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The Impact of DAOs on Corporate Law: An Analysis of DAO Frameworks and Potential Legal Implications

Rebecca Gonzalez
University of San Francisco, rgonzalez26@usfca.edu

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University of San Francisco, School of Law

Rgonzalez26@usfca.edu

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INTRODUCTION

Blockchain technology has the potential to revolutionize industries, including the way business organizations are conducted. However, the legal implications of this technology are not yet fully known. The decentralized nature of blockchain technology led to the creation of decentralized autonomous organizations ("DAOs") that are run by a set of rules encoded into smart contracts. This thesis analyzes how DAOs have contributed to the developments in corporate governance– which has evolved from structures such as general partnerships and limited liability companies to the newest form, the DAO LLC; regulatory issues emanating from DAOs; and tensions between regulation and blockchain technology developments in corporate law. This paper reviews enforcement actions taken by the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") and compares the developments in blockchain regulation to a seminal corporate law case, Enron, which led to federal regulations for corporations and markets.

Section I of the paper provides an overview of blockchain technology and DAOs. Section II discusses various business organizations and the legal implications of DAOs with respect to organizational structures. Section III lays out developments of regulation of DAOS by the CFTC and SEC. Section IV draws comparisons between the development of regulations following Enron to those developing in response to the recent FTX scandal. Finally, section V discusses a proposal for a federal regulatory agency that oversees blockchain organizations.

I. BLOCKCHAIN OVERVIEW

Blockchain

A blockchain is a sharable and immutable ledger that makes transactions and computations between systems easier and more secure and tracks assets across the business world.[1] Generally, it can be defined as a digital registry whose entries are joined in a

[1]Joseph Thachil George, *Introducing Blockchain Applications, (2022).*

series/chains of “blocks” and strung together in sequential order, and whose integrity is ensured using cryptography.[2] Hence the name ‘blockchain.’The majority of blockchains are decentralized distributed networks that validate new transactions with a collective consensus algorithm. Transactions contain new information pertaining to which accounts in the ledger should be debited and which accounts should be credited. For example, when one user wants to send cryptocurrency to another user, miners collect the broadcasted information in a new “candidate” block.[3] It is transparent and immutable: anyone can view the blockchain at any time, because it resides on the network; and, it is unchangeable such that its contents, once written, cannot usually be altered or deleted without the entire architecture being invalidated.[4]

DAOs

A DAO is an organization that operates on blockchain software and is controlled by members who have invested in it.[5] DAOs connect people with shared economic or social missions by leveraging blockchain protocols. Protocols are rules which govern the functioning of a blockchain. A DAO is made of a collection of individuals organized around the decentralized autonomous functioning, transparency, and democratic principles.[6] DAO consists of any individual who votes on or obtains tokens from the DAO. A token is a transferable unit of value issued on top of a blockchain. For many DAOs, members are pseudoanonymous: token holders remain anonymous and are identified only by their wallet addresses.[7]

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[2] Id.
[3] Id.
[4] Id.
[5] Ghavi, A. *et al.* (2022) *A Primer on Daos*, *The Harvard Law School Forum on Corporate Governance*.
[6] Id.
[7] Gilbert, A. (2022) *Decentralized Autonomous Organizations: The new llcs?*, *Bloomberg Law.* Available at https://news.bloomberglaw.com/securities-law/decentralized-autonomous-organizations-the-new-llcs (Accessed: April 14, 2023).

DAO management is decentralized without top executive teams and built on automated rules encoded in smart contracts. Their governance works autonomously based on a combination of on-chain and off-chain mechanisms that support community decision-making. DAOs differ from hierarchical organizations because they do not have executive boards and CEOs who decide for everyone else; rather, the entire peer to peer community of contributors proposes, votes, and decides. In DAOs, all members can participate in collective decision-making and investment decisions. The investors are cryptocurrency holders that invest in DAOs and become members. When they invest cryptocurrencies on the DAO, they receive DAO tokens as a means to access to given functions (e.g., voting, exchange, propose changes) within the DAOs. The investors become contributors when they vote and validate the whitepapers and work on developing the DAOs' purposes through different activities and novel proposals. They are active contributors to the DAO governance and collective decision-making, mainly through off-chain governance mechanisms, such as voting, discussing the proposals, proposing new actions.

Machine governance (on-chain) includes consensus mechanisms, smart contracts and intelligent matching. For example, in a token-based quorum, a proposal is voted on and in order to pass a certain number of DAO members must participate in the voting process. If the threshold has been met,the decision that has received the most votes wins.[8] In a permission relative majority DAO voting mechanism, the key factor is how many voters have voted ‘for’ and ‘against’ a proposal. There is no minimum voting requirement, and even one member can be the sole participator in the decision-making.[9]

DAOs serve various purposes, such as fundraising and organizing a project. Common DAO projects have included supporting charities, providing seed funding for start-ups,

[8]Limechain Tech, DAO Voting Mechanisms Explained, (2022).
[9]Id.

facilitating software development , managing decentralized protocols, coordinating social activities, and buying artwork and historical facts.[10]

Interest and involvement in DAOs have marginally increased since they began in 2020. In 2021, the total value of crypto funds held in DAO treasuries reportedly surged from $400 million to $16 billion, and the number of holders of interests in DAOs rose from just 13,000 to 1.6 million.[11] According to SnapShot Labs, a voting platform for DAOs that also provides analytic data, the number of DAOs increased from about 700 in May 2021 to about 6,000 as of June 2022.[12]

A DAO can be a helpful alternative to traditional institutions because they potentially eliminate certain burdensome issues related to third-party intermediaries and principal-agent problems. A decentralized database does not depend on a specific organization or administrator but is distributed among all peers.[13] DAOs are essentially functioning in a total democracy where all peers take part in the decision making. The blockchain provides transparency with respect to what money has come in and where the money goes. If the data-base is modified the information saved by all nodes will be noticed. [14]

Challenges to New DAOs

Two kinds of legal challenges have emerged: uncertainty as to which laws apply to DAO activity and membership, and the need for protection from bad actors.

