

Goodmans^{LLP} Update

Class Action Lawsuit Highlights Importance of Legal Wrappers for Decentralized Autonomous Organizations

Introduction

In a first-of-its kind lawsuit filed in the Southern District of California last month, a handful of members of a decentralized autonomous organization (DAO) called bZx DAO (bZx), commenced a class action lawsuit against the founders and certain significant investors in the core development team's corporation. The members of bZx, which owned and managed a protocol for tokenized margin lending and trading, are alleging liability for a security breach that resulted in the theft of approximately USD\$55 million of cryptocurrency from the bZx protocol's implementations on the Polygon and Binance blockchains.

Although DAOs have been around since 2016, they have received little serious consideration outside of academic circles concerning the legal implications of what is effectively a novel form of economic and social coordination. The bZx litigation therefore offers the first chance for a North American court to directly address some of the pressing issues regarding DAOs – in particular, whether a DAO, absent a formal legal wrapper, constitutes a general partnership, which would have meaningful implications for DAO developer and member liability. Similarly, the litigation offers the opportunity for a court to define the various stakeholder groups in a DAO. Whatever the results of the litigation, it will have wide-reaching effects in the Web3 community and Metaverse, as DAOs appear positioned to play a significant role in the economic and social underpinnings of both.

This article will provide a brief overview of what a DAO is, a summary of the bZx litigation, some key points for development teams to consider as they launch DAOs in Canada, and conclude with thoughts about the implications for the future of legal DAOs. The bZx litigation marks the beginning of what is likely to be a long and difficult process of determining where and how DAOs fit into our existing legal systems, and what changes should be made to the latter to adequately capture the value DAOs can provide.

What is a DAO?

A DAO is an internet native organization that is collectively governed and operated by its members through a set of smart contracts. DAOs can develop organically around a community organized through a social application, or by being launched in connection with an established blockchain-based protocol. Some are launched as community-oriented investment vehicles, disbursing funds raised through token sales to projects chosen by the DAO members. Unless the DAO incorporates, its founders and members will not have the legal rights and protections afforded under Canadian corporate law.

Once launched, a DAO's smart contracts are intended to be transparent and malleable for its members, who may vote on proposals submitted to the DAO to take actions related to the DAO's operations, finances, and core functionality. For example, members may vote to implement changes to the code of an underlying protocol, or to disburse funds to a particular project. Proposals may be limited to members (i.e., only token holders may submit proposals) or may be open to the public more generally (i.e., open to development teams looking for funding for a new project). By leveraging blockchain and social technology in this way, DAOs enable a novel structure for decentralized social and economic co-ordination, in which community ownership and control are inextricably linked.

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DAOs are being implemented across a number of use cases, some of which mirror traditional forms of economic coordination. For example, investment DAOs like BitDAO and Flamingo raise funds through the sale of tokens, entitling token holders to vote on investment proposals submitted to the DAO. Others, like Uniswap, provide infrastructure services – in that example, a decentralized cryptocurrency exchange – with members voting on proposals regarding changes to the service's protocol. Not all use cases, however, are primarily financial – there are also social DAOs, like Friends With Benefits and Invisible College, which aim to bring together communities of like-minded individuals to help implement Web3 through education, funding and other support functions. Similarly, DAOs may be used for purely non-profit purposes, like community organization and charity.

Consistent with the other technologies in the Web3 space, DAOs, like non-fungible tokens, represent relatively simple building blocks that can be combined and recombined in innumerable ways to build a complex product or ecosystem. As a core part of this tool set, DAOs will almost certainly become prevalent in the Web3 and Metaverse economies. Accordingly, as investment in and development of those spaces accelerate in the coming years, our legal systems will need to adapt to ensure consumers continue to receive adequate protections without stifling innovation, allowing Canadian entrepreneurs and institutions alike to continue to be leaders.

DAO's Legal Status

One of the primary legal problems posed by DAOs is an extension of the same core challenge posed by the Internet over the last several decades: that technology has begun to create business interactions and relationships that were not contemplated when our existing legal structures were created. For example, corporate law structures do not easily accommodate DAOs because the separation of ownership and control is one of the core tenets of corporate law, but that distinction is blurred with DAOs, where both ownership and control can be held and transferred in a virtually frictionless manner.

Launching a DAO in Canada may, depending on the circumstances, result in the creation of a partnership. Under the *Partnerships Act*, a partnership exists when there are “persons carrying on a business in common with a view to profit.” Again, depending on the circumstances, an argument might be advanced that a profit-seeking DAO would be captured by this definition. A finding that a partnership had been created would risk exposing the individual founders and members of the DAO to all of the DAO's liabilities and might also create unwanted tax and other legal complications for individuals with financial interests.

It is worth noting that without a legal wrapper – i.e. without a recognized legal identity – a DAO may have difficulty engaging with the real world and ensuring compliance with its tax obligations. From a commercial perspective, uncertainty regarding their legal status may make it challenging for DAOs to engage with institutional players and investors who may want to effectively manage their risk of liability, particularly in a tighter market.

bZx Litigation

The uncertainties regarding DAO's legal status and the potential liability that may arise therefrom are at issue in *Sarcuni et al v. bZx DAO et al* (S. D. Cal., May 2, 2022). In *Sarcuni*, the plaintiffs allege that the DAO in question, bZx DAO, and its co-founders and members, are jointly and severally liable for negligence in connection with the theft of approximately USD\$55 million in funds from a decentralized finance protocol they launched. Named defendants include the DAO's co-founders and investment firms that invested in the DAO and contributed to governance matters. At the core of the case is the alleged failure by bZx to take security measures it knew were necessary to protect the funds deposited with its security protocols. Although bZx had taken such security measures with its Ethereum implementation, it had failed to do so with its Polygon and Binance implementations, which were ultimately the victims of an e-mail phishing scam.

