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Comment on the Fiduciary-ness of Business Associations

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For the past 20 years of my professional life, I have worked with small start-up companies who are in the process of commercializing their intellectual property. As a result, my comments today concerning the recent Tennessee and Wyoming[1] legislation which allows for the creation of decentralized organization LLCs in their respective states, are informed by my experience. In addition, my scholarly interests are focused on innovation and its importance to our economy and quality of life, and as such I embrace innovation when the potential benefits outweigh the costs. Having shared this perspective, I too have concerns that there is a need to reexamine the law in Tennessee to ensure that the individuals who are "investing" in the Decentralized Autonomous Organization (DAO) are protected from unscrupulous behavior or negligence by other participants in the DAO. Before addressing the questions that Professor Heminway posits, I feel that some background information should be provided to assist us in understanding how and why the need to create liability protection for DAO's has come about.

Background and Understanding

The decentralized automated organization is a relatively new phenomenon, the first of which was created only 6 years ago in April 2016 by German startup Slock.it and was simply named "The DAO." Its stated objective was to democratize venture capital investing by allowing token holders to vote on what projects were funded. The platform was made up of complex smart contract mechanisms that were running on the

[1] *See* TENN. CODE ANN. §§ 48-250-101 – 48-250-115 (2022); WYO. STAT. ANN. §§ 17-31-101 – 17-31-116 (2022) (codified as the "Wyoming Decentralized Autonomous Organization Supplement").

Ethereum blockchain. Initially, The DAO was highly popular and even managed to raise over $150 million from more than 11,000 investors making it the largest ever crowdfunding campaign at the time. Its tokens were sold as an initial coin offering (ICO) and granted users with an ownership stake and voting rights within The DAO. Unfortunately, shortly after its launch, The DAO was exposed to the largest hack in the history of cryptocurrency at that time, during which about ⅔ of the funds were drained from it. It is an event like this, where those who are damaged look to lawyers to pursue potential remedies. However, because members of the organization can be spread around the world and for all practical purposes are anonymous to the other members, resolving such legal disputes becomes very complex.

More recently on May 2, 2022, a class action complaint was filed in the Federal District Court Southern District of California alleging that bZx DOA[2] negligently allowed a hacker[3] to abscond with approximately $55 million dollars equivalent of cryptocurrency, $1.6 million dollars of which were from class members who were domiciled in 14 different countries. Because bZx DOA had no formal corporate structure, the plaintiffs sued not only the DOA, but also the cofounders, the crypto currency investor in the bZx protocol, the company that operated the trading platform, and the company that controlled the protocol as general

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

[3] Despite the representations that were made to the members that the decentralized finance (DeFi) protocol was secure, a hacker was able to obtain the software keys of one of the bZx developers through means of a phishing attack.

partners. Because bZx DOA was not a formal business entity, the individuals that worked to create the DOA were sued under California's general partnership statute, where each partner is deemed jointly and severally liable for the actions of the DOA.

What Motivated the Creation of the Tennessee LLC Act?

As the bZx DOA case illustrates, without a statutory framework providing limited liability protection, a Court could apply the statutory default partnership on the DOA, thus exposing any given member to the debts, obligations and liabilities of the organization. In addition, any token holder in a DAO, could theoretically be held liable for the debts of the DAO, even though the DAO actions were carried out automatically by a computer-run smart contract on autopilot without any human intervention. It appears that much of the motivation for introduction of the DAO legislation in Tennessee came from local tech companies with some support from national trade organizations. The promise that Tennessee could be the next hotbed for Web3[4] companies sparked the attention of legislators that believe that the DAO legislation will signal investors and innovators that Tennessee is the place to be and invest. State House Representative, Jason Powell, the bill's sponsor announced

[4] Web3 (also known as Web 3.0) is an idea for a new iteration of the World Wide Web which incorporates concepts such as decentralization, blockchain technologies, and token-based economics.

that the legislation will make "Tennessee the Delaware of DAO's". The bill was passed unanimously by both houses.

In recent years, DAOs have experienced radical growth. According to the data analytics site DeepDAO, in 2021 alone, the total value of DAO treasuries skyrocketed fortyfold, from $400 million to $16 billion, and the number of participants surged from 13,000 to 1.6 million. With DAOs growing at such a rapid rate, forecasters are predicting that this novel organizational form could expand to one trillion dollars in the next ten years. The vast amount of revenue that could potentially be brought to Tennessee by providing limited liability to such entities, in my judgement, was the primary motivating factor for the legislation.

