HONG KONG COURT CALLED FOR TRANSPARENCY IN DECENTRALIZED AUTONOMOUS ORGANISATIONS ("DAOs") - FROM *Mantra Dao Inc. & Anor v John Patrick Mullin & Ors [2024] HKCFI 2099*

The concept of a DAO was supposed to be a type of internet-based organization that operates based on smart contracts containing specific sets of self-executing and self-enforcing rules on a blockchain network. The aim of a DAO was to enable its participants to achieve their common goals without the need of a central authority/intermediary (such as a board of directors) to manage its operations (hence "decentralized"). DAOs were meant be transparent and democratic, with their decision-making power distributed among its members (usually token holders), through a voting system (based on the number of tokens held by each DAO participant).

The first DAO, "The DAO", was launched in April 2016 on the Ethereum blockchain.[1] Within the first month of launch of The DAO, it raised over US$150 million in funding. Unfortunately, only in June 2016, The DAO was subjected to a hacking, resulting in the loss of approximately one-third of its funds and its ultimate shut down. Despite such incident underscoring the vulnerability of DAOs, the development of DAOs has continued. Up to May 2024, there are already over 13,000 DAOs operating on different blockchain networks.[2] Nevertheless, a lot of the projects have misused the term "DAO", and they may not be as decentralized and transparent as originally envisaged.

In the recent case of *Mantra DAO Inc. & Anor v John Patrick Mullin & Ors [2024] HKCFI 2099*, the High Court of Hong Kong was faced with an application for an order requiring the disclosure of books and records relating to the operation of a DAO.

A. Case Summary

The case concerns a dispute between Mantra DAO, Inc. and RioDeFi (the Plaintiffs) — its infrastructure host — and former RioDeFi employees, regarding (1) the control and ownership of a DAO platform project (the **"Project"**) and (2) the alleged misappropriation by the former RioDeFi employees.

The Plaintiffs assert that the Project belongs to, and should ultimately be controlled and managed by them. They further claim that they delegated the day-to-day management to RioDeFi's employees, i.e. the 1st and 2nd Defendants, and their team in around August 2020, on the basis of and in reliance upon: (1) their employment duties; and (2) the agreement that they would regularly report on the assets, finances and operations of the Project (the **"Management Agreement"**).

However, the Plaintiffs alleged that since around January 2021, reporting from the 1st and 2nd Defendants became more and more infrequent, contrary to their duties. According to the Plaintiffs, the 1st and 2nd Defendants, together with the other Defendants, began treating the Project as their own. Further, the Plaintiffs claim that the Defendants have "misappropriated"

[1] See Whitepaper of The DAO at https://github.com/the-dao/whitepaper
[2] "How should we deal with decentralised autonomous organisations (DAOs)?", Aaron Kelly, 15 May 2024, at https://www.ogier.com/news-and-insights/insights/how-should-we-deal-with-decentralised-autonomous-organisations-daos/

the Project and its business and assets from the Plaintiffs. In particular, it is alleged that the 1st to 4th Defendants had misappropriated assets from a cryptocurrency account (known as the "Hex Account") allegedly belonging to the 1st Plaintiff by making various "unaccounted-for" withdrawals. As a result, the Plaintiffs now have no visibility at all as to the management decisions made by the Defendants or how the Project's assets are being deployed.

On the other hand, the Defendants' case is that the Project should not be owned or controlled by the Plaintiffs at all as a DAO is an organization where the ultimate decision-making power lies with the holders of digital tokens, operating through computer codes which exist on a blockchain. Moreover, the Defendants argued that the operation of the Project is governed by the Governance Agreement and the White Paper of the Project, which provides, *inter alia*, that:-

(a) The Project lacks its own legal personality and was not intended to be owned by any single individual or entity.

(b) The decision making over the assets of the Project was supposed to lie ultimately with the token holders through the exercise of voting rights, thereby authorizing the entities holding assets for the token holders (not beneficially) to act on behalf of the Project.

To preserve the status quo of the Project and to monitor the Project's operation and development pending trial, the Plaintiffs initially in 2022 applied for an injunction against disposing of or dealing with cryptocurrency, prohibition against use of trademarks and passing off, but was unsuccessful. Subsequently, the Plaintiffs focused solely on a court order requiring the disclosure of books and records relating to the operation of the Project (the **"Accounts Disclosure Order"**), which Justice Lok granted at the substantive hearing.