In claiming directly against the defendants on a joint and several basis, the plaintiffs rely heavily on the allegation that the DAO is a general partnership. In advancing that allegation, the plaintiffs rely upon statements made by the DAO's founders, to the effect that the revenue from the underlying protocol and control aspects of such protocol would be transitioned to the DAO. The plaintiffs allege that, as a result, “the legal entity bZeroX LLC [ceased] to exist.” In effect, the plaintiffs allege that the lack of a legal entity to which such assets could have been transferred resulted in the creation of a general partnership.

There are differences between Canadian and American law regarding whether a partnership exists. Nevertheless, a party may seek to advance similar arguments if and when similar litigation arises in Canada. Interestingly, the plaintiffs in *Sarcuni* are not clear whether they consider

every owner of the DAO's tokens during the time in question should be considered a partner and therefore subject to liability, or whether there is some threshold of ownership or participation that would apply. This is particularly curious in light of the fact that some of the plaintiffs are token holders in the DAO and would accordingly, by the plaintiffs' logic, be jointly and severally liable for the losses they are currently claiming. Accordingly, to render any clear decision on the liability of the various defendants, the Court in *Sarcuni* may be required to comment on the nature of the DAO's stakeholder groups, which may include the original development team, early investors, passive users of the underlying protocol, and individuals with varying degrees of control connected to the governance tokens they hold.

Any decision in *Sarcuni* is likely to have wide-reaching implications for DAO participants across the United States and may have implications for DAO participants in Canada. In particular, it should serve as a caution to project teams currently developing DAOs, as well as their investors, that they may be exposing themselves to potential liability. Such teams should therefore take care to ensure they use a structure – which may include traditional means of protection, like the use of corporate blockers – that appropriately mitigates their risk, while not unduly restricting future flexibility that may be required to create the most value with the DAO.

On a related note, given the traditional distinction between ownership and control as a foundational point of the limited liability offered by corporations, core development teams should be aware of the risks that retaining skeleton key access to their DAO protocols may pose. While developers or their investors may retain such skeleton keys for practical purposes, a court may consider the retention of a skeleton key – which would give the development team or investor the ability to access and alter the DAO or underlying protocol – to be an indicia of control, which may affect the court's determination of liability amongst and between the participants.

Legal Wrappers in Canada

Although there has been some effort made in the United States to create legal wrappers for DAOs – most notably, the Wyoming DAO LLC – there has been no such development in Canada. Moreover, there is no clear Canadian corollary for a member-managed LLC, which would be the legal wrapper of choice in the United States. The closest form in Canada, the limited partnership, requires a strict separation of ownership and control. It is possible that a corporation's constating documents could be drafted in a way to allow for the determination of operational and governance decisions through a DAO's decentralized voting mechanism; however, Canadian corporate statutes explicitly require the participation of directors in a corporation's management, along with other traditionally centralized functions.

While there may not be a perfect legal wrapper for top-level DAOs in Canada, existing legal wrappers may be used on an ad hoc basis to implement certain functions. For example, corporations or limited partnerships may be used for fundraising purposes and tax structuring, and non-profit or other community-based corporate forms like cooperatives could be leveraged for project-specific purposes, as appropriate. Project teams looking to implement DAOs in Canada should give careful thought to their choice of legal wrapper.

Although there has not yet been any direct litigation in Canada on these issues, as the DAO space continues to grow, it seems inevitable that there will be. In order for corporate structures to be used effectively by DAOs, there may be a need for legislative reform, as the existing statutes do not provide for structures that meet the business and technological needs of DAOs. Done correctly, such changes could also lead to economic growth and development, as the certainty they provide would attract investment from otherwise jurisdiction-agnostic industry participants.

Going Forward

Until a decision is released in the bZx litigation or legislative bodies begin to take these issues seriously, we will be left with substantially more questions than answers. That being said, it is clear that, until more answers and clarity are provided by Canadian legislators and courts, DAO developers, investors and participants should give careful consideration to their potential exposure. As with other parts of the Web3 space, while these organizations may appear similar to the businesses most people interact with in their day-to-day life, the lack of formal legal wrappers and the benefits they provide may expose the unwitting to substantial liability. Similarly, forging ahead without tackling the difficult question of legal structure and without clearly defining the DAO's stakeholder groups may not only result in liability for developers, but may also create roadblocks to the full implementation and success of their respective solutions.

As blockchain technology, smart contracts and decentralized finance become more embedded in our day-to-day lives, understanding how these novel technologies work is crucial to fully appreciate their legal implications. Whether legislative reform related to DAOs – or more broadly, to

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blockchain-based technologies – will be introduced in Canada remains to be seen. Goodmans team continues to work through these problems side-by-side with our clients to find creative solutions that enable them to harness the full value of these exciting new technologies.

Goodmans Technology Group

Blockchain technology is quickly transforming the corporate landscape, disrupting many industries and creating novel legal challenges like those described above. Goodmans technology practice offers unparalleled expert advice to allow our clients to capitalize on the benefits of this exponential technology while remaining abreast of the complex laws and evolving regulations that govern it. Our lawyers deliver innovative and sophisticated solutions to meet the challenges of this new and evolving industry in the areas of corporate and securities laws (including advising on ICOs and other token offerings), venture financing, investment funds, tax law, brokers, consulting firms and exchangers.

As blockchain radically changes business as we know it, Goodmans remains ahead of the pack in this new technology space. For additional information on these issues and opportunities, please contact any member of our [Technology Group](#).

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