Part II: With New DAO Law on the Books, Utah Joins Race with Wyoming and Tennessee to Become U.S. "Crypto Capital"

Blockchain and the Law   on **May 31, 2023**

As discussed in **Part I** of this series, state DAO LLC laws have been enacted in the last several years and have become one option for decentralized autonomous organizations (or DAOs) to create a so-called "legal wrapper" or real-world corporate entity to shield individual members from liability.

In **Part II** we will look at some of the standout features of the United States' DAO laws.[1]

DAOs as LLCs, or LLDs. As discussed below, the Wyoming (SF0038, codified at W.S. §17-31-101 through §17-31-116; Wyoming Governor Mark Gordon signed an amendment to the DAO Supplement into law (SF0068) (the DAO Supplement and its 2022 amendments) (collectively, the "WY Law") and Tennessee (HB2645/SB2854, to be codified at Tenn. Code Ann. §48-250-101 through 48-250-115) (the "TN Law"), DAO LLC laws opt for the "wrapper" approach by "wrapping" DAOs within an LLC. Utah, however, goes further. Under the "Utah Decentralized Autonomous Organizations Act" (HB 357) (codified at Utah Code Ann. §48-5-101 – 406) (the "Utah Law"), rather than being wrapped by an LLC, limited liability decentralized autonomous organizations (or "LLDs") are *the* legal entity formed under the Utah Law. (Utah Code Ann. §48-5-104). Under the Utah Law, LLD members enjoy limited liability and are only liable for the on-chain contributions that the member has committed to the DAO. (Utah Code Ann. §48-5-202). Further, members cannot be held personally liable for any excess liability after the DAO assets have been exhausted. (Utah Code Ann. §48-5-202(1)(b)). Utah further covers situations when a DAO refuses to comply with an enforceable judgment or order against the DAO by stating that members who voted against using the DAO's treasury to satisfy a judgment may be liable for any monetary payments in the judgment or order "in proportion to the member's share of governance rights in the [DAO]." (Utah Code Ann. §48-5-202(d)(2)). The Utah Law, in another effort to foreclose certain theories of liability, also explicitly states that a developer, member, participant or legal representative of a DAO may not be imputed to have fiduciary duties toward each other or third parties solely on account on their role, absent certain express actions or statements. (Utah Code Ann. §48-5-307). These questions have been more salient for DAO members, given the ongoing CFTC enforcement against the Ooki DAO and the recent California district court ruling that various governance token holders in a DAO could be deemed to be members of a "general partnership" under California law and thus potentially joint and severally liable in the suit.

In general terms, the Wyoming and Tennessee laws make DAOs a subtype of LLCs. The laws stipulate that "a decentralized autonomous organization is a limited liability company" and each state's LLC Act applies to decentralized autonomous organizations to the extent not inconsistent with the DAO law (W.S. §§ 17-31-103, 104; Tenn. Code Ann. §48-250-103). DAOs based outside the U.S. are excluded from being formed under both the Wyoming and Tennessee DAO laws (W.S. § 17-31-116; Tenn. Code Ann. §48-250-115). By classifying DAOs this way, the laws provide the regulatory certainty and legal precedent associated with LLCs to DAOs. In other words, this statutory backstop helps DAOs and their members understand precisely what is (and is not) expected of them by the state and how certain governance mechanisms (e.g., required notices for operating agreements and procedures for withdrawal of members and dissolution) might work. While crypto enthusiasts might understand the nuances and processes related to DAOs, the technology is nascent, and legal clarifications provided by Wyoming and Tennessee will offer some familiar legal frameworks to operate within and aid industry efforts to onboard new users.

