisms
  - (e.g. Omen.eth implementation using Kleros)
  - (e.g. Aragon Court in [Pocket Protocol](#))
- Appoint representative by way of proposal to prosecute and defend on DAO’s behalf
Structuring Unwrapped DAOs: Disputes

Kleros: Example of pleading in Kleros dispute No. 1170 (Avi Eisenberg v Unslashed)

But please also see: Eisenberg's post mortem
Structuring Unwrapped DAOs: Disputes

The dispute mechanisms outlined do not resolve:

- Disputes between DAOs and state authorities, and disputes between DAOs and third parties who did not agree to the dispute mechanism which is in the constitution, bylaws or contract (e.g. tort)

- Who will go after the hacker?

Do blockchain dispute resolution mechanisms really render justice?

- Crypto-economic incentives & wisdom of the crowd vs. decision from an independent arbitrator

Will the decision rendered hold in court if challenged?

- Do Kleros and other dispute resolution mechanisms qualify as arbitration (in accordance with the New York Convention)?

- How to enforce the decision (on-chain / off-chain)?
Structuring Unwrapped DAOs: Liability

How to limit liability for participants and token holders?

- Individual incorporation of DAO members to act as owner of DAO tokens and function as a protection against liabilities (e.g. LLCs)
  - Whales or core team members or those exercising certain functional control, e.g. on multisig, have a higher risk as they are more likely to be the subject of third party claims
- Selective incorporation of certain functions adjacent to the DAO (e.g. treasury/income generating functions sit in a trust structure)
- Indemnifications for DAO participants in private ordering agreements
- Legal defense funds (usually a sequestered treasury that can be used under certain circumstances)
  - MakerDAO proposal and polling result
  - Sushi proposal forum discussion
Structuring Unwrapped DAOs: Liability

Your role in the DAO can affect your liability
- Initiator
- Contributor
- Voting member
- Token holder

Other factors that may be relevant
- Pseudonymity / Anonymity
- Your jurisdiction
A DAO can be qualified as an unincorporated association & any token holder who ever voted using the DAO’s governance token is a member of that entity (CFTC v. Ooki DAO)

According to the law, all associates of an unincorporated association are jointly and severally liable for the entity’s debts and obligations

=> voting in a DAO can make you jointly and severally liable for the debts and obligations of the DAO

Rodrigo will go into more details about the Ooki Cases
Structuring Unwrapped DAOs: Tax

Tax is the Achilles heel of unwrapped DAOs:
- DAOs may be considered pass-through entities with each token holder personally liable to report (e.g. if the DAO has members in the US that receive payments from its treasury, the DAO would be required to file tax returns, same goes for other jurisdictions)
- Current practice:
  - House income generating part of the DAO in a trust or other entity in an a low tax jurisdiction
  - Sequester funds on an on-going basis for potential tax payments in the future
Tornado.Cash chill on unwrapped DAOs

Recap: Tornado Cash was added to OFAC’s SDN list in August/Nov 2022.

Result:

Any US person is prohibited from using the Tornado privacy tool.

This + the expansive interpretation of general partnership of the Ooki CFTC and Class Action lawsuits presents projects with two options:

1. implement sanction screening tools (incl. on base layer);
2. ensure no US participants/collaborateurs in the DAO

Also see OFAC FAQ No. 1095 for a Tornado Cash definition
What is happening in the Ooki DAO cases?

Learnings from Ooki

Ongoing lobbying efforts
Legal Considerations of Unwrapped DAOs

Thank you!

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May 2, 2023
Update on Ooki DAO

Rodrigo Seira
Crypto Counsel @Paradigm

Stanford University, May 2, 2023
GSBGEN-323/LAW-1078/CS-352B Blockchain Governance
Ooki DAO Background

- “bZx protocol” was launched by the US-based developers and allowed users to go long or short and lend assets
- Deployed on Ethereum, Polygon, BSC
- Similar to many early DeFi protocols

**Long Positions**
Taking a long position involves a simple swapping of one asset for another. For example, you could swap DAI for ETH because you think ETH will go up in value faster than DAI.

**Short Positions**
Taking a short position is more complicated. A short position is betting that something will go down over time. Short positions require escrow, leverage, and margin calls.

**Leveraged Positions**
Leveraged positions use the same mechanics as short positions, but with leveraged positions you're able to borrow more than you have. For example, you could go 100x long on Ethereum.
Ooki DAO Background

- In 2020 protocol hacked for $9m ($8m recovered)
- DevCo transferred certain admin rights to Ethereum deployment of bZx protocol to Governor Bravo SC (“the DAO”)
- In 2021, protocol was exploited for $55m through a phishing attack on one of the developers that compromised private keys to BSC and Polygon deployment of bZx protocol
- DAO voted for “compensation plan” to pay back portion of assets to users
- Rebranded to “Ooki DAO”
Decentralization as regulatory arbitrage

“It’s really exciting. We’re going to be really preparing for the new regulatory environment by ensuring bZx is future-proof. So many people across the industry right now are getting legal notices and lawmakers are trying to decide whether they want DeFi companies to register as virtual asset service providers or not – and really what we’re going to do is take all the steps possible to make sure that when regulators ask us to comply, that we have nothing we can really do because we’ve given it all to the community”
Two Lawsuits

- Class action lawsuit
- CFTC enforcement
Sarcuni - Class Action Complaint

● Allege D were **negligent** because they owed P duty to maintain security and failed to put in place adequate procedures.

