Decentralized Autonomous Organizations Face Increasing Legal Scrutiny, Raising Risks for Project Backers

Key Takeaways

- **Proponents of Decentralized Autonomous Organizations (DAOs)—a novel arrangement prominent in decentralized finance (DeFi) projects—have argued that DAOs are software code lacking any capacity to be sued. Recent decisions from the United States District Court for the Northern District of California, however, underscore potential legal risks associated with DAOs. Participants in, and communities surrounding, DAOs should closely follow these cases to evaluate whether their participation may subject them to potential liability, and consider ways to create records that mitigate the allegations raised in the complaints.**
- **The cases have held at the pleadings stage that DAOs can be considered general partnerships that may be brought into court. This means that founders, early stage investors, tokenholders and others may be treated as partners in these partnerships.**
- **Rather than providing a legal bulwark, DAOs may actually increase legal risk. If a DAO is found to be a general partnership, each partner may become jointly-and-severally liable for the acts of the partnership and would not receive the same liability protections as equity investors in corporations.**
- **The cases are currently proceeding through discovery and may shed additional light on the criteria for determining whether a tokenholder of a DAO may be treated as a general partner that thus is jointly-and-severally liable for the acts of the DAO as a deemed general partnership.**

Background

The tidal wave of innovation unleashed by the emergence of cryptocurrencies in 2009 has led to lawsuits requiring courts to weigh in on novel legal issues—including whether tokens associated with a particular project are “securities” and, if so, which entities may be liable for offers or sales of those tokens in unregistered transactions. This article discusses the latter question[1] and focuses on two cases currently proceeding in the Northern District of California that have recently discussed the legal liability of DAOs.

[1] For additional insight on the first question, see our recent article discussing Senior District Judge William H. Orrick’s decision in the *SEC* v. *Payward, Inc.* litigation, *available at* https://www.cahill.com/publications/firm-memoranda/2024-09-05-unclear-at-best-sec-v-payward-inc-et-al-and-the-ongoing-struggle-to-understand-secondary-crypto-transactions.

In *Houghton* v. *Leshner et al*.[2] and *Samuels* v. *Lido DAO et al*.,[3] plaintiffs allegedly purchased tokens that could be used to govern the Compound decentralized lending protocol and the Lido decentralized staking protocol, respectively. Plaintiffs in both cases allege that these DAO governance tokens (COMP and LDO) are unregistered securities sold in violation of Sections 5 and 12 of the Securities Act of 1933 (the Securities Act). Plaintiffs seek to represent classes of purchasers of the COMP and LDO tokens and seek rescission (*i.e.*, cancellation of the purchases). Named defendants in both suits include the DAO itself—each alleged to be a general partnership under California law—along with the respective projects' founders, early investors, and advisors—who are alleged to be general partners in the general partnership. As explained below, these two cases have yielded significant decisions at the motion to dismiss stage that threaten to expand liability surrounding DAOs and sweep in entities and individuals that may have believed they were insulated from liability.

Houghton v. *Leshner et al.* (Compound DAO)

In *Houghton*, plaintiffs allege that the COMP tokens are unregistered securities and the defendants are liable under Sections 5 and 12(a)(1) of the Securities Act. Under Section 12(a)(1), liability for losses incurred from the purchase of unregistered securities only attaches to someone who "offers or sells" those securities.[4] This requires a plaintiff to plead and prove that the defendant either passed title to the security or successfully solicited someone else to buy a security motivated in part by a desire to serve their own or the security owner's financial interests.[5] Plaintiffs in *Houghton* conceded that defendants had not directly passed them title to COMP and therefore alleged that defendants had solicited the purchases.

The so-called "partner defendants" (including the project founders and early venture capital investors—but not Compound DAO itself) moved to dismiss. Conceding for purposes of the motion only that COMP tokens qualified as securities, the partner defendants primarily argued they had not "solicited" plaintiffs' purchases of the tokens within the meaning of Section 12 of the Securities Act and related case law. In a September 2023 decision, Senior District Judge William H. Orrick denied the motions to dismiss and allowed the case to proceed.[6] Plaintiffs' allegations regarding the defendants' "design and governance decisions, their efforts to successfully monetize COMP and bring it to secondary markets, and their public comments" about the COMP token were sufficient to allege that the partner defendants engaged in "solicitation" of unregistered securities.[7] Judge Orrick emphasized, however, that discovery was needed to determine whether each particular defendant actually engaged in "solicitation."[8]

In addition, Judge Orrick noted in his September 2023 decision that the extent of liability as to Compound DAO was "still to be determined," observing in a footnote that Compound DAO had not yet appeared in the case and that plaintiffs had not filed a motion seeking entry of default by the court.[9] More recently, in September 2024, plaintiffs moved for alternative service on Compound DAO, explaining that they had attempted to effectuate service

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[2] Civ. No. 22-07781 (WHO) (N.D. Cal.).