(Partly) Autonomous Management. Utah's law recognizes the reality of DAOs – that they are enabled by code, not run by it. As such, the Utah LLD law refrains from providing for management by smart contract; instead, the Utah Law notes that the LLD adopts by-laws which provide for the management of the DAO and "establish internal organization and procedures for the decentralized autonomous organization." (Utah Code Ann. §48-5-203). Implied in this requirement is that the *members* manage the LLD, not any applicable smart contracts (though, it should be noted that the Utah Law states that a DAO must retain a legal representative to undertake tasks that cannot be achieved on-chain). (Utah Code Ann. §48-5-306). The Utah Law also contains a provision contemplating certain questions following a hard fork in the underlying blockchain. (Utah Code Ann. §48-5-403).

The WY Law incorporates the "A" in DAO by recognizing that a DAO may be member-managed or managed by "the members *and* any applicable smart contracts" (emphasis added) (W.S. §17-31-109). Interestingly, this concept was walked back by the 2022 amendment: The original law allowed for fully autonomous "algorithmically managed" DAOs ("Management of a [DAO] shall be vested in its members, if member managed, or the smart contract, if algorithmically managed"), but the legislature recognized that DAOs, as contemplated, may vary in the extent that they are "member managed" or "algorithmically managed." This recognition—that DAOs require humans at the edges with automation in the center—prompted the legislature to replace mention of "algorithmically managed" DAOs with management by the "members and any applicable smart contract."

While Wyoming refers to DAOs, the TN Law avoids the use of "autonomous" altogether by referring to Decentralized Organizations ("DOs") (we use "DAO" and "DO" interchangeably in this post). As explained below, the distinction can be important from a technical perspective, but is a distinction without a difference as used by Wyoming, Tennessee and Utah. Tennessee defines a Decentralized Organization as a "decentralized organization, organized under this chapter," (Tenn. Code Ann. §48-250-101(1)), which is essentially the same language as Wyoming. The TN Law, however, more closely resembles the original WY Law in that it recognizes that DAOs may be "member-managed" and "smart-contract managed" (Tenn. Code Ann. §48-250-108). The TN Law defines a "smart contract" as an "event-driven computer program that executes on an electronic, distributed, decentralized, shared, and replaced ledger that is used to automate transactions..." (Tenn. Code Ann. §48-250-101(10)). Similarly, the Utah Law defines a DAO 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)).

While most in the industry use DAOs and DOs interchangeably, many understand that the "autonomous" in DAO is a spectrum, with organizations on the extreme end of that spectrum able to operate without any human management. A classic theoretical example is a vending machine operated by a DAO that not only accepts money in exchange for a good, but also uses that money to automatically reorder inventory or pay for maintenance. In such fully autonomous DAOs, humans operate at the edges, while the automation operates in the center. This example can be extrapolated to ride-sharing, food delivery, or any number of business models.

Contrast the vending machine example with the common DAO understanding, and as DAOs are contemplated under the various state legislative regimes: most DAOs operate with much more human involvement. For example, a DAO may manage a decentralized finance ("DeFi") project through its governance protocols which interact with the DAOs smart contracts. The members are involved in governance decisions like setting transaction fees, investing treasury assets, or even using treasury assets to purchase sponsorship rights. In this case, the DAO is member-managed—unlike the vending machine, which requires no human involvement or management if operating properly and so is "smart contract-managed." This distinction becomes important because traditionally, management powers cannot legally be vested into a non-human protocol like a smart contract (i.e., computer code), because there is no one to hold accountable in case of harmful decisions and no one to handle situations not contemplated by the smart contract. Smart contracts may effectuate the rules of a DAO, as developed by the founders, but members (holders of governance tokens) may want certain voting rights in DAO actions. Even if DAO members are comfortable with completely delegating management to a smart contract, there is a potential problem for the state. Traditionally, if the corporate form is abused, then LLC law will "pierce" the veil of limited liability and the bad acting member(s) may be held liable. However, in a 100% smart contract managed DAO, the management powers are vested into the smart contracts. Thus, if the veil of limited liability must be pierced, LLC law, as currently developed, could dictate that responsibility ends with a "smart contract," not a member, potentially giving bad-faith actors another layer of liability protection. The question then becomes, who can be held liable if a smart contract-managed DAO "commits" bad acts? A smart contract cannot be liable for anything, so questions of whether members would be held liable (or the founders or the code developers) would fall under each state's general LLC law (and perhaps contract and other related laws).

