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Blockchain Law

Can the autonomous remain anonymous?

Robert A. Schwinger, *New York Law Journal* — May 23, 2023

Utah recently passed novel legislation granting "decentralized autonomous organizations"—often referred to as "DAOs"—their own recognized form of legal existence and providing for limited liability. This new kind of legal entity has several distinctive attributes, including some intended to help DAO members remain anonymous. But questions loom about how Utah's hopes for DAO member anonymity will fare when they come up against recently adopted provisions under U.S. federal law that seek to promote transparency by forcing disclosure of the individuals who stand behind legal entities. Can this seeming conflict be resolved? Can the autonomous ultimately remain anonymous?

The State of Utah recently passed novel legislation granting "decentralized autonomous organizations"—often referred to as "DAOs"—their own recognized form of legal existence and providing for limited liability. The Utah legislation responds to both the growing interest in DAOs for various kinds of smart contract-based applications, particularly in DeFi, see R. Schwinger, "DAOs Enter the Spotlight", N.Y.L.J. (Mar. 21, 2022), and the recognized need for states to adopt new laws to accommodate this new form of organization. See generally Ravi Guru Singh, "New York Is Losing the Race To Be a Home for DAOs", N.Y.L.J. (July 18, 2022).

This new kind of legal entity established under Utah law has a number of distinctive attributes, including some that are intended to help DAO members remain anonymous. But questions loom about how Utah's hopes for DAO member anonymity will fare when they come up against recently adopted provisions under U.S. federal law that seek to promote transparency by forcing disclosure of the individuals who stand behind legal entities.

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The Utah DAO Act

On March 13, 2023, Utah's governor signed into effect the Utah Decentralized Autonomous Organizations Act (the "Utah DAO Act" or the "Act"). Utah Code Ann. §48-5-101 et seq. The Act creates a form of legal recognition unique to DAOs—the Utah limited liability DAO, or "LLD."

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The bill's "long title" explains that it "allows a decentralized autonomous organization that has not registered as a for-profit corporate entity or a non-profit entity to be treated as the legal equivalent of a domestic limited liability company." The Utah DAO Act will go into effect January 1, 2024.

The Act defines a "decentralized autonomous organization" as "an organization: (a) created by one or more smart contracts; (b) that implements rules enabling individuals to coordinate for decentralized governance of an organization; and (c) that is an entity formed under this chapter." Utah Code Ann. §48-5-101(6). The Act defines an entity as being "decentralized" when its "decision-making is distributed among multiple persons." Id. §48-5-101(5).

Any person "who has governance rights in" a DAO is deemed to be a "member" of the LLD, id. §48-5-101(16)(a), except for persons who have "involuntarily received a token with governance rights, unless that person has chosen to participate in governance by undertaking a governance behavior" for the DAO, id. §48-5-101(16)(b), irrespective of whether that behavior is "on-chain or off-chain," i.e., "recorded and verified on a blockchain" or not. Id; see id. §§48-5-101(17)-(19).

Anonymity of most LLD members

The Act provides that an LLD, in addition to being governed by the Act itself, is to be governed by the DAO's by-laws (and by Chapter 3a of the Utah Revised Uniform Limited Liability Act's provisions on issues when the Act and the DAO's by-laws are silent). Id. §48-5-102.

Notably, and in contrast to many LLC statutes, the Act has no provision for any membership agreements to be signed onto by the DAO's members when they join the entity. Rather, membership simply flows from ownership of DAO tokens that give governance rights, with the rights and relations among members being defined entirely by the DAO's by-laws.

The Act thus "define[s] DAO ownership" in a way "that complies with the ethos of DAO communities, using bylaws to protect their ownership through anonymity censoring." See Samuel Mbaki Wanjiku, "Utah State Legislature passes the Utah DAO Act", Crypto News (Mar. 6, 2023).

Under the Act, the only persons associated with the LLD whose names need to be publicly disclosed are the DAO's "organizers," who file a certificate of organization for the LLD with the State of Utah, at least one of whom needs to be an individual. Act, §48-5-201. This provision reportedly was "a compromise" to address a "concern [about] the anonymity and unaccountability of DAOs" by "requiring DAOs to divulge an incorporator while still maintaining anonymity." Amaka Nwaokocha, "DAO gets legal recognition in the US as Utah DAO Act passes", Cointelegraph (Mar. 7, 2023).