[3] Civ. No. 23-06492 (VC) (N.D. Cal.).

[4] *See* 15 U.S.C. § 77*l*(a).

[5] *See Pinter* v. *Dahl*, 486 U.S. 622, 646 (1988).

[6] 2023 WL 6826814.

[7] *Id.* at *3.

[8] *See, e.g.*, *id.* at *6 ("The exact contours of liability, whether it flows from the acts of 'Compound DAO' or flows from the acts of one or more Partner Defendants, cannot be determined at this juncture. Liability is more appropriately tested on a full evidentiary record at summary judgment or trial.")

[9] *Id.*

on Compound DAO by serving one of its alleged general partners and by creating a post in the Compound Community Forum.[10] During a November 13, 2024 oral argument, Judge Orrick indicated he would likely grant the motion for alternative service (which remains pending as of the date of this publication).[11] If Judge Orrick grants the motion for alternative service, Compound DAO will be obligated to respond to the complaint's allegations or else face default judgment.[12]

Discovery in *Houghton* remains ongoing, with summary judgment motions currently scheduled for oral argument in February 2026.[13]

Samuels v. *Lido DAO et al.* (Lido DAO)

Samuels raises similar allegations and issues as *Houghton* but is different in at least one key respect regarding the level of involvement of the DAO itself—while in *Houghton* the DAO was absent from the briefing, in *Samuels* District Judge Vince Chhabria granted plaintiffs' motion for alternative service on Lido DAO prior to ruling on the motions to dismiss.[14] Notably, however, Lido DAO did not file an appearance in the case. Rather, an entity called "Dolphin CL, LLC" was formed for the purpose of making a limited appearance on behalf of Lido DAO in order to argue that Lido DAO could not be sued because it is ultimately software code that is not owned or operated by any particular entity or group and that anyone can deploy.[15] The other defendants named in the complaint—AH Capital Management LLC, Paradigm Operations LP, Dragonfly Digital Management LLC, and Robot Ventures LP—filed motions to dismiss raising similar arguments as in *Houghton*, namely that plaintiffs had not sufficiently alleged that Lido DAO was a general partnership or that the defendants were general partners, and that plaintiffs had not sufficiently alleged that defendants "solicited" plaintiffs' purchases of LDO.[16]

On November 18, 2024, Judge Chhabria denied defendants' motions to dismiss, citing approvingly to Judge Orrick's decision in *Houghton*.[17] Judge Chhabria forcefully rejected the argument made by Dolphin CL on behalf of Lido DAO, remarking on the very first page of his decision that the case "presents several new and important questions about the ability of people in the crypto world to inoculate themselves from liability by creating novel legal arrangements to profit from exotic financial instruments" and that DAOs "seem[] designed, at least in part, to avoid legal liability for its activities."[18] Ultimately, Judge Chhabria held that "Lido's alleged actions are not those of an autonomous software program—they are the actions of an entity run by people[,]" pointing to allegations that Lido DAO makes decisions through tokenholder votes, maintains a treasury, and has hired over 70 employees.[19]

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[10] *See* Plaintiffs' Motion for Alternative Service on the Compound DAO, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 186 (Sept. 24, 2024).

[11] Notably, Judge Orrick authored one of the very first opinions regarding a DAO's capacity to be sued, granting the CFTC's motion for entry of default judgment against the Ooki DAO. *See Commodity Futures Trading Comm'n* v. *Ooki DAO*, Civ. No. 22-05416 (WHO), 2022 WL 17822445 (N.D. Cal. Dec. 20, 2022).

[12] *See generally* Fed. R. Civ. P. 55(b)(2).

[13] *See* Joint Case Management Statement at 1, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 165 (June 4, 2024).

[14] *See* Order Granting Motion for Alternative Service and Denying Entry of Default, Civ. No. 23-06492 (VC) (N.D. Cal.), Dkt. No. 75 (June 24, 2024).

[15] *See* Dolphin CL's Motion to Dismiss Amended Complaint, Civ. No. 23-06492 (VC) (N.D. Cal.), Dkt. No. 82 (July 11, 2024).

[16] *See generally* Motions to Dismiss, Civ. No. 23-06492 (VC) (N.D. Cal.), Dkt. Nos. 60, 61, 62, 63 (May 2, 2024).

[17] *See* --- F.Supp.3d ----, 2024 WL 4815022 (N.D. Cal. Nov. 18, 2024).

[18] 2024 WL 4815022, at *1.

[19] *Id.* at *5.