It appears that Wyoming recognized these issues in its amended law by qualifying smart contract-managed DAOs as also being at least partially member-managed. By contrast, the TN law does not appear to contemplate this question.

Management. A notable feature of the WY and TN statutes is the absence of a manager-managed option, the usual alternative to member management under state LLC statutes, under both laws (W.S. §17-31-109; Tenn. Code Ann. §48-250-108). Under state LLC statutes, the owners elect a manager(s) to handle day-to-day business decisions. Members can typically still undertake actions such as dissolving the company, electing a new manager, inspecting books and voting.

Conversely, in Utah, there is a person who is responsible for formation whose information may be redacted – an effort to maintain the core anonymity function of DAOs. (Utah Code Ann. §48-5-201(4)). Utah's statute also allows a DAO to retain legal representation to undertake tasks that cannot be achieved on-chain. For instance, the legal representative may act on the DAOs behalf and enter into contracts, as authorized.

DAOs are typically founded by a core team of developers who build the protocol and generate interest in their organization's aims. After generating interest, the core team will launch the DAO by distributing ownership over the protocol and activating the smart contracts. When the governance smart contracts are activated, control and ownership are passed from developers to the holders of the governance tokens.

Smart Contract Dominance in WY and TN, but not Utah. One of the most eye-catching sections of the Wyoming and Tennessee laws is, surprisingly, located in the "Miscellaneous" provision near the statutes' ends. (W.S. §17-31-115; Tenn. Code Ann. §48-250-114). The provisions begin: "The articles of organization and the operating agreement of a [DAO] are effective as statements of authority." The WY Law goes on to state, that "the smart contract, shall preempt any conflicting provisions of the articles of organization" (with some exceptions), which in turn preempt any conflicting operating agreement (or other agreement) terms (W.S. §17-31-115), while the TN Law is essentially identical. It is also relevant that the WY Law contains a provision on operating agreements that already provides that an "operating agreement may be a smart contract" (W.S. §17-31-108), while the TN Law is noticeably silent on the matter. This means that DAOs' smart contracts are binding—not just technically, but legally—giving new meaning to the phrase "[code is law](#)." However, the Wyoming legislature seemed wary of a smart contract gone awry or a robot apocalypse. In the dissolution provision (W.S. §17-31-114; Tenn. Code Ann. §48-250-113), a DAO shall be dissolved upon certain occurrences, including where the DAO is deemed to no longer perform a lawful purpose. However, the WY Law goes further – perhaps anticipating potential issues that might arise when legally binding smart contracts have bugs or other issues – requiring the dissolution of a DAO when the organization "no longer performs a lawful purpose *or* is no longer under the control of at least one (1) natural person" (emphasis added) ((W.S. §17-31-114(v)). Similarly, another provision of the WY Law requires that all of these smart contracts "shall be capable of being updated, modified or otherwise upgraded" (W.S. §17-31-109). Generally speaking, the smart contracts underlying a DAO may be updated (i.e., replaced) through a governance proposal approved through a consensus of token holders.

In contrast, the governing hierarchy of a Utah LLD is comprised of (1) the act; (2) the by-laws of the decentralized autonomous organization; (3) if the by-laws and the act are silent, then provisions of Chapter 3a of the Utah Revised Uniform Limited Liability Company Act; and (4) the principles of law and equity. (Utah Code Ann. §48-5-102). Given there is no provision for smart contracts, which are generally immutable, the Utah legislature likely recognized that DAOs need to be able to create flexible management structures outside the strict confines of smart contracts.

