2 Cases Show DAOs May Face Increasing Legal Scrutiny

By **Samson Enzer, Lewis Cohen and Gregory Mortenson** (December 3, 2024)

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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 at the U.S. District Court for the Northern District of California that have recently discussed — at the pleadings stage — the legal liability of decentralized autonomous organizations, a novel arrangement prominent in decentralized finance projects.

In Houghton v. Leshner[2] and Samuels v. Lido DAO,[3] plaintiffs allegedly purchased tokens that could be used to govern the Compound decentralized lending protocol and the Lido decentralized staking protocol, respectively.

The plaintiffs in both cases allege that these DAO governance tokens — COMP and LDO, respectively — are unregistered securities sold in violation of Sections 5 and 12 of the Securities Act. The 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 advisers, 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 not only to expand the potential liability for activity attributed to DAOs but also to indirectly create liability for entities and individuals participating in a DAO that may not have believed they would be held responsible individually for the collective actions of the various DAO participants.

Houghton v. Leshner (Compound DAO)

In Houghton, the 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]

The plaintiffs in Houghton did not allege that the defendants directly passed them title to COMP, and instead alleged that the 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 the plaintiffs' purchases of the tokens within the meaning of Section 12 of the Securities Act and related case law.

In a September 2023 decision, U.S. District Judge William H. Orrick denied the motions to dismiss and allowed the case to proceed.[6] The 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 the plaintiffs had not filed a motion seeking entry of default by the court.[9]

In September 2024, the plaintiffs moved for alternative service on Compound DAO, explaining that they had attempted to effectuate service by serving one of its alleged general partners and by creating a post in the Compound community forum.[10]

On Nov. 5, Judge Orrick granted the motion for alternative service while simultaneously denying the defendants' motion to compel arbitration.[11] Citing approvingly to both his own 2023 decision granting the U.S. Commodity Futures Trading Commission's motion for entry of default judgment against the Ooki DAO in CFTC v. Ooki in the Northern District of California[12] — one of the very first opinions regarding a DAO's capacity to be sued — as well as U.S. District Judge Vince Chhabria's decision in Samuels, Judge Orrick found that alternative service was "appropriate under the circumstances here in light of the intentionally opaque nature of the DAO's organization."[13]

Once service is effectuated pursuant to Judge Orrick's order,[14] Compound DAO will be obligated to respond to the complaint's allegations or else face default judgment.[15]

Discovery in Houghton remains ongoing, with summary judgment motions currently scheduled for oral argument in February 2026.[16] However, the defendants filed a notice of appeal with respect to the denial of their motion to compel arbitration,[17] and Judge Orrick ordered briefing on whether the appeal would entitle the defendants to a stay of the district court proceedings.[18]

Samuels v. 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, Judge Chhabria granted the plaintiffs' motion for alternative service on Lido DAO prior to ruling on the motions to dismiss.[19]

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.[20]

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 the plaintiffs had not sufficiently alleged that Lido DAO was a general partnership or that the defendants were general partners, and that the plaintiffs had not sufficiently alleged that the defendants solicited the plaintiffs' purchases of LDO.[21]

On Nov. 18, Judge Chhabria denied the defendants' motions to dismiss, citing approvingly to Judge Orrick's decision in Houghton.[22] 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 a DAO seems "designed, at least in part, to avoid legal liability for its activities."[23]

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.[24]

In addition, Judge Chhabria held that the complaint sufficiently alleges that Lido DAO is a general partnership under California law,[25] and that at least three of the four named defendants are its general partners.[26] More specifically, Judge Chhabria allowed the claims against AH Capital Management LLC, Paradigm Operations LP and 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.[27]

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 he invited the plaintiffs to replead their claims against Robot Ventures LP if discovery so warranted.[28]

With respect to who might be considered a general partner, Judge Chhabria emphasized that it is a question of fact, while noting that the plaintiffs had not alleged that merely holding an LDO token is sufficient to make one a partner. Rather, the 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."[29]

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.[30]

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."[31]

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."[32]

A status conference in Samuels is set for Jan. 10, 2025, to discuss a schedule for discovery.[33]

Conclusion and Takeaways

The Houghton and Samuels litigations are two cases at the forefront of understanding the potential liability of DAOs and those participating in DAO activity.

