BEYOND A REASONABLE DAOUBT: TENNESSEE'S LIMITED LIABILITY STATUTE FOR DECENTRALIZED AUTONOMOUS ORGANIZATIONS (DAOS)

Date: 4 August 2022

U.S. Corporate Alert

On 20 April 2022, Tennessee became the second state in the United States to create a specialized business entity for decentralized autonomous organizations (DAOs), an emerging collaborative management structure for legal entities using blockchain technology.[1]

The new legislation amends Title 48 of the Tennessee Code to allow Tennessee limited liability companies (LLCs) to register as "decentralized organizations" by including new elective language in their articles of organization.[2]

According to the bill's sponsor, the new law seeks to make Tennessee "a beacon for blockchain investment, new jobs and investment."[3] Indeed, some have observed that DAO assets under management could grow to US$1 trillion over the next decade.[4] DAO proponents have tried to illustrate this inevitable growth by analogizing that 'DAO is to LLC, as email is to mail.'

By providing limited liability protection for decentralized organizations, Tennessee has removed a significant hurdle to the more wide-spread adoption of DAOs as business entities.

BACKGROUND ON DAOS

There are several types of organizations that may be called a DAO;[5] most have in common collaborative management of digital assets using technology tools derived from public network blockchain systems. For example, a DAO may be a business organization that is governed using tools derived from a web3 or other distributed ledger environment. As the name implies, a DAO's management is intended to be "decentralized" in the sense that there is no requirement for a centralized governing authority, like a board of directors or manager, and its members agree to manage the DAO by voting using "smart contracts", rather than traditional corporate voting procedures. The DAO may use smart contracts to automate certain management and economic processes, with members only supplying information needed by the entity, making the entity theoretically "autonomous" or, where members are entitled to vote, "quasi-autonomous" in the sense that the DAO uses code to effectuate the decisions of its voters.

Among many potential applications, DAOs have been used by businesses where there is a perceived benefit to "community decision-making," and a strong desire to avoid censorship of other members' ideas or expressions. For example, one DAO based partly in Nashville, Tennessee operates a group chat forum where users may monetize their chats. Still other DAOs have been structured as investment holding companies, or groups of investors who desire to organize for a single investment purpose. These entities may contract with a management organization to oversee certain investment functions and conduct due diligence on potential

©2005-2026 K&L Gates LLP. All Rights Reserved.

acquisition targets. Similarly, a DAO could be affiliated with an operating business for the purpose of rewarding and incentivizing service providers.

THE NEED FOR LIMITED LIABILITY PROTECTION

The predicate for many DAOs is collective management of some asset or activity, such as a business or other valuable property (tangible or intangible), in which each member may own a fractional interest. Yet, in addition to regulatory and securities laws risks, whenever valuable assets are invested and held by any organization, the risks and liabilities of holding those assets and operating the business must be adequately proportioned among the participants in that organization.

Earlier this year, one case in the Southern District of California tested the question of whether a decentralized organization, which delegates decision making to a computer program, would provide de facto limited liability protection for its members. In May 2022, plaintiffs in Sarcuni et al v. bZx DAO et al., filed a federal law suit in the Southern District of California against bZx DAO, which operated a decentralized finance (DeFi) protocol for "tokenized margin trading and lending."[6] Despite statements made to its members that the DeFi protocol was secure, a hacker was able to obtain access to the private software keys in the wallet of one bZx developer through means of a phishing attack. The hackers were then able to alter bZx's DeFi protocol, resulting in the theft of US$55 million of cryptocurrency from bZx.[7] In their Complaint, the Plaintiff's argued that:

> Since the protocol has failed to pay back what was taken as a result of the protocol's negligence, all of these Defendants are jointly and severally responsible for making good to the Plaintiffs. That is because the bZx protocol purports to be a socalled DAO, or de-centralized autonomous organization, that lacks any legal formalities or recognition. There is another phrase in American law for that kind of arrangement: general partnership. That means each of the partners is jointly and severally liable to the Plaintiffs and must make good on the full amount of its debts.[8]