In addition, Judge Chhabria held that the complaint sufficiently alleges that Lido DAO is a general partnership under California law[20] and that at least three of the four named defendants are its general partners.[21] More specifically, Judge Chhabria allowed the claims against AH Capital Management LLC, Paradigm Operations LP, Dragonfly Digital Management LLC to proceed based on allegations that they made public statements about participating in governance of the Lido DAO and lending expertise, in addition to purchasing substantial amounts of LDO tokens.[22] By contrast, Judge Chhabria dismissed the claims against Robot Ventures LP without prejudice because the "complaint doesn't actually allege that Robot did or said anything other than purchase some unknown quantity of LDO" but invited plaintiffs to re-plead Robot Ventures LP if discovery so warranted.[23]

With respect to who might be considered a general partner, Judge Chhabria emphasized that it is a question of fact, while noting that plaintiffs had not alleged that merely holding an LDO token is sufficient to make one a partner; rather, plaintiffs had more specifically alleged that "only those entities with the capacity for meaningful participation in management of the DAO were admitted as partners by the founders (and, for later-joining partners, by any other then-existing partners) and are jointly carrying on the Lido DAO's staking service for profit."[24]

Finally, Judge Chhabria held that the complaint sufficiently alleges "solicitation" liability, adopting an expansive reading of the statute and case law and rejecting an argument that Section 12(a)(1) of the Securities Act applies only to public offerings.[25] Allegations that "Lido worked to get crypto exchanges to list LDO; that Lido promoted the listings and increases in LDO's price through posts on social media; and that Lido encouraged people to participate in Lido governance, which requires them to purchase LDO," all supported the claim for solicitation liability, and "[t]he alleged statements about LDO's price and availability on exchanges and about participation in DAO governance are plausibly encouragements to purchase LDO."[26] Perhaps most notably, Judge Chhabria stated that "solicitation can be achieved through mass communications, and individual plaintiffs do not need to have relied on or had their purchases caused by these communications" and further held that, with respect to the requirement that solicitation be motivated by serving one's own financial interests or those of the securities owner, Lido DAO had a "financial interest in every transaction because every purchase contributes to demand—creating, in the aggregate, a market for LDO and raising its price."[27]

A status conference in *Samuels* is set for December 6, 2024, to discuss a schedule for discovery.

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[20] *See, e.g.*, *id.* at *6 ("The complaint alleges that Lido DAO's founders formed it to run an Ethereum staking service that keeps a percentage of the staking rewards and that they plan to ultimately distribute this revenue to themselves and other tokenholders—in other words, to carry on, as coowners, a business for profit.").

[21] *Id.* at *8-10.

[22] *Id.* at *8-9.

[23] *Id.* at *9.

[24] *Id.* at *6. Notably, in this regard the allegations are a departure from an earlier case regarding DAO liability filed by the same plaintiffs' counsel as in *Houghton* and *Samuels*. In interpreting and assessing the allegations of that case, Judge Larry A. Burns of the United States District Court for the Southern District of California stated that "anyone holding a BZRX token is a partner in the partnership[.]" *Sarcuni* v. *bZx DAO*, 664 F. Supp. 3d 1100, 1118 (S.D. Cal. 2023). However, this statement was not subsequently tested, as *Sarcuni* settled on a confidential basis a few months later. *See* Minute Order, Civ. No. 22-00618 (LAB) (S.D. Cal.), Dkt. No. 75 (Aug. 14, 2023).

[25] *Id.* at *11-15.

[26] *Id.* at *11.

[27] *Id.* at *12.

Conclusion and Takeaways

The *Houghton* and *Samuels* litigations are two cases at the forefront of understanding the potential liability of DAOs. The motion to dismiss decisions issued by Judges Orrick and Chhabria emphasizes that a DAO structure alone may not be sufficient to insulate participants from legal liability. However, although early rulings in the cases indicate the potential for significant liability for individuals and entities deemed to be “general partners” of the DAOs, the battle is far from over. Summary judgment, trial, and appeals are all on the horizon, where defendants may try to implead other tokenholders as general partners and otherwise challenge that they qualify as general partners. Moreover, the plaintiffs’ claims are predicated on the applicable tokens (COMP and LDO) themselves being “securities,” a position not yet litigated in either case.

Parties who may be maintaining or considering deploying DeFi or other blockchain-based protocols that rely on input from a community of token holders to adjust protocol parameters or otherwise provide input as to changes in the workings of the protocol code should follow, and give careful consideration to, both the *Houghton* and *Samuels* cases. As noted above, the judges’ decisions are heavily based on the specific facts of these cases, and communities interested in, and supporting, decentralized protocols have the opportunity to create records that minimize, or possibly eliminate, the arguments being asserted by the plaintiffs in these cases.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Samson A. Enzer (partner) at senzer@cahill.com or 212.701.3125, Lewis Rinaudo Cohen (partner) at lrcohen@cahill.com or 212.701.3758, or Gregory Mortenson (counsel) at gmortenson@cahill.com or 212.701.3708; or email publicationscommittee@cahill.com.

Disclosure: Mr. Mortenson worked on certain matters discussed in this article while at his previous law firm, which continues to litigate them.

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