Requirements for qualifying as a Utah LLD

A DAO when registering must meet and submit "evidence" of various technical and other requirements to qualify as a Utah LLD. Act, §48-5-201(3). These requirements include showing that the DAO "is deployed on a permissionless blockchain" and "has a unique public address through which an individual can review and monitor the [DAO's] transactions." Id. §§48-5-201(3)(a)-(b). Its "software code" must be "available in a public forum for any person to review" and must have "undergone quality assurance." Id. §§48-5-201(3)(c)-(d).

The Act requires an LLD to have a "graphical user interface that: allows a person to read the value of the key variables of the [DAO's] smart contracts" and "monitor all transactions originating from, or addressed to, the [DAO's] smart contracts."

The interface must also "specif[y] the restrictions on a member's ability to redeem tokens," "make[] available the [DAO's] by-laws," and "display[] the mechanism" for contacting the DAO's administrator. Id. §48-5-201(3)(e).

An LLD also must have "a publicly specified communication mechanism that allows a person to contact the registered agent of the [DAO] and provide legally recognized service," with a DAO "member or administrator" being "able to access the contents of this communication mechanism." Id. §48-5-201(3)(h). The LLD must also "describe[] or provide[] a dispute resolution mechanism" that is "binding" on the DAO and its members and "participants," and that is "able to resolve disputes with third parties capable of settlement by alternative dispute resolution." Id. §48-5-201(3)(i).

Legal existence for LLDs with limited liability for members

The Act provides that an LLD which qualifies under the Act will have a "legal personality," meaning that it:

> (1) shall be deemed a legal entity separate and distinct from the decentralized autonomous organization's members;
>
> (2) has the capacity to sue and be sued in the decentralized autonomous organization's own name and the power to do all things necessary or convenient to carry on the decentralized autonomous organization's activities and affairs;
>
> (3) shall meet the decentralized autonomous organization's liabilities through the decentralized autonomous organization's assets;
>
> (4) may have any lawful purpose; and
>
> (5) has perpetual duration.

Act, §48-5-104. The Act requires LLDs to be identified as such by including in their names "LLD" or certain other prescribed identifiers. Id. §48-5-105(1).

Once this legal entity is created, the Act provides that the LLD members shall enjoy "limited liability" in most circumstances. Id. §§48-5-201(6), 48-5-202. LLD members "may only be liable for the on-chain contributions that the member has committed to the [DAO]." Id. §48-5-202(1)(a). They "may not be held personally liable for any excess liability after the [DAO's] assets have been exhausted" or "for any obligation incurred by the [DAO]." Id. §§48-5-202(1)(b)-(c). Members also "may not be held personally liable" in their capacity as such for any "wrongful act or omission" of any other DAO member. Id. §48-5-202(1)(d).

However, if a DAO "refuses to comply with an enforceable judgment, order, or award entered against [it]," then any "members who voted against compliance may be liable for any monetary payments ordered in the judgment, order, or award in proportion to the member's share of governance rights in the [DAO]." Id. §48-5-202(2). Also, the Act's limited liability protections "do not affect the personal liability of a member in tort for a member's own wrongful act or omission." Id. §48-5-202(3).

Notably, while the Act distinguishes between LLD "members" (who hold governance rights in the DAO through their tokens) and "participants" (non-members who "hold[] or interact[] with" the DAO's tokens), see id. §§48-5-101(16), 48-5-101(22), the limited liability provisions noted above apply only to LLD "members." Id. §48-5-202.

Participants, members and others do enjoy some other protections, however, in the Act's provision that a DAO "developer, member, participant, or legal representative… may not be imputed to have fiduciary duties towards each other or third parties solely on account of their role, unless the developer, member, participant, or legal representative: (1) explicitly holds themselves out as a fiduciary; or (2) stipulates to assume a fiduciary status" under the DAO's by-laws. Id. §48-5-307.

