

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Alexander C. Drylewski

Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Stuart D. Levi

Partner / New York
212.735.2750
stuart.levi@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Manhattan West
New York, NY 10001
212.735.3000

Court Ruling Could Affect the Future Direction of DAOs

A March 27, 2023, decision by a California federal court in a putative class action, *Sarcuni v. bZx DAO*, has brought into focus how courts might construe the legal existence of decentralized autonomous organizations (DAOs).

The *bZx DAO* case concerns the same decentralized finance (DeFi) protocol, bZx, that was the subject of an earlier Commodity Futures Trading Commission (CFTC) enforcement action. There, too, the CFTC action asked a court to consider how to construe a DAO, arguing in the context of proper service that the DAO should be considered an unincorporated association akin to a general partnership.

Background

The bZx DAO operated the bZx Protocol, which allegedly offered cryptocurrency margin trading and lending products. When the bZx Protocol was first created, it was controlled by bZeroX LLC, which was co-founded and controlled by developers Tom Bean and Kyle Kistner. In August 2021, the bZx Protocol announced plans to transition control of the protocol from bZeroX LLC to the bZx DAO, a DAO controlled by individuals and entities holding BZRX tokens, a cryptocurrency issued by the DAO.

The bZx DAO was charged with “maintaining the protocol, building new products, marketing the brand, and managing the community.” Token holders had the right to suggest and vote on governance proposals that, if adopted, would be implemented by the bZx Protocol. bZeroX LLC then transferred all of its assets to the bZx DAO and dissolved.

In November 2021, a hacker successfully executed a phishing attack against one of the bZx developers, obtained the developer’s private key and stole \$55 million in cryptocurrency. The bZx DAO approved a compensation plan for those impacted by the hack that would compensate anyone who lost BZRX tokens with replacement BZRX tokens that vested over time. The plan also provided “debt tokens” that would gradually be repurchased to make the hack victims whole.

In December 2021, users of the bZx Protocol were encouraged to move their transactions to a successor platform called the Ooki Protocol. The Ooki Protocol is controlled in the same manner as the bZx Protocol, except the controlling DAO is called the Ooki DAO and the governance tokens are called OOKI tokens. Many BZRX token holders transferred their tokens for OOKI tokens.

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

The Class Action Complaint

The plaintiffs in *bZx DAO* brought a putative class action against Kistner, Bean and their original LLC, *bZeroX LLC*; two investors, *Hashed International LLC*, and *AGE Crypto GP, LLC*; *bZx DAO*; and its successor, *Ooki DAO*.

The plaintiffs alleged they lost \$1.7 million in the cyberattack and that the repayment plan would take thousands of years to make them whole. Significantly, the plaintiffs alleged that the *bZx DAO* is a general partnership comprised of all holders of *BZRX* tokens and that each defendant, as a *BZRX* token holder, is therefore jointly and severally liable for the losses arising from the cyberattack.

The General Partnership Issue

Are DAOs General Partnerships?

The California federal court began its analysis of the general partnership question by laying out some basic partnership principles under California law:

- A partnership exists when there is an “association of two or more persons to carry on as co-owners of a business for profit,” whether or not the intent was to form a partnership.
- Unless persons associated to do business together establish a formal entity like a corporation, the association may be deemed to be a partnership (again, regardless of the parties’ intent).
- Persons may unintentionally create a partnership where their actions and behavior demonstrate an intent to engage in business together.

According to the court, a plaintiff can plead the existence of a partnership by making specific factual allegations demonstrating:

- The right of the purported partners to participate in the management of the business.
- The sharing of profits and losses among the purported partners.
- Contributions of money, property or services by the purported partners to the partnership.

Taking the *bZx DAO* plaintiffs’ allegations as true (as the court was required to do at the pleading stage), the court concluded that the plaintiffs had properly alleged each of these factors with respect to the *bZx DAO* — specifically, that it was an association of two or more persons (the token holders and the investors) that generated profits through the Protocol’s alleged margin trading and lending products. The court also held that the plaintiffs adequately pleaded co-ownership through the governance rights that came with ownership of the *BZRX* tokens.