The first DAO participants focused on revolutionizing group organization by using blockchain technology. They often ignored possible regulatory requirements and the potential need thereof. The new digital space has involved unprecedented interactions and transactions

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[10] Neitz, Michele, Intro to DAOs Class Lecture, Blockchain Tech and the Law, USF School of Law (Feb. 6, 2023).
[11] Ghavi, A. *et al.* (2022) *A Primer on Daos*, *The Harvard Law School Forum on Corporate Governance*.
[12] Id.
[13] Zheng, Z. et al (2021) From Technology to Society: An Overview of Blockchain-based DAO.
[14] Id.

which made it a mystery as to which laws to comply with. Additionally, the lack of legal definitions for blockchain technology contributed to the enigma as to what regulatory bodies and regulations governed blockchain usage. Finally, the novelty of the technology created uncertainty for users, contributors, and service providers as to what protective standards to set within the industry.

Emerging industries have the potential to promise new opportunities for gain. However, when industries emerge and evolve faster than the government anticipates, there is the risk that current government regulations do not provide specific protections that encompass the nuances of the new industry. When government regulation is lacking, bad actors can emerge. While nefarious activities on specifically the blockchain may be novel – as discussed below– the development of business organizations and subsequent regulations of such organizations shows that this is no new phenomenon. This compounds legal uncertainties presented by the development of blockchain technology and DAOs. To understand the legal implications stemming from DAO participation and how the exploitation of blockchain technology has been dealt with by regulation by enforcement, this paper will first lay out the foundation of corporate structures, then it will discuss seminal cases in corporate law leading to federal oversight and recent blockhain cases.

II. BUSINESS ENTITY GOVERNANCE

General Partnerships

Under the terms of the Uniform Partnership Act (1914) ("UPA"), of which many state laws are based, a partnership is "an association of two or more persons to carry on as co-owners of a business for profit.[15] Under the Revised Uniform Partnership Act (1997) ("RUPA"), a partnership is "an association of two or more persons to carry on as co-owners a business for

[15] Uniform Partnership Act (1914) § 6(1).

profit formed under Section 202, predecessor law, or comparable law of another jurisdiction."[16] Implied, among other things, is that the partnership may continue as the same entity even if some partners dissociate or new partners join.

In a general partnership, each partner is individually liable for partnership obligations and partners share equally in profits and losses.[17]A general partnership is built on consent or it can be inferred without a formal agreement.[18] Once a partnership is inferred, fiduciary duties emerge. Individuals acting together to meet a common objective may result in a partnership being formed.[19] If a person receives a share of a business's profits, it is prima facie evidence that a person is a partner in a business, unless the payment is wages.[20] Evidence of a partnership can also include sharing business responsibilities, input of capital, common ownership of property, and decision making powers.[21]

A DAO, as demonstrated in its original form, is an unincorporated general partnership. DAOs function with no physical headquarters, no place of business, and no bank account. DAOs function without directors, hired managers, leaders, or employees. However, due to the collaborative and goal oriented nature of DAOs, they are susceptible to the classification of an implied general partnership –therefore subject to the liabilities such organizations are ascribed. An individual who inputs capital by token could be considered a partner. Moreover, an individual who participates by voting in a DAO is also eligible for a general partner classification. Member involvement is precarious as there could be no limit to the liability between members, and each

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[16] RUPA § 201(a).
[17] Williams, A. et al, Commentaries and Cases on the Law of Business Organization
[18] Id.
[19] Id.
[20] Vohland v. Sweet, 433 N.E.2d 860 (Ct. App. 1982)
[21] Williams, A. et al, Commentaries and Cases on the Law of Business Organization, Personal Liability and the Nature of Partnership Property.

member can potentially be held jointly and severally liable for the acts of any of the other members.

Since DAO organization is novel and its functions are still unraveling, legal minds oscillate on such classifications. Courts have found that DAO participants are implied general partners. However, one could argue that the classification of DAO membership as a general partnership is not quite a close enough fit, moreover, determining that a DAO is a general partnership can create issues with respect to litigation. For example, questions such as who shall receive service of process or how can individual defendants even be identified when there are potential millions of anonymous participants. In deciding what laws to apply, notions of justice and fairness may be at play, since it would be unfair to hold someone liable if all they have done was receive a token via airdrop or perhaps even voted contra an initiative that resulted in the legal action against the organization.

Legal Wrappers

A formal legal wrapper is often required in order to limit legal risks to members and to protect them from liability or damages caused by the DAO or other members.[22] Thus, DAO members should become aware of choices of business entities and their respective protections and ascribed obligations. Some states, such as Wyoming, have already recognized a business entity type specifically for DAOs.[23]

In organizing and operating a business, owners may choose a variety of forms. The major choices are corporations, partnerships (discussed above), limited partnerships, sole proprietorships and limited liability companies. Factors that often influence the choice are the

[22]Seira, R. Brummer, C, (2022) DAO Strategy and Legal Wrappers
[23] Id.

need for limited liability, free transferability of interests, continuity of existence, centralized management, costs, access to capital and taxation.[24]

Limited Partnerships and LLCs

A limited partnership is a business organization which provides partnership-style tax treatment and limited liability for some owners as limited partners. Unlike corporate shareholders who can serve as officers and directors and still have limited liability, if a limited partner gets involved in the control of the limited partnership she may lose limited liability.[25] Unlike the general partnership, it is created by compliance with state law which includes paying of fees and the filing of the articles of corporations and will not be inferred.[26]

The Limited Liability Company ("LLC") seeks to combine the most sought-after features of a corporation with those of a partnership. Unlike limited partnership law, LLC law permits unlimited participation in the business by some or all the owners, seen as another advantage to the LLC form of entity. A practitioner forms an LLC by filing a brief document, sometimes known as the articles of organization, with a state official, often the secretary of state. The operating agreement contains governance provisions and financial provisions. As to legal issues, courts often employ many analogies to corporate law, for example, fiduciary duties owed and piercing the veil of limited liability.