Inverted Inspection Requirements. Another innovation of the both the WY and TN Laws is the provision exempting DAOs from providing information to members that is "available on an open blockchain" (W.S. §17-31-112; Tenn. Code Ann. §48-250-111). This stands in contrast to the "books and records" provisions of many states' LLC laws, which typically allow LLC members to inspect their company's internal records (so long as certain "reasonable standards" are met, such as that the inspection is related to the member's interests as a member). Here, we see technology has changed certain recordkeeping and access procedures that corporate entities have traditionally had to fulfill regarding books and records. Both laws place the onus on DAO members to be cognizant of their DAOs publicly recorded transactions and other blockchain-based information, and incentivizes DAOs to record information on a public blockchain to avoid the expense of records requests (though, to the extent information is not publicly available, a member could conceivably request such records under existing law).

While TN and WY suggest the DAO should be deployed on a permissionless blockchain, Utah explicitly requires it. (Utah Code Ann. §48-5-201(3)(a)). Further, in order for the LLD to be formed, one of the requirements is that the DAO has a unique public address where individuals can review and monitor the DAO's transactions. (Utah Code Ann. §48-5-201(3)(b)).

Fluid Membership. The Utah Law provides that where the DAO has tokens providing governance rights to token holders, the token holder is considered a member of the DAO from the time the ownership of the tokens is established to be in possession of an address or from the time when ownership if first acknowledged by the token holder though an on-chain interaction with the DAO. (Utah Code Ann. §48-5-301).

The WY Law establishes default rules for DAO membership. Attempting to reflect the existent realities of token-based membership, the amended WY Law states that "a person shall be considered a member if the person purchases or otherwise assumes a right of ownership of membership interest or other property that confers upon the person a voting or economic right within the [DAO]" (W.S. §17-31-113(d)(i)) (a similar provision removes membership from persons who sell their interests). Thus, unlike LLCs, which generally require written agreements when their membership changes, a Wyoming DAO's membership are able to shift as tokens are bought, sold, and airdropped. This is good news for token purchasers and airdrop recipients, as it means that by buying in, they will conceivably receive the same liability protections held by their fellow members.

By contrast, the TN Law does not provide the same clarification as the amended WY Law. The TN Law provides that members associate and dissociate "in accordance with the terms set forth in the articles of organization, the smart contracts, or, if applicable, the operating agreement" (Tenn. Code Ann. §48-250-112). Basics of DAO governance, like association and dissociation, are baked in the governance token held by members (and therefore encoded within smart contracts) because one must own a right of ownership and control, typically through a token, to participate in governance. Thus, while helpful, the Wyoming amendment above does not necessarily bestow rights on participants in a Wyoming DAO that are unavailable to a participant in a Tennessee DAO.

Final Thoughts

It remains to be seen how effective the Utah Law, amended WY Law, and the TN Law (and the Vermont BBLLC law) will be at encouraging formation and attracting DAOs to these states. In the near future, other state governments, already seeking to attract crypto businesses and miners, may follow Salt Lake City's, Cheyenne's and Nashville's recent enactments and adopt similar—or not so similar—DAO statutes. The laws will likely require additional amendments as DAOs and their underlying blockchain technology further develop, or if additional investor protections or clarifications are desirable. In the long run, experimenting with DAO legislation in the state laboratories of blockchain law will benefit an industry seeking legislative and regulatory clarity and consumer DAO members seeking certain legal protections. For now, though, the beginnings of a trail have been blazed by these states clearly jockeying for position as crypto hubs.

_____

[1] Wyoming was actually not the first state to enter the DAO fray. In July 2018, Vermont passed a law that created "blockchain-based limited liability companies" (BBLLCs). See S0269 (2018) (codified at 11 V.S.A. § 4173 et seq.). The law similarly seeks to promote fintech and blockchain innovation by permitting DAOs to choose to form under a recognized legal wrapper. BBLLCs may provide for its governance in whole or in part by blockchain technology, allowing for member proposals and voting, and execution via smart contract. The law also specifies the rights and obligations of members.

View original.

- **Peter J. Cramer**
  Associate