Importance of anonymity

While LLD members thus enjoy a substantial degree of limited liability protection, the anonymity-enhancing provisions of the Act further serve to reduce the likelihood that they might even find themselves embroiled in litigation (meritorious or not), because they are difficult to identify.

Preserving DAO members' anonymity can have practical and financial benefits because, as some recent court rulings in DAO cases have shown, DAOs and their members can indeed face litigation risk arising out of DAO activity.

In *CFTC v. Ooki DAO*, 2022 WL 17822445 (N.D. Cal. Dec. 20, 2022), for example, the court held that a DAO could be sued as a kind of legal entity, if only as a kind of "unincorporated association" of its tokenholders under state law, regardless of whether any of those individual tokenholders were also sued.

Thereafter, in *Sarcuni v. bZx DAO*, 2023 WL 2657633 (S.D. Cal. Mar. 27, 2023), another court held that a negligence claim could be asserted not only against the defendant DAO itself but also against persons holding its tokens when they were alleged to be members of a general partnership, thus making them jointly and severally liable for the DAO's alleged torts, when the allegation of partnership was based on "their structures and the way they operate."

The court in *Sarcuni* denied the defendants' motion to dismiss and held the plaintiffs' allegation that the DAO was a partnership was "plausible" in view of the complaint's allegations that the DAO was an "association of two or more persons" that "operates as a business for profit," in which the tokenholders "carry on as co-owners of the DAO" because they exercise "governance rights in the DAO" and "can share in the DAO's profits."

Can member anonymity be maintained under federal law?

A difficulty raised by the Utah DAO Act is that its anonymity-enhancing provisions might conflict with the transparency-promoting requirements found in pre-existing federal law.

Congress on January 1, 2021 passed the Corporate Transparency Act ("CTA"), 31 U.S.C. §5336, as part of the Anti-Money Laundering Act of 2020 in the National Defense Authorization Act for Fiscal Year 2021. Pub. L. No. 116-283, 134 Stat. 338. Like the Utah DAO Act, the CTA goes into effect on Jan. 1, 2024.

The CTA requires that reporting companies file a report with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN) identifying the entities' beneficial owners, with FinCEN to propose rules specifying the information to be collected, the manner of collection, and how such information should be shared with other law enforcement agencies. 31 U.S.C. §5336(c)(2)(C).

FinCEN issued its final rule on Beneficial Ownership Information Report Requirements (the "Reporting Rule") in September 2022.

Under the Reporting Rule, unless an exemption applies, reporting companies must provide for each beneficial owner the name, birthdate, address and unique identifying number and issuing jurisdiction from an acceptable identification document (and the image of such document). 31 C.F.R. §1010.380(b)(1)(i).

There is no maximum number of beneficial owners that a reporting company must disclose. See Beneficial Ownership Information Reporting Requirements, 87 Fed. Reg. 59498, 59570 (Sept. 30, 2022) (codified at 31 C.F.R. Part 1010).

Will an LLD member (or DAO tokenholders more generally) be deemed a "beneficial owner" under the terms of the CTA and the FinCEN Reporting Rule? The CTA broadly defines "beneficial owner" to include any individual who, "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise (i) exercises substantial control over the entity; or (ii) owns or controls not less than 25% of the ownership interests of the entity" (subject to certain exceptions). 31 U.S.C. §5336(a)(3).

Under the Reporting Rule, an individual exercises "substantial control" over an entity not merely by having a senior officer position or power over the board, but also if they "direct[], determine[], or ha[ve] substantial influence over important decisions" made by the entity "or ha[ve] any other form of substantial control" over it. 31 C.F.R. §1010.380(d)(1).

It is not clear what level of governance power an LLD member would need to possess from holdings of tokens, either individually or perhaps from working in concert with like-minded fellow tokenholders, to qualify as having "substantial control" over the LLD so as to be a reportable "beneficial owner" for CTA purposes.

And even if the tokenholder were reportable, would the LLD as a practical matter be in any position to determine and submit the required personal identifying information and documentation for that person, when "member" status stems entirely from holding tokens that are traded anonymously or pseudonymously on a blockchain?