In Justice Lok's Reasons for Decision, he notably acknowledged that cryptocurrency trading is an innovative matter that the court has little experience with. He further commented that Hong Kong courts, and many other courts in different jurisdictions, may not be familiar with the *modus operandi* and the structures of DAOs. The legal effects of the Governance Agreement, the White Paper, the Management Agreement and the Employment Agreements are to be fully investigated at the trial.

In opposition to the Accounts Disclosure Order, the Defendants argued that such Order would cause undue hardship. However, this has been dismissed by Justice Lok, who took the view that:-

(1) Damages are an inadequate remedy if the application is refused, due to the fast-growing nature of the cryptocurrency industry.

(2) With the level of assets controlled and managed by the Defendants, it is important that the Plaintiffs be given regular updates on the financial operation of the Project, given their claim over the ownership, management and control of the Project.

(3) The Accounts Disclosure Order would not disrupt the operation of the Project but would impose the duty for managers to keep proper accounts, thereby promoting the healthy operation. Such duty should not cause any additional or significant burdens on the Defendants as they should be expected to do so as managers of the Project.

B. Observations

Hong Kong courts are willing to keep DAOs within reach of traditional legal principles. There has been a misconception within the crypto-community that the pure fact that the concept of DAO is not embedded in legislations, it is beyond the ambit of law. However, in Justice Lok's groundbreaking decision, being one of the first judicial examinations of DAOs, he has clearly shown that the courts are willing to apply traditional legal principles on DAOs. The court has sent a strong message that, despite DAOs' novel features, they are expected to maintain proper accounting records, just like other organizations. However, based on our experience, legal battles surrounding the extent and/or quality of the accounts disclosure can be anticipated, as it is more likely than not that the accounting records of DAOs are likely to be shambolic.

DAOs investors should exercise caution in examining its governance mechanism, in particular, the wallet management policy. Although Justice Lok did not delve into the merits of the case when dealing with the Accounts Disclosure Order, His Honour highlighted the importance of thoroughly examining the governing and constitutional documents of Mantra DAO during the trial. This subtle comment suggests that investors of DAOs should examine constitutional documents and internal compliance policies, in particular, the wallet management policy, to ensure that the DAO and/or its assets would not be hijacked by any of its founders or staff. There are now various types of DAOs, and some may have lost their original "decentralized" feature. At the token generation event stage (commonly known as the TGE stage), creators often retain founder tokens to retain majority voting power. If founder tokens constitute a significant portion of all tokens, founders can effectively dominate voting, resembling a central authority.

Hong Kong Government should consider whether law reform is desirable in light of the surge of DAOs. The hacking incident involving The DAO has already highlighted the vulnerability of DAOs to hacking and security breaches. Another concern surrounding DAOs is the uncertainty in their legal status. Globally, a few jurisdictions, including the state of Wyoming in the USA, the Marshall Islands, and Malta, have already recognized the legal status of DAOs and have promulgated relevant DAO legislations. In other jurisdiction such as Hong Kong, however, the legal landscape remains uncertain. Members of a DAO may encounter challenges when seeking to enforce their rights within the legal system, as courts are relatively inexperienced in dealing with novel entities like DAOs. Following Justice Lok's Reasons for Decision, Hong Kong Legislative Council member Mr. Johnny Ng, a vocal supporter of making Hong Kong a crypto hub, advocates for a new legal framework to regulate DAOs, believing that it will enhance Hong Kong's stability in the Web3 investment landscape, thereby attracting significant overseas talent and capital.

Nevertheless, in mid-July, the UK Law Commission has published a scoping paper on DAOs[3]. In the paper, the Commission considered how DAOs can be characterized under existing legal principles, and concluded that "unincorporated association" is a more fitting characterization than "general partnership". Interestingly, they concluded that England does not need a new form of organisation specifically for DAOs as there is no consensus on a standardized DAO structure and organisational law should remain technology neutral. The Commission suggests that the

[3] https://cloud-platform-e218f50a4812967ba1215eaecede923f.s3.amazonaws.com/uploads/sites/30/2024/07/DAOs-scoping-paper-110724.pdf

introduction of a "limited liability not-for-profit association with flexible governance options" can be considered. We would suggest that the Legislative Council take a more in-depth investigation in DAOs to consider whether any further work could or should be undertaken to address the concerns or uncertainties surrounding the legal status and liabilities of DAOs, in order to give more certainty to market participants.

At Henry Yu & Associates, our experienced legal team has ample experience in advising on setting up and investing in DAOs and related legal matters and so far, the founders and initial investors have achieved their original goals.

Please do get in touch with our team members at hyu@lylawoffice.com or (+852) 2115-9525 if you have any views on the above or would like to further discuss any of the issues raised in this Client Alert more generally.

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