Proponents of DAOs have argued that, rather than being "organizations" — despite the moniker — DAOs are in fact simply constructs comprising software code, and thus lack any capacity to be sued.[34] The alternative service and motion to dismiss decisions issued by Judges Orrick and Chhabria emphasize that an attempt to shift the focus of potentially illegal conduct to a DAO structure may not alone be sufficient to insulate participants in the DAO from legal liability.

In fact, rather than providing protection from legal claims, as some have suggested, structuring an arrangement as a DAO may actually increase legal risk for participants. If a DAO is treated as something more than just the underlying code and found to be a type of collective business, such as a general partnership, each participant that is deemed to be a partner may become jointly and severally liable for the acts of the deemed partnership, and would not receive the same liability protections as equity investors in corporations.

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, 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.

The 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.

Perhaps most importantly, for those considering setting up new arrangements that seek to maximize decentralization, there are already some early takeaways.

Activity that can appear to a judge as proactive business decisions being made for the benefit of a more passive group of small-ticket tokenholders — especially when those decisions are driven as a practical matter by a relatively small handful of insiders, i.e., founders and large early-stage tokenholders — will likely attract legal responsibility in some form, regardless of the technology used or moniker applied to that technology. This can be

exacerbated when actual decisions are made through the use of a multisignature wallet controlled by those insiders.

Fortunately, blockchain technology is incredibly flexible and tools already exist to allow for direct changes to protocol code through the outcome of on-chain instructions provided by token owners, minimizing the indicia of a business entity that is separate from the code itself. Avoiding the moniker "DAO" and limiting tokenholder activity to direct, on-chain voting may help to mitigate potential liability.

Parties that may be maintaining or considering deploying DeFi or other blockchain-based protocols that rely on input from a community of tokenholders 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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Disclosure: Mortenson worked on the Houghton v. Leshner matter discussed in this article while at a previous law firm.

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[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.

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

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

[4] See 15 U.S.C. § 77l(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.

[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] See Order Denying Motion to Compel and Granting Motion for Alternative Service, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 213 (Nov. 25, 2024).

[12] See Commodity Futures Trading Comm'n v. Ooki DAO, Civ. No. 22-05416 (WHO), 2022 WL 17822445 (N.D. Cal. Dec. 20, 2022).

[13] Order Denying Motion to Compel and Granting Motion for Alternative Service, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 213 at 12 (Nov. 25, 2024).

[14] See id. at 13-14.

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

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

[17] See Notice of Appeal, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 215 (Nov. 26, 2024).

[18] Order Denying Motion to Compel and Granting Motion for Alternative Service, Civ. No. 22-07781 (WHO) (N.D. Cal.), Dkt. No. 213 at 6 n.8 (Nov. 25, 2024).

[19] 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).

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

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

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

[23] 2024 WL 4815022, at *1.

[24] Id. at *5.

[25] 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.").

[26] Id. at *8-10.

[27] Id. at *8-9.

[28] Id. at *9.

[29] 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).

[30] Id. at *11-15.

[31] Id. at *11.

[32] Id. at *12.

[33] See Order Granting Joint Stipulation to Continue Case Management Conference and Joint Report Deadline, Civ. No. 23-06492 (VC) (N.D. Cal.), Dkt. No. 120 (Nov. 27, 2024).

[34] Cf. Van Loon v. Dep't of the Treasury, No. 23-50669, 2024 WL 4891474 (5th Cir. Nov. 26, 2024) (holding that Tornado Cash's smart contracts were not "property" within the meaning of the International Emergency Economic Powers Act).