To What Degree Did the Legislature Consider the Effects of Elimination of Statutory Fiduciary Duties to the Members of the DOA LLC?

It doesn't appear that DAO LLC member protection was at the forefront of considerations when the DAO legislation was drafted. The legislation contains language that unless the articles of organization or operating agreement provide otherwise, DAO members do not have fiduciary duties to the DAO or its members but are subject to the implied contractual covenant of good faith and fair dealing. A member does not have a right under the new law to separately inspect or copy DAO records, and the DAO has no obligation to furnish information about its activities, financial condition or other circumstances to the extent that such information is available on publicly available distributed ledger technology (or blockchain). Such provisions serve to reduce the risk to and liability exposure to the DOA LLC organizers at the expense of the investors. As

Professor Heminway aptly points out, it does not appear that there was any participation by the practicing bar or the Tennessee Bar Association to examine and critique the legislation as has been customary in the past.

As a practical matter, the average person does not enter into a business relationship with a clear understanding that they are protected by statutory fiduciary duties. When a business opportunity is proposed, it is only the sophisticated party that takes the time to read an operating agreement to fully understand the rules and obligations of the parties. As mentioned earlier, it is only when a party feels aggrieved do they seek the advice from a lawyer, who does understand the default rules pertaining to fiduciary duties to determine if there is a cause of action based on their breech. DOA proponents would argue that its members are protected by the "implied covenant of good faith and fair dealing."

Despite both containing the term "good faith," the concepts of the fiduciary duty of good faith and the implied covenant of good faith and fair dealing are two distinct legal concepts and many business owners and even attorneys are unaware of the differences of the two concepts. The duty of good faith is the principle that directors and officers of a company in making all decisions in their capacities as fiduciaries must act with a conscious regard for their responsibilities as fiduciaries. Defined simply, the duty requires fiduciaries to have subjectively honest and honorable intentions in all professional actions. Numerous courts have found that the duty of good faith requires controlling shareholders to exercise their powers in good faith and in a way that does not oppress the minority. It

can be argued that the structure of the DAO prevents the creation of a fiduciary relationship between the parties, because the DAO has no directors or officers that are making all of the decisions, the identity of the members are unknown to the other members, and that all the members of the DAO have the same voting power depending on the number of tokens held.

The implied covenant of good faith and fair dealing on the other hand is a tool of contract interpretation meant to ensure that the parties' reasonable expectations are fulfilled. The implied covenant prevents a party to a contract from violating the "spirit" of the contract, even if the contract does not expressly prohibit the party's actions. When invoking the implied covenant, courts are guided primarily by the goal of compelling fairness. The implied covenant is by design limited by the written terms of a contract. Courts will not use the implied covenant to contradict or change the written terms of a contract. Unlike the duty of good faith, the implied covenant of good faith does not create a requirement that a party act in a morally commendable sense. Instead "good faith" in context of the implied covenant refers to a party's faithfulness to the scope, purpose, and terms of the parties' contract. In this case, whether a party acted with good faith would be constrained by the terms of the operating agreement. Since the operating agreement will be the product of the DAO organizers, they have total control of the structure and content of the contract, and will likely not contain any provisions that can later be used to impose legal liability through use of the implied covenant of good faith and fair dealing, as it would not be a "democratically" negotiated document.

Conclusion

The evolution of the DAO and the use of Cryptocurrency present a number of regulatory challenges. Both federal and state law has struggled to keep up with the innovations that have been made in this space. Both state and local regulators find it difficult to keep pace. On January 1, 2021, Congress enacted the Corporate Transparency Act of 2021[5] (the "CTA") in an attempt to "'improve transparency for national security, intelligence, and law enforcement agencies and financial institutions concerning corporate structures and insight into the flow of illicit funds through those structures' and 'discourage the use of shell corporations as a tool to disguise and move illicit funds.'"[6] More recently in June of this year, The Responsible Financial Innovation Act was introduced in the Senate which attempts to clarify the regulatory and tax treatment of digital assets. In addition, it identifies the need to set up rules for purposes of consumer protection. With such national attention focused on these issues, it is incumbent for the Tennessee Legislature to revisit the law as relates to DAO LLC, to ensure that the appropriate checks and balances are in place to ensure that appropriate measures are taken to ensure organizational integrity.

[5] 31 U.S.C. § 5336.

[6] Beneficial Ownership Information Reporting Requirements, 86 Fed. Reg. 69920, 69925 (proposed Dec. 8, 2021) (to be codified at 31 C.F.R. pt. 1010).