● D are jointly and severally liable “because the bZx protocol purports to be [?] a so-called DAO, or de-centralized autonomous organization, that lacks any legal formalities or recognition. There is another phrase in American law for that kind of arrangement: general partnership.”

● D include: (i) founders; (ii) DevCo; (iii) investors; and (iv) DAO
  ○ Who is the “DAO”? -> all tokenholders
Sarcuni - Class Action Complaint

● Tokenholder governance rights = corporate governance rights?
  ○ Complaint analogizes tokenholder’s governance rights to actions “typically done by corporate officers, boards, or employees.”

● Upgradability = custody?
  ○ Argues that since smart contract was upgradeable, it was effectively custodial
Sarcuni - Order Denying MTD

- MTD granted in part and denied in part = the show goes on...

- Complaint doesn’t allege that DevCos held tokens, managed DAO or shared profits.
  - Complaint fails to allege that DevCos were general partners

- Dismisses claims against one founder and DevCo without prejudice
  - Bean did not have requisite minimum contacts for personal jurisdiction
Sarcuni - Order Denying MTD

- Denies Rule 12(f) motion to strike class allegations
  - Ds argued Ps held tokens and were also general partners
  - Allegations that no P “held meaningful stakes of BZRX tokens” doesn’t mean they necessarily held tokens

- Veil Piercing
  - Founders argue complaint doesn’t plead any facts that warrant veil piercing
  - Complaining alleges founders liable as partners of DAO, not members of LLCs

- Denies Rule 12(b)(4) motion to dismiss
  - Hashed and AGE argue they are not tokenholders
  - At MTD stage, court bound by allegations in complaint

- Denies Rule 12(b)(1) motion to dismiss b/c lack of standing
  - Hashed argued complaint doesn’t plead causation
  - P’s injury is fairly traceable to DAO
CFTC’s Ooki DAO enforcement - Sept. 2022

- CFTC settled w/ the two US based developers and the Dev. Co. for offering margin commodities trading to retail without registering
  - Founders violated CEA by **operating** the bZx Protocol
    - when it was under the control of the Dev. Co. and
    - as members of “the Ooki DAO”
CFTC’s Ooki DAO enforcement - Sept. 2022

- CFTC concurrently sued “the Ooki DAO”,
  - CFTC argues **DAO was an unincorporated association** comprised of token holders that have voted on any governance proposal
  - According to CFTC, bZeroX LLC “transferred control” of the protocol to the “DAO.”
  - A key bZeroX objective in transferring control of the bZx Protocol to the bZx DAO was to attempt to render the bZx DAO, by its decentralized nature, **enforcement-proof**.

**CoinDesk**

**Ooki DAO Case So ‘Egregious,’ CFTC Had No Choice, Chair Behnam Says**

The controversial case against Ooki DAO was “so egregious and so obvious” that the U.S. Commodity Futures Trading Commission (CFTC) had to...
Amicus re: Service of Process

- Judge Orrick originally granted alternative service motion

- LexPunk, DeFi Education Fund, Paradigm and a16z filed amicus briefs arguing service was not proper and DAO was not an entity that could be served

- Judge Orrick reconsidered alternative service, but ultimately approved service
unincorporated association is “an unincorporated group of two or more persons joined by mutual consent for common lawful purpose, whether organized for profit or not.” Cal. Corp. Code § 18035(a).
  o CFTC showed that Ooki DAO is a “group of two or more persons”
  o CFTC sufficiently showed that two or more persons joined Ooki DAO “by mutual consent”
  o CFTC sufficiently demonstrated that Ooki DAO has a “common lawful purpose,” which is governing the DAO, particularly through its central Treasury

“fairness requires recognizing the DAO as a legal entity because as alleged in the complaint, the Protocol itself is unregistered in violation of federal law, and someone must be responsible. Holding responsible the entity that governs the Protocol is fair”
Was the CFTC’s service through the front-end’s help chatbox and governance forum sufficient?
- “The CFTC sufficiently alleged that Ooki DAO has the capacity to be sued as an unincorporated association”
- “Ooki DAO has received both actual notice and the best notice practicable under the circumstances”

“I reiterate that my determination that Ooki DAO has the capacity to be sued does not necessarily establish that the DAO is an association that can be held liable under the CEA.”
CFTC’s Default Motion

- Relief includes:
  - Permanent injunction for DAO
  - Removal of Ooki DAO’s website
    - Applies to any person providing web-hosting or domain-name registration services
  - Civil Money Penalty
    - $643,542 payable “by electronic funds transfer, U.S. postal money order, certified check, bank cashier’s check, or bank money order.”
- How?
Joint Amicus

- The court determined the “Ooki DAO” is an association for purposes of service of process

- BUT Amici urge court to:
  - decide nothing more about legal status of DAO (incl. whether DAO can be liable under CEA)
  - Limit default judgment to apply only to “Ooki DAO”, not individuals