FinCEN has in fact proposed an "escape hatch" for CTA reporting that would address this very situation (and various others unrelated to DAOs). FinCEN earlier this year proposed a form for reporting CTA information that would allow entities to select an option that they are "unable to identify" all beneficial owners or that key details about the beneficial owners are "unknown." See Agency Information Collection Activities; Proposed Collection; Comment Request; Beneficial Ownership Information Reports, 88 Fed. Reg. 2760 (Jan. 17, 2023).

But in an April 3, 2023 letter addressed to FinCEN and U.S. Treasury Secretary Janet Yellen, a bipartisan group of U.S. House and Senate members demanded the elimination of this "escape hatch," arguing that including it in the reporting form

"deviates significantly from Congress' intent" in setting forth the mandatory disclosures required under the CTA. What the final reporting form will be, and whether it will rescue LLDs from having to make CTA disclosures that they do not seem equipped to make, remains to be seen.

The Reporting Rule also lists 23 different categories of entities that are exempt from the definition of a "reporting company" and thus need not file a beneficial ownership report. These categories include, amongst others, securities reporting issuers, governmental authorities, banks, credit unions, money services businesses, registered broker dealers, exchanges and clearing agencies, investment companies, certain tax exempt entities, entities assisting tax-exempt entities, and large operating companies. 31 C.F.R. §1010.380(c)(2).

The irony, however, is that blockchain-based DeFi applications in general have steadfastly resisted claims by the SEC or other financial regulatory authorities that they fall into categories that would subject them to registration with and regulation by such authorities. While these issues are far from settled at present, it seems unlikely that a Utah LLD would now switch course and claim such status and take on all those burdens merely to avoid having to make CTA disclosure of its members.

Can member anonymity be maintained under the FRCP?

The CTA is not the only challenge that federal law poses against the Utah DAO Act's design for preserving member anonymity. The laws governing federal diversity jurisdiction and a recent amendment to the Federal Rules of Civil Procedure might also run into conflict with the design of the Act.

Federal diversity jurisdiction is governed by 28 U.S.C. §1332, which looks to the citizenship of the parties to a lawsuit. The Supreme Court has held that when it comes to entities, the diversity jurisdiction analysis looks to the citizenship of *all* the entity's members, unless Congress establishes an exception for a particular kind of entity like it did for corporations in 28 U.S.C. §1332(c) (looking instead at just the corporation's place of incorporation and principal place of business). See *Carden v. Arkoma Assocs.*, 494 U.S. 185 (1990) (LLC shares the citizenships of all its members); *Americold Realty Trust v. ConAgra Foods, Inc.*, 577 U.S. 378 (2016) (real estate investment trust shares the citizenships of all its members including its shareholders).

Carden and *Americold* thus suggest that for diversity jurisdiction purposes, a Utah LLD should share the citizenships of all its members. But how could that citizenship be determined—either by a party suing the LLD in diversity or by the LLD itself when suing in diversity as plaintiff or removing an action to federal court—when the Utah DAO Act was designed to keep the LLD's members anonymous to the world as mere tokenholders on a blockchain?

Moreover, the LLD's citizenship could potentially change repeatedly during the pendency of the litigation any time that an LLD member transfers tokens to a new owner whose citizenship is not identical with the transferor's.

A further wrinkle is provided by a 2022 amendment to Rule 7.1 of the Federal Rules of Civil Procedure. Under the new Fed. R. Civ. P. 7.1(a)(2), which went into effect on Dec. 1, 2022, a party "must, unless the court orders otherwise, file a disclosure statement…when the action is filed in or removed to federal court" and again "when any later event occurs that could affect the court's jurisdiction." The disclosure statement "must name—and identify the citizenship of—every individual or entity whose citizenship is attributed to that party." Id. This requirement "is designed to facilitate an early and accurate determination of jurisdiction" in diversity cases. See Fed. R. Civ. P. 7.1, 2022 Adv. Comm. Notes.