DAO LLC

Currently, only Wyoming, Tennessee, and Vermont specifically allow for DAOS to be formed as species of an LLC.[27] The Wyoming DAO LLC is a relatively new type of entity introduced in March 2021 by the passing of a DAO Supplement in the Wyoming senate.[28] A

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[24] Id.
[25] U.P.A. §31(1)(b)(1914)
[26] 48
[27] Andrew Gilbert, DECENTRALIZED AUTONOMOUS ORGANIZATIONS: THE NEW LLCS? BLOOMBERG LAW (2022)
[28] Taras Zharun, WYOMING LLC AS A DAO LEGAL WRAPPER: WHAT YOU NEED TO KNOW LEGAL NODES - VIRTUAL LEGAL OFFICERS

DAO LLC needs to have a statement that the company is a DAO in its articles of organization, in order to be considered a DAO LLC under the DAO Supplement.[29] A DAO LLC helps to protect DAO members from unlimited liability for any of the DAO's actions.[30]

The DAO LLC poses many advantages for DAOs such as easy and inexpensive establishment process and limitation of liability to participants. However, a DAO LLC formed under Wyoming laws will have to dissolve if the DAO failed to approve any proposals or take any actions in a one-year period.[31] This may not be suitable for DAOS that don't vote on decisions that often. Additionally, the Corporate Transparency Act that applies to all LLCs will also apply to a DAO LLC in Wyoming,[32]so a DAO will have limitations on preserving the anonymity of its members.

Corporations and Securities

In forming a corporation, at least one person must act as the incorporator.[33] She is responsible for filing the articles of incorporation, usually with the secretary of state. Upon acceptance of the articles of incorporation by state officials, corporate existence commences. Once the corporation exists, all further actions on the corporation's behalf must be taken by the incorporator, such as adopting a set of bylaws, holding initial shareholders and directors meetings, arranging the election of directors and officers, opening a bank account for the corporation, issuing shares.

Corporations may issue securities that can be broadly described as debt, common and preferred shares. Generally, each security carries with it attributes relating to (1) the risk of loss on investment, (2) the power to control the business, and (3) the ability to share in the success of

[29] Id.
[30] Id.
[31] Id
[32] Id. See also Committee on Financial Services, Corporate transparency act of 2019.
[33] Model Business Corporation Act: Official text with official comments and statutory cross-references (1999).

the enterprise. Corporations which have a class of equity securities held by 500 or more persons and over $10 million in assets must register with the SEC and in doing so, commence governance by provisions of the Securities Exchange Act of 1934.[34]

The virtual and decentralized nature of blockchain technology has made traditional legal frameworks less than compatible. This has demanded that lawyers use imaginative thinking in order to create frameworks that meet the objectives of users and organizers of blockchain entities. The DAO LLC is an example of how blockchain technology has webbed itself into the ever evolving world of corporations and poses an opportunity for serious innovation in corporate governance.

III. REGULATION OF DAOS

Decentralized cryptocurrencies can be used in several applications such as transferring money, recording data, and investing. However, decentralized cryptocurrencies do not yet have a specific legal entity that is responsible for consumer protection. Due to recent incidents of fraud and hacking which have led to demand for consumer protection, regulators have been prompted to engage in creating and enforcing laws on blockchain technology. Currently, there is a tension point between DAOs and state and federal regulators due to the lack of regulatory cohesion. The federal agencies that have led the way in DAO regulations are the SEC and the CFTC.

Triggers to Enforcement

Due to the diversity of use cases, regulatory bodies in the United States have responded with patchwork regulations in an attempt to provide consumer protection. For example, the question of how to legally treat virtual currency is being determined independently by each agency.

Specific Challenges to DAO Enforcement

[34]Committee on Banking and Currency., Securities exchange act of 1934 (1954).

Several key challenges exist for regulators, including establishing which agency has authority over the industry. Authority between the SEC and CFTC lands on whether the tokens involved are classified as a commodity or security.

The Commodity Futures Trading Commission (CFTC) is a regulatory agency in the United States that is responsible for overseeing and regulating the commodity futures and options markets. The CFTC has the authority to regulate a wide range of financial instruments and activities. The CFTC has stated that virtual currencies– including those used in DAOs– are considered commodities and therefore fall under the CFTC's regulatory jurisdiction. When analyzing commodities like gold or silver, courts hold that those minerals are not securities because their value depends on market forces, not efforts of others.[35] Likewise, the value of a token hinges only on the market's appreciation of the value of the token. The CFTC reinforces this in *re Coinflip*, in which the commission asserted that virtual currencies, including bitcoin, are commodities under the Commodities Exchange Act. [36]

SEC Regulation

The U.S. Securities and Exchange Commission (SEC) has made several attempts to regulate cryptocurrency to protect investors and prevent fraudulent activity in the crypto space. Some of the ways the SEC has attempted to regulate cryptocurrency include the classification of cryptocurrencies, enforcement actions, registration requirements, investor education, and clarification of regulations. Overall, the SEC's attempts to regulate cryptocurrency have been aimed at protecting investors and ensuring that companies and individuals operating in the crypto space comply with federal securities laws.

[35] S.E.C v. Reynolds Enterprise Inc., 952 F2d at 1135 (US. Ct. App. 1991)
[36] *In re* Coinflip, Inc., CFTC No. 15-29, at 3

For the SEC to bring cryptocurrencies within its jurisdiction, it must show that a particular cryptocurrency is a security as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act).[37] The Securities Act defines a security as "any note, stock … [or] investment contract.[38]

In 2019, the U.S. Securities and Exchange Commission (SEC) released a statement, titled "Framework for 'Investment Contract' Analysis of Digital Assets."[39] The statement provides a framework for analyzing whether digital assets, including cryptocurrencies, qualify as securities under federal securities laws. According to this framework, if a cryptocurrency meets certain criteria, such as being marketed as an investment, it will be considered a security and fall under the SEC's jurisdiction. The framework provides a guide to help market participants determine whether a particular digital asset is an investment contract and thus a security.

According to the SEC's framework, a digital asset may be considered a security if it meets all of the four prongs of the Howey Test adopted by the Supreme Court: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) solely from the efforts of others.[40]

The framework outlines additional factors that the SEC will consider in determining whether a digital asset is a security, such as the distribution of the digital asset and the nature of the underlying blockchain or network.The SEC's framework is intended to provide greater clarity and guidance to market participants on how to comply with federal securities laws when dealing with digital assets. However, it is important to note that the framework is not a formal rule or regulation and does not have the force of law.