As the bZx case illustrates, without a statutory framework providing limited liability protection, a Court could infer an entity upon members of an unincorporated or "alegal" DAO with the result that any given member could be liable for the debts, obligations, and liabilities of any other member, all members, or for "the DAO" itself.[9] Fortunately, DAOs properly formed in Tennessee may enjoy the same limited liability protections afforded to members of an LLC.[10]

THE TENNESSEE STATUTE

The Tennessee statute, Tenn. Code Ann 48-250-101 et. seq., provides a basic framework for creating a DAO under the state's law. Following this framework, a DAO properly organized in Tennessee will be able to offer its members the same limited liability protections afforded to a traditional LLC. In summary:

- At least one member must sign and deliver the articles of organization to the secretary of state for filing. The person forming the decentralized organization does not need to be a member of the organization.

©2005-2026 K&L Gates LLP. All Rights Reserved.

- The governing documents of a DAO must contain a statement that "the company is a decentralized organization".
- Alternatively, DAOs may be formed as LLCs and then later converted to a DAO through an amendment to the LLC's articles of organization.
- Certain notices regarding potential restrictions on duties and transfers in a DAO, and how those restrictions may be materially different from that in an LLC, are required to be included in the organizational documents.
- The registered name for a DAO must include the words "DO", "DAO", "DO LLC" or "DAO LLC" to note its status as a decentralized organization.
- The DAO's articles of organization must define whether it is a "member-managed" or "smart contract-managed" DAO. If a DAO is not specified to be smart contract managed, the presumption will be that the DAO is member managed. The smart contract, if applicable, must be capable of being amended, and a publicly available identifier of a smart contract directly used to manage, facilitate, or operate the decentralized organization must be included.
- The organization must be based inside the United States and its territories.

Whether Tennessee will become the "Delaware of DAOs" remains to be seen.[11] DAOs may not be appropriate for every type of business organization, and governance through smart contracts does not guarantee better decision making compared to conventional corporate governance procedures. Yet as digital currencies continue to gain acceptance in the marketplace and regulatory enforcement becomes more transparent and predictable, the prevalence of member managed and smart-contract enabled DAOs geared toward automation and democratizing corporate governance is likely to be a growing trend for certain types of businesses.

FOOTNOTES

[1] Tenn. Code. Ann 48-250-101 et seq.; HB 2645, https://www.tba.org/docDownload/1943411

[2] https://www.tba.org/?pg=Articles&blAction=showEntry&blogEntry=73474

[3] https://www.nashvillescene.com/news/pithinthewind/tennessee-becomes-second-state-to-pass-dao-legislation/article_ecbd4cbe-b5e2-11ec-abe0-77a2385be512.html

[4] https://www.businessinsider.com/crypto-venture-fund-cofounder-dao-vc-assets-one-trillion-dollars-2022-4

[5] *See* generally https://blog.ethereum.org/2014/05/06/daos-dacs-das-and-more-an-incomplete-terminology-guide/ initially proposing the term as applied to distributed ventures operated on blockchains; the legal and alegal daos described herein are closer to the entities classified as DACs by Buterin.

[6] Sarcuni, et al., v. bZx DAO et al., No. 22-cv-618, Complaint (S.D. Cal. May 2, 2022)

[7] *Id*.

[8] *Id*. at 3 (emphasis added).

©2005-2026 K&L Gates LLP. All Rights Reserved.

[9] *See*, for example, https://www.coindesk.com/markets/2016/05/19/the-law-of-the-dao/. For a discussion of downsides to organizing via an "alegal dao, see https://jcl.law.uiowa.edu/sites/jcl.law.uiowa.edu/files/2021-08/Hinkes_Final_Web_0.pdf, at 884-885

[10] *See* Tenn. Code § 48-250-109

[11] https://www.nashvillescene.com/news/pithinthewind/tennessee-becomes-second-state-to-pass-dao-legislation/article_ecbd4cbe-b5e2-11ec-abe0-77a2385be512.html

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.