Thus, if a Utah LLD is deemed to share the citizenships of all its members under *Carden* and *Americold*, but those members are anonymous under the Utah DAO Act, then how can the LLD comply in good faith with new Rule 7.1(a)(2)? What happens if the LLD cannot comply? Can a court simply dismiss the action of a non-complying LLD plaintiff? Can it simply enter a default judgment against a non-complying LLD defendant?

The Advisory Committee Notes to Rule 7.1(a)(2) explain that the rule "is shaped by the need to determine whether the court has diversity jurisdiction under §1332(a). . . . Every citizenship that is attributable to a party or intervenor must be disclosed." The Notes observe that pleading and disclosing

relevant citizenships may be more difficult for some kinds of entities than for others:

> A party suing an LLC may not have all the information it needs to plead the LLC's citizenship. The same difficulty may arise with respect to other forms of noncorporate entities, some of them familiar—such as partnerships and limited partnerships—and some of them more exotic, such as "joint ventures." Pleading on information and belief is acceptable at the pleading stage, but disclosure [under Rule 7.1(a)(2)] is necessary both to ensure that diversity jurisdiction exists and to protect against the waste that may occur upon belated discovery of a diversity-destroying citizenship.
>
> . . . . This rule does not address the questions that may arise when a disclosure statement or discovery responses indicate that the party or intervenor cannot ascertain the citizenship of every individual or entity whose citizenship may be attributed to it.

Could a plaintiff or a removing defendant have a good faith belief that it has diversity jurisdiction over an LLD so as to justify invoking federal diversity jurisdiction if it does not yet know the identities and citizenships of the all the LLD members?

Would it be enough, for example, to plead on information and belief that it is not impossible based on presently available information for diversity of citizenship to exist, then seek to take Rule 7.1(a)(2) discovery to smoke out the facts, given the statement in the Advisory Committee Notes that "discovery may be appropriate to test jurisdictional facts by inquiring into such matters as the completeness of a disclosure's list of persons or the accuracy of their described citizenships"?

It is unclear whether the problem could be solved by pleading that the LLD consists of various "John Doe" members whose identities and citizenships will be identified later when that is possible.

Courts are divided on whether naming "John Doe" defendants without specific identities destroys diversity jurisdiction. The general rule is that "because the existence of diversity jurisdiction cannot be determined without knowledge of every defendant's place of citizenship, 'John Doe' defendants are not permitted in federal diversity suits." *Howell by Goerdt v. Trib. Ent. Co.*, 106 F.3d 215, 218 (7th Cir. 1997); see, e.g., *United Fin. Cas. Co. v. Lapp*, 2013 WL 1191392, at *2 (D. Colo. Mar. 21, 2013).

But a minority of courts have ruled that the mere presence of "John Doe" defendants does not destroy diversity jurisdiction unless the defendants are later revealed to have the same citizenship as the plaintiffs. See *Macheras v. Ctr. Art GalleriesHawaii, Inc.*, 776 F. Supp. 1436, 1440 (D. Haw. 1991).

In sum, it may be very unclear how a Utah LLD would fare in an attempted federal court diversity action, either as plaintiff or defendant, particularly with Rule 7.1(a)(2) bringing this issue to the forefront almost immediately.

Conclusion

Utah has taken a bold stand in the Utah DAO Act to help put DAOs on a more secure legal footing, and in a way that is different even from what some other pro-DAO jurisdictions have done. Compare, e.g., Ravi Guru Singh, supra.

By allowing Utah DAOs to register as cognizable legal entities whose members enjoy limited liability, just like corporate shareholders and LLC members, Utah has enabled new innovation with lowered risk when using this new form of entity in areas involving smart contracts and DeFi and other applications, including by utilizing tokens on a blockchain to give that entity a membership registry in which interests are highly liquid and negotiable.

It may be unclear whether Utah's attempt to cloak LLD membership in anonymity can survive in a world that imposes legal requirements designed to bring about greater transparency about the ownership of entities.

But it is also unclear how such problems could ever be avoided with entities whose membership and governance is determined entirely by blockchain tokens that are owned and can be transferred anonymously or at least pseudonymously. At present, the world may not quite be ready for the Utah LLD or other entities like it that innovation-promoting states may seek to create.

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