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[37]Securities exchange act of 1934 (1954).
[38] Neil Tiwari, The Commodification of Cryptocurrency, 117 Mich. L. Rev. 611, 619 (2018).
[39]Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019).
[40] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); see also SEC v. Edwards, 540 U.S. 389, 393 (2004).

Enforcement actions -SEC

The SEC has also taken legal action against several companies that have conducted initial coin offerings (ICOs) without complying with federal securities laws. The SEC has also filed lawsuits against individuals and entities engaged in fraudulent activities, such as Ponzi schemes, related to cryptocurrencies. For example, in November 2018, the SEC settled charges against Paragon Coin Inc. for conducting an unregistered ICO that raised approximately $12 million.[41] Paragon agreed to register its tokens as securities, pay a $250,000 penalty, and file periodic reports with the SEC. In September 2019, the SEC settled charges against Block.one, the company behind the EOS cryptocurrency, for conducting an unregistered ICO that raised over $4 billion. Block.one agreed to pay a $24 million penalty and register its tokens as securities.[42] In June 2020, the SEC obtained a final judgment against Kik Interactive Inc. for conducting an unregistered ICO that raised approximately $100 million. The court ruled that Kik's tokens were securities, and ordered Kik to pay a $5 million penalty.[43] In December 2020, the SEC filed a complaint against Ripple Labs Inc. and two of its executives, alleging that they conducted an unregistered securities offering of XRP, a cryptocurrency developed by Ripple.[44] The case is ongoing.

More recently, in December 2021 the SEC filed a complaint against BitConnect and its founder, alleging that they conducted an unregistered securities offering and defrauded investors of approximately $2 billion.[45] The case is ongoing. In November 2021, the SEC settled charges

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[41] Press Release, SEC, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities, (2018) (on file with author).
[42]Press Release, SEC, SEC Orders Blockchain Company to Pay $24 Million Penalty for Unregistered ICO, (2019 (on file with author).).
[43] Press Release, SEC Obtains Final Judgement Against Kik Interactive For Unregistered Offering (2020) (on file with author).
[44] Press Release, SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering (2020) (on file with author).
[45] Complaint at 2, SEC v. Bitconnect , Kumbhani, and Future Money LTD (S.D.N.Y 2021)(No 21 CV. 7349).

against Poloniex LLC for operating an unregistered digital asset exchange and for failing to implement required anti-money laundering procedures.[46] Poloniex agreed to pay a $10 million penalty and to disgorge over $1.4 million in profits. In September 2021, the SEC filed a complaint against Loci Inc. for conducting an unregistered ICO that raised approximately $7.6 million.[47] In August 2021, the SEC settled charges against Coinschedule Ltd. for promoting and offering ICOs without disclosing that it received compensation from the issuers. Coinschedule agreed to pay a $154,434 penalty.[48]

This litany of recent cases demonstrate the SEC's continued focus on enforcing federal securities laws in the digital asset space, particularly in the context of ICOs and unregistered digital asset offerings. The SEC has made it clear that it will continue to take legal action against companies and individuals that violate securities laws.

The DAO Report

The DAO Report released by the SEC recognizes DAOs as virtual organizations embodied in computer code and executed on a blockchain.[49] The SEC investigated the first DAO, created by Slock.it, which raised funds through the sale of tokens to investors. The holders of the DAO tokens stood to share in the anticipated earnings from these projects as a return on their investment in the tokens, and Slock.it's co-founders and others provided the opportunity for DAO Token holders to have their investment returned to them. [50] As a result of the investigation, the Commission determined that the *DAO Tokens* were securities under the Securities Act and the Exchange Act.[51] Thus, the SEC effectively stated that it– rather than the CFTC– has jurisdiction over regulation of DAOS.

[46] Press Release, SEC, SEC Charges Poloniex for Operating Unregistered Digital Assets Exchange (2021).
[47] Press Release, SEC Charges ICO Issuer and CEO with Fraud and Unregistered Securities Offering (2021).
[48] Press Release, ICO "Listing" Website Charged With Unlawfully Touting Digital Asset Securities (2021).
[49] Rep. of Investigation Pursuant to Section 21(a) of the Sec. Exch. Act of 1934: The Dao, Release No. 81207 (July 25, 2017)
[50] Id.
[51] Id.(emphasis added)

Enforcement Actions-CFTC

In its first enforcement actions taken by the CFTC with respect to Bitcoin transactions, in 2015, the CFTC declared that Bitcoin and other virtual currencies are properly defined as commodities under the Commodity Exchange Act (CEA) and subject to the CFTC's regulatory oversight. [52]

Thereafter, the CFTC also took enforcement action against individuals and companies that engaged in fraudulent or deceptive practices in the virtual currency space involving DAOs. In 2017, the CFTC filed a lawsuit against a company called Gelfman Blueprint, Inc. for running a Ponzi scheme involving virtual currency, including transactions conducted through a DAO.[53] The CFTC stated that American retail investors can buy leveraged or margin-dependent derivative products on a *regulated* exchange but not outside of an exchange. [54]

According to Section 1a(9) of the Commodity Exchange Act (CEA), a commodity is defined as "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.[55]" If virtual currencies are commodities, subject to CFTC regulation by the CFTC, then they cannot also be securities regulated by the SEC. As described above, the distinction between securities and commodities is a case by case fact based inquiry–at the moment.

Ooki DAO

Natural persons and legal entities are potentially jointly and severally liable for all of a DAO's violations of the Commodity Exchange Act (CEA) and CFTC regulations if they

[52] *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29.* 2015 WL 5535736 (Sept. 17, 2015)
[53] CFTC Charges Nicholas Gelfman and Gelfman Blueprint, Inc. with Fraudulent Solicitations, Misappropriation, and Issuing False Account Statements in Bitcoin Ponzi Scheme (September 21, 2017).
[54] Scott D. Hughes, Cryptocurrency Regulations and Enforcement in the U.S., 45 W. St. L. Rev. 1, 13 (2017)
[55] 7 U.S. Code §1(a)

participate in the governance of the DAO through voting of the DAO's governance tokens charged the CFTC in two related enforcement actions filed on September 22.