The court rejected the argument of certain defendants that *BZRX* token holders only possess “limited governance rights relating to a narrow set of parameters of the protocol.” According to the court, a partnership can still exist when individual partners only control a part of the enterprise.

The court also rejected the argument that the complaint merely “speculated” that *BZRX* token holders could share in the profits, concluding instead that allegations in the complaint that token holders had the right to vote to distribute *DAO* treasury assets to token holders was akin to how corporations authorize dividends, and therefore sufficient.

The court also took judicial notice of the *CFTC*’s finding that the *bZx Protocol* liquidity pool’s assets were supplied by liquidity providers who, in exchange, had received interest-generating tokens as well as *BZRX* tokens. According to the court, this reinforced the *bZx DAO* complaint’s allegations that token holders can share in the *DAO*’s profits either by voting to distribute treasury assets among themselves or via an interest-generating token.

The court similarly rejected the argument of certain defendants that the plaintiffs had failed to allege that *BZRX* token holders had agreed to share any losses, concluding that an agreement to divide profits implied an agreement to also divide losses.

The court also rejected the defendants’ policy argument that finding that every *BZRX* token holder could be a co-owner of a business with unlimited personal liability for losses would constitute a “radical expansion and alteration of long-standing principles of partnership law.”

Here, the court focused on statements by the *bZx Protocol* developers that creation of a *DAO* would insulate the Protocol “from regulatory oversight and accountability for compliance with U.S. law,” a point the *CFTC* had focused on as well. Citing California precedent, the court noted that attempts to take on the advantages of a partnership without the corresponding liabilities will be treated as a general partnership.

Being Deemed a General Partner

As noted, in *Ooki DAO*, the *CFTC* had focused on whether individual *DAO* members had actually voted, using their tokens as the test for whether an individual could be liable for the *DAO*’s liabilities. Here, the court allowed to survive the plaintiffs’ claim that merely holding a *BZRX* token made a person a partner in the partnership, and that plaintiffs had, with respect to most defendants, either directly alleged such token ownership or had alleged participation in decision-making (which created a reasonable inference of token ownership).

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

The court found that no such allegations were made with respect to Leveragebox LLC or bZeroX LLC, however, and dismissed the complaint with respect to those defendants.

Do the Plaintiffs Have a Conflict of Interest as Members of the DAO?

In one of the more interesting arguments that could impact future claims against DAOs, the defendants moved to strike the class allegations, arguing that the plaintiffs could not be adequate class representatives since they themselves were BZRX holders. Based on the plaintiffs' own theory of general partnership, the defendants argued that the plaintiffs had a conflict of interest because they were members of the very DAO they were claiming had acted negligently.

The court denied the motion to strike on the ground that there was no evidence, at this stage, to demonstrate that the plaintiffs were BZRX token holders. Citing the wording of the complaint that none of the plaintiffs or proposed class held "meaningful stakes" of BZRX tokens, the court effectively side-stepped the issue by holding that no "meaningful stake" could be interpreted to mean the named plaintiffs held zero BZRX tokens, and therefore the conflict was not evident. The court did state that the defendants could renew their motion if the fact of the plaintiffs' holdings was established.

Takeaways

The *bZx DAO* opinion is not binding on any other court or judge. It nevertheless creates case law supporting the notion, albeit only in the context of a motion to dismiss, that the manner in which a DAO operates can constitute a general partnership under California law.

The fact that the court held that allegations of mere ownership of governance tokens — whether they were used to vote or not — is sufficient to overcome a motion to dismiss, is notable, and DAO governance token holders should consider its potential importance.

Whether this decision causes more DAO members to seek to impose a corporate structure, such as an LLC under the "DAO LLC" laws of Tennessee, Wyoming, Vermont or Utah, remains to be seen. And the question remains whether the court would reach a different result if it turns out that the named plaintiffs hold BZRX tokens. That could mean those plaintiffs are fatally conflicted from pursuing their claims, as they would effectively be both plaintiffs and defendants under their theory of the case.