The CEA furnishes four bases for individual liability: (1) individuals commit the violations themselves, (ii) they control the person who committed the violation, (iii) they are the principal of an agent who committed the violation, or (iv) they aid and abet the violation. Recently, the CFTC charged “voting members” of the Ooki DAO for its violations of the CEA and CFTC regulations by facilitating margined and leveraged retail commodity transactions.[56]

Ooki DAO– originally BZeroX–was a decentralized finance (“DeFi”) protocol that allowed users to contribute margin (collateral) to open leveraged positions whose ultimate value was determined by the price difference between two digital assets from the time the position was established to the time it was closed.[57] The Ooki DAO was ultimately exploited by hackers. BZeroX was a centralized organization with two operators (Tom Bean and Kyle Kistner) and its business was then transferred to a DAO, with many operators.[58]

The CFTC asserted that these transactions were unlawful because they were required to take place on a designated contract market.[59] Additionally, it asserted that bZeroX illegally operated as an unregistered futures commission merchant (“FCM").[60]

In response to the allegations, the court was presented with the questions whether and how Ooki DAO could be sued; whether the Ooki DAO had the capacity to be sued; and whether it was properly served in that capacity.[61]

On the same day that the CFTC filed the lawsuit, it reached a settlement with bZeroX, LLC founders Bean and Kistner for offering margined commodity trading in digital assets

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[56] CFTC Complaint CFTC v. Ooki DAO, et all (N.D.Cal.) (No 3:22-cv-5416)
[57] Id
[58] Id.
[59] CFTC Complaint CFTC v. Ooki DAO, et all (N.D.Cal.) (No 3:22-cv-5416)
[60] Id.
[61] David Zaslowsky, The Ooki Dao Lawsuit, Baker McKenzie (Jan. 3, 2023), The Ooki Dao Lawsuit - Blockchain

without registering, and failing to adopt a customer identification program as part of a Bank Secrecy Act compliance program.[62] Thus, in the lawsuit against Ooki Dao, it was essentially being charged with the same violations as the settling respondents.

In a recent motion to dismiss, the movants argued that Ooki DAO could not be sued and contended that Ooki DAO is a technology, not an entity or group of persons, and so suing it is akin to sueing any other technology, or like trying to hold "the internet" liable. The court disagreed, at least with respect to the specific facts of this case.[63]

The CFTC argued that Ooki DAO is an unincorporated association comprised of Token Holders that used ("voted") their tokens to "govern" the protocol. BZeroX LLC had "Administrator Keys" which allowed bZeroX to "access and control" the operation of the smart contracts and the funds held in those smart contracts. When control of the software transitioned to Ooki DAO, according to the CFTC, control of those Keys transitioned to Token Holders. Those Token Holders comprise Ooki DAO, and it is their actions and choices taken on behalf of the DAO that the CFTC is seeking to hold liable.

The Ooki DAO complaint relied on the novel and untested legal theory that all the Ooki DAO's token-holders who voted for the operation of the protocol should be held liable for violations of various federal statutes. [64]The movants argued that Ooki DAO is not subject to suit under the Commodity Exchange Act because it is not a person or unincorporated association and that the CFTC must instead pursue its claims against individuals."[65]

With regard to service of process, the court determined that there were several reasons to conclude that the CFTC sufficiently alleged, for purposes of their service of process motion, that

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[62] David Zaslowsky, The Ooki Dao Lawsuit, Baker McKenzie (Jan. 3, 2023)
[63] Id.
[64] Nag Young Chu, CFTC Charges Against Ooki DAO Could Have Significant Implications for DAOS (OCt. 13, 2022), Winston & Strawn LLP. CFTC's Charges Against Ooki DAO Could Have Significant Implications for DAOs
[65] Id.

Ooki DAO is an unincorporated association under state la2.[66] First, the CFTC showed that Ooki DAO is a "group of two or more persons" because it is comprised of individual Token Holders, who are real persons.[67] Second, the CFTC sufficiently showed that two or more persons joined Ooki DAO "by mutual consent." Third, the CFTC sufficiently demonstrated that Ooki DAO has a "common lawful purpose."[68] The court reasoned that Token Holders own tokens that can be used to vote on certain governance decisions, which may include pausing or suspending trading, making changes to the software protocol, distributing funds from the central Treasury, or choosing to rebrand the DAO.[69] The common purpose is governing the DAO, particularly through the use and distribution of funds from its central Treasury. Finally, the CFTC sufficiently showed, for the purposes of capacity, that Ooki DAO "function[s] under a common name under circumstances where fairness requires the group be recognized as a legal entity." For all these reasons, the court held that Ooki DAO had the capacity to be sued as an unincorporated association under state law.[70]

The consequence of this decision subjects members to much more liability than they may have intended in deciding to participate in the DAO. The imposition of liability amongst partners in a general partnership can be traced back to the decision in *National Biscuit Company v. Stroud,* where the Supreme Court of North Carolina held that a general partner could be liable for purchase of bread by a food store operated by two partners. This was because the purchase was an ordinary matter connected with partnership business within the UPA –which provided that any difference arising as to ordinary matters connected with partnership business may be decided by the majority of partners. Although the partner told the bread seller he would not be personally

[66] Id.
[67] Id.
[68] Id.
[69] Id.
[70] David Zaslowsky, The Ooki Dao Lawsuit, Baker McKenzie (Jan. 3, 2023).

responsible for additional bread sold to the store, partner and partnership were liable for such purchase by a copartner.[71] DAO participation, as we have seen, is not always so simple. Members can participate on one decision and never participate in another vote again. Or, a member can vote against an initiative that wins the majority vote. So, the question is whether it is fair to hold members liable in canonical general partner form?

If *National Biscuit Co.* is applied, the answer would likely be yes. There, the court explained that activities within the scope of the business will not be limited unless by a majority decision on a disputed question.[72] Essentially, the court held that minority voters on a matter may still be held liable for the decision of the majority vote. Accordingly, pursuant to *National Biscuit Co.*, even minority voters in the Ooki DAO can be held liable for the DAO.

The suggestion that holding and voting DAO tokens is a sufficient basis for personal liability for the actions of the DAO, however, has been criticized as being pervasive and far reaching. Commissioner Summer K. Mersinger issued a dissenting opinion to an enforcement action stating that the CFTC order "arbitrarily" defines an unincorporated association as token holders who *exercise* their voting rights (as opposed to those who do not vote) and may have the chilling effect of discouraging voting participation, which could undermine proper governance and compliance. [73]

If the court agrees with the CFTC, the decision could have significant implications for DAOs. Specifically, it would enable the CFTC–and other regulators like the SEC– to hold individuals personally liable for voting in DAO decisions, even if they are minority voters. Additionally, DAOs themselves may be compelled to register with the CFTC. An adverse

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[71] Nat'l Biscuit Co. v. Stroud, 249 N.C. 467, 106 S.E.2d 692 (1959)
[72] Nat'l Biscuit Co. v. Stroud, 249 N.C. 467, 471, 106 S.E.2d 692, 695 (1959) See also (Crane on Partnership, 2d Ed., p. 277)
[73] Supra

decision in this case could curtail the appeal of organization via a DAO. This would either hamper a potentially revolutionary form of business organization or incentivize DAO formation offshores.

IV. DEVELOPMENT OF REGULATIONS IN CORPORATE LAW AND COMPARISONS TO RECENT BLOCKCHAIN CASES

Enron Scandal

The Enron Corporation was an American energy, commodities, and services company based in Houston, Texas. The company was formed in 1985 by the merger of Houston Natural Gas and InterNorth, and through diversification, transformed itself into a trading enterprise in various forms of highly complex transactions.[74] It quickly became one of the largest companies in the world. However, in 2001, the company's financial scandal was revealed, which was one of the biggest corporate fraud cases in history.[75] The company's executives, particularly its CEO, were found to have been involved in a number of illegal activities, such as insider trading, accounting fraud, and manipulation of the company's financial statements. Enron's financial statements were found to have been heavily inflated, and the company's true financial condition was hidden from investors and the public. As a result, the company's stock price collapsed, and it was forced to file for bankruptcy. Many of the company's executives, including its CEO, were charged with criminal offenses and many of them were convicted and sent to prison. [76]

A dramatic change in approach to corporate board composition, conduct, and responsibility has occurred at the legal and regulatory levels, largely in response to a perceived failure by the Enron Board to have prevented management conduct that led to the company's downfall.[77] The scandal had a significant impact on the industry, leading to the Sarbanes-Oxley

[74] Peregrine, Michael & Elson, Charles,Twenty Years Later: The Lasting Lessons of Enron, Harvard Law School Forum on Corporate Governance (2021)
[75] Id.
[76] Supra
[77] Elson, Charles &Gyves, Christopher, The Enron Failure and Corporate Governance Reform, 38 Wake Forest L. Rev. 855, 856 (2003)

Act, which imposed new regulations on public companies and accounting firms.[78] The scandal also led to the loss of jobs and retirement savings for thousands of employees and shareholders.[79]

The Sarbanes-Oxley Act imposed new requirements and obligations on publicly traded companies, auditors, and corporate executives.[80] The Act established the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of public companies and to enforce professional auditing standards. [81]Additionally it required that companies disclose their internal financial controls and that auditors attest to the effectiveness of those controls. [82]The Act prohibited certain types of non-audit services provided by auditors to their audit clients. The Act included the requirement that corporate executives certify the accuracy of financial statements and the effectiveness of internal controls. Finally, the Act imposed new criminal penalties for corporate fraud and obstruction of justice.[83]

The response from corporations to Sarbanes Oxley was generally mixed. Some corporations welcomed the increased transparency and accountability, while others felt that the increased compliance costs were burdensome.[84] The law resulted in increased spending on accounting and legal services, as well as increased complexity in financial reporting. Despite criticisms, Sarbanes is widely considered to have improved the overall quality and integrity of financial reporting in the US.[85]

Governance Theory

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[78]Peregrine, Michael & Elson, Charles,Twenty Years Later: The Lasting Lessons of Enron, Harvard Law School Forum on Corporate Governance (2021)
[79] Id.
[80] Id.
[81] 15 U.S.C.A. § 7211
[82] 15 U.S.C.A. § 7213
[83] 15 U.S.C.A. § 1350
[84] Peregrine, Michael & Elson, Charles,Twenty Years Later: The Lasting Lessons of Enron, Harvard Law School Forum on Corporate Governance (2021)
[85] Id.

Directors and officers owe the corporation a duty of loyalty by advancing the purposes of the corporation, and not of their own, in good faith. Corporate officers and directors are not permitted to use their position of trust and confidence to further their own private interests.[86] To fulfill their oversight responsibilities effectively while upholding their duty, directors must be independent of management and holders of a personally meaningful equity stake in the enterprise.[87] Independence, which involves the absence of any economic ties to management or the company itself other than equity ownership, provides a director with the distance and objectivity necessary to examine management action in the most effective manner. A lack of independence leads to ineffective monitoring because it makes a director either too comfortable with management and its representations, or due to relational concerns, unable to effectively disengage to objectively review management conduct.[88]

In the corporate world, the primary objective is painlessly unambiguous: senior managers must create corporate value. Legally, the board of directors is expected to actively monitor whether such management is fulfilling the objective for shareholder benefit.[89] Modern governance theory has emphasized the need for a director to hold an equity stake in the corporation, as a way to incentivize directors to meet the objective.[90] The logic is that this will incentive directors to generate profits, because when the corporation is better off, then so are the directors due to the equity stake they hold. Moreover, it allows for directors to remain independent within the definition described above. This approach comes with benefits and pitfalls for companies. On the one hand, it fosters innovation and profit producing results. On the other hand, it tempts business decisions that are adverse to shareholders and it also invites

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[86] Williams, A. et al, Commentaries and Cases on the Law of Business Organization, The Duty of Loyalty: Conflict Transactions

[87] Id.

[88] Elson & Gyves, The Enron Failure and Corporate Governance Reform, (2003)

[89] Williams, A. et al, Commentaries and Cases on the Law of Business Organization, The Corporate Form.

[90] Supra

indifference to injurious impact to social welfare. In the absence of an embedded culture of corporate ethics and compliance, has been and still remains the potential for some executives to pursue "edge of the envelope" business practices, especially when those practices produce meaningful near term financial or other operational results."[91] However, the result of such behavior has in many cases been to the demise of shareholders and investors. Two seminal examples of such are *In re Walt Disney* and the WorldCom scandal in 2002.

In the case *In re Walt Disney*, After the high-profile hiring Michael Ovitz, shareholders brought a derivative suit against the board of directors for a breach of fiduciary duties, when the board approved a 140 million dollar severance package for Ovitz, who was, by then, the former president.[92] The shareholders alleged that the board members had "consciously and intentionally disregarded their responsibilities" with respect to their decision to hire and fire Ovitz.[93] The court ultimately held that the defendants did not breach their fiduciary duties or commit waste, however, the bereavement the decision caused to the shareholders was emphatic and undeniable. The WorldCom scandal was a major accounting scandal that unfolded when Worldcom senior executives hatched a plan to boost earnings by overstating its assets by more than 11 billion dollars.[94] The company booked line cost expenses as capital expenditures, which led to material misstatements in the company's actual profits.[95] Consequently, the SEC charged WorldCom with civil fraud and reached a $2.25 billion settlement. Several executives and the CEO were indicted on charges of securities fraud, conspiracy, and filing false documents with regulators. WorldCom filed for Chapter 11 bankruptcy protection and, in 2006, what remained of the once-mighty

[91] Peregrine & Elson,Twenty Years Later: The Lasting Lessons of Enron, Harvard Law School Forum on Corporate Governance (2021)
[92] In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), (The Delaware Supreme Court affirmed the Court of Chancery's conclusion that the shareholder plaintiffs had failed to prove that the defendants had breached any fiduciary duty.)
[93] Id. at 1, 35
[94] What Went Wrong at WorldCom?, Knowledge at Wharton Staff (2002)
[95] What Went Wrong at WorldCom?, Knowledge at Wharton Staff (2002)

corporation was purchased by Verizon.[96] In both these cases, the corporate culture intended to incentive directors and executives to act for the welfare and gain of shareholders, led to acts that were counter to shareholder's interests and even illegal. The fallibility of this approach has resurfaced in light of the new blockchain frontier within companies that implement blockchain technology.

FTX Scandal

FTX is a cryptocurrency derivatives exchange that was founded by Samuel Bnakman-Fried and his co-founder in 2019, known for its high trading volume and advanced trading features. On December 13, 2022, the Securities and Exchange Commission charged Samuel Bankman-Fried with orchestrating a scheme to defraud equity investors in FTX Trading Ltd. (FTX).[97] According to the SEC's complaint, FTX, based in The Bahamas, raised more than $1.8 billion from equity investors, including approximately $1.1 billion from approximately 90 U.S.-based investors.[98] In his representations to investors, Bankman-Fried promoted FTX as a safe, responsible crypto asset trading platform, specifically touting FTX's sophisticated, automated risk measures to protect customer assets.[99] The complaint alleged that Bankman-Fried engaged in fraudulent behavior by concealing the diversion of FTX customers' funds to his own hedge fund, Alameda Research, as well as providing Alameda with preferential treatment and exemption from risk mitigation measures. The complaint also alleges that FTX was exposed to undisclosed risk due to Alameda's holdings of overvalued and illiquid assets. Additionally, Bankman-Fried was accused of using FTX customers' funds at Alameda to make undisclosed investments, purchase real estate, and make large political donations.[100]

[96] George, Betsy, Fraudulent Accounting and the Downfall of WorldCom, University of South Carolina (2021)
[97] Press Release, SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX (2022)
[98] Id.
[99] Id.
[100] Id.

Comparison of Enron and FTX

The FTX scandal involving the cryptocurrency exchange and its CEO, Sam Bankman-Fried, shares some similarities with the Enron scandal. Both scandals involved fraudulent activities by the executives of the companies, leading to financial misstatements and inflating their stock prices and earnings reports. They also faced legal issues, including criminal charges and fines, and had a significant impact on employees and investors who lost money due to fraudulent activities.

However, there are also significant differences between the FTX scandal and the Enron scandal. The scale of the scandals is different, with Enron being much larger in scale, involving billions of dollars in losses and assets, while the FTX scandal involved millions of dollars.
The regulatory response to the two scandals –this far– has been different. The Enron scandal resulted in the Sarbanes-Oxley Act.[101] The FTX scandal, on the other hand, has led to increased scrutiny of the cryptocurrency industry, but has not yet resulted in significant regulatory changes.

The Evolution of Corporate Governance

Corporate governance has undergone significant changes from the Enron era to the blockchain era. In the Enron era, there was a lack of accountability and transparency in corporate governance practices, which led to the failure of several high-profile companies like Enron. Since then, corporate governance has continued to evolve, and the emergence of blockchain technology has brought about new opportunities and challenges. With the creation of new entity types, such as the DAO LLC, blockchain technology has opened new opportunities for corporate governance. As discussed above, the number of investors in blockchain technology is only rising even in light of the recent events. Because of the increasing interest, the government must no

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[101] see supra

longer take a reactive approach, and must take seriously the fact that blockchain technology is becoming increasingly integrated into the functioning of the world.

Potential Benefits of DAOs

DAOs have the potential to resolve issues of mismanagement by providing increased transparency, accountability, and security in business operations. DAOs provide an opportunity to facilitate secure and transparent communication and collaboration between various stakeholders, including shareholders, regulators, and executives.

A key contribution of DAO protocols to corporate governance is increased transparency. All transactions are recorded and verified by multiple parties, creating an immutable and transparent audit trail. This can help to prevent fraud and corruption by ensuring that all transactions are visible and traceable, which can promote greater accountability and trust between stakeholders. DAOs also have a tamper-proof and secure method of storing and transferring data. This can help to prevent data breaches and cyber attacks, which can have significant financial and reputational impacts on companies.

Similarly, DAOs can provide those same features of increased transparency, accountability, and participation in the decision-making processes of the organization. DAOs have the ability to promote greater participation in decision-making processes. Since DAOs operate on a consensus-based model, where decisions are made based on the agreement of a majority of stakeholders, this can help to promote greater inclusivity and diversity in decision-making, as all stakeholders have an equal voice in the decision-making process.

DAO technology greatly contributes to improving the efficiency of agency relationships and reducing agency costs by an order of magnitude.[102] DAO token holders are not affected by

[102] Zheng, Z. et al (2021) From Technology to Society: An Overview of Blockchain-based DAO

existing corporate hierarchies and its restrictive effect.[103] DAOs can also improve the efficiency of corporate governance by streamlining decision-making processes. Traditional corporate governance models can be slow and cumbersome, as decisions must be made through a hierarchical structure. DAO governance can reduce searching, monitoring, and enforcement costs. In DAO governance, direct connections are not required between collaborators. [104] DAOs can make decisions more quickly and efficiently, as they operate on a decentralized and autonomous model. Because DAOs can seriously contribute to the functioning of corporate governance, regulators should adopt an approach to regulation that encourages DAO participation, rather than discourages it.

Reasons for Regulations of Blockchain Organizations

Despite the potential benefits of DAOs, regulation of the industry is needed. The FTX scandal, like the Enron scandal, has highlighted the potential dangers of neglecting regulation in any industry. As such, there are several reasons why the federal government should respond to the FTX scandal with regulations such as the Sarbanes-Oxley, and should keep these needs (such as preventing future scandals, protecting the public, and protecting consumers) in mind when regulating DAOs. Regulation would benefit from being both forward looking and back looking at history.

The Sarbanes-Oxley Act was created in response to the Enron scandal. The Act established new standards for corporate governance, financial disclosure, and the responsibilities of corporate boards and auditors. Similarly, regulations in response to the FTX scandal can help prevent future scandals by requiring greater transparency and accountability in the blockchain financial industry.

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[103] Id.
[104] Id.

The financial industry plays a crucial role in the economy, and the actions of a few bad actors can have devastating consequences for the public. The FTX scandal has already resulted in significant losses for investors, and if left unchecked, it could lead to a larger financial crisis. Thus, actors should be forward looking when coming up with laws in order to prevent consumer harm before the fact, and avoid after the fact (ie, regulation by enforcement) punishment.

Issues with Regulation by Enforcement

The current patch work regulation by enforcement is proving to be ineffective. Moreover, regulation by enforcement is not helping. What is additionally adverse is the attempt to regulate this new technology with incompatible laws. The government may not have the necessary expertise to regulate DAOs effectively. Therefore, it is necessary that policymakers stay informed about the latest developments in the field and work to ensure that the legal framework keeps pace with the rapidly evolving technology. Lawmakers need to create laws that are not overly aggressive so that DAOs are not pushed to organize offshores where there are less restrictive regulations. For example, to avoid having to comply with US securities laws, many DAOs have chosen to organize offshore in places like the Cayman Islands where corporate regulations are more lax and tax impacts are limited as compared to US jurisdictions.[105]

This lack of understanding of DAO functioning and purposes could lead to poorly designed regulations that may have unintended consequences. Overregulation of blockchain technology could stifle innovation and discourage investment in the industry. Overregulation of blockchain technology could have unintended consequences, such as driving the industry overseas or encouraging the development of alternative technologies that are more difficult to regulate.

V. PROPOSAL

[105]Gilbert, A. (2022) *Decentralized Autonomous Organizations: The new llcs?*, *Bloomberg Law.*

Need for an Agency

In order to promote cohesion between consumer protection and the promotion of innovation, the Federal government needs a regulatory agency specifically tasked with governing DAOs. The agency should implement a comprehensive framework for DAO regulations and should oversee and audit the operation of DAOs. The government can look at how the Public Company Accounting Oversight Board (PCAOB) was implemented to oversee the auditing of public companies and to enforce professional auditing standards. This agency could even be modeled after the CFTC and SEC.

While implementing a regulatory agency for DAOs presents a number of challenges, there are several approaches that the government could take to create a regulatory agency for DAOs. These include adopting a collaborative approach, creating an expert panel, and promoting international cooperation.

A collaborative approach that involves the DAO community, industry stakeholders, regulators, and policymakers could be effective in developing a regulatory framework that supports innovation while addressing the potential risks associated with the technology.

The agency could create an expert panel composed of legal, technical, and financial experts to advise on the regulatory issues related to DAOs. This panel could help develop standards and guidelines for the operation of DAOs and provide input on policy decisions.

Given the global nature of DAOs, it may be beneficial for the government to work with other countries to establish a uniform approach to regulation. International cooperation can be achieved through initiatives like the International Organization of Securities Commissions (IOSCO), which brings together securities regulators from around the world.

Implementing a regulatory agency for DAOs would require a careful approach that balances the need to protect consumers and investors with the need to encourage innovation. A collaborative approach that involves industry stakeholders, regulators, and policymakers would be the most effective way to develop a regulatory framework for DAOs.

CONCLUSION

Though still in the early stages of adoption, DAOs offer significant potential benefits with regards to business organizations. The basic features of transparency and immutability are in themselves potential solutions against fraud and under the table business deals, which is why the government should seriously consider adopting an approach to regulate DAOs that encourages involvement rather than crushes.

Encouragement does not posit a lack of regulation. DAOs offer many beneficial features; however, this does not mean they are immune from exploitation or a need for consumer protection. Government agencies are charged with ensuring compliance with the law and regulations and to protect the public from fraudulent activities and ensure the stability of such systems. Blockchain scandals such as FTX highlights the need for greater regulation in the industry within blockchain. Comprehensive regulations can help restore investor confidence, prevent future scandals, protect the public, and hold wrongdoers accountable. Establishing an agency with the expertise and knowledge to effectively regulate DAOs can provide DAO organizations with the certainty and expectations they need to provide organizational functions.