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U.S. Appeals Court Rules That the Department of Treasury Exceeded Its Authority in Sanctioning Tornado Cash

The Fifth Circuit Court of Appeals held that Tornado Cash's immutable smart contracts are not the "property" of a foreign national or entity, meaning:

1. Smart contracts cannot be blocked under the International Emergency Economic Powers Act (IEEPA) and
2. OFAC overstepped its authority in sanctioning Tornado Cash.

OFAC's Sanctions on Tornado Cash

- The IEEPA and the North Korea Sanctions and Policy Enhancement Act vest the President with the authority to regulate (or block) “property” in which a foreign “national” or “person” (or “entity”) has an “interest.”
- In late 2022, OFAC sanctioned Tornado Cash, a software protocol that facilitates anonymous transactions by obfuscating the origins and destinations of digital asset transfers.
- OFAC added Tornado Cash to the list of Specially Designated National and Blocked Persons (SDN) and imposed an across-the-board prohibition against any dealings with Tornado Cash “property,” which OFAC defined to include open-source computer code known as “smart contracts.”
- OFAC designated as “entities” the website tornado.cash, certain Tornado Cash smart contracts, and several Ethereum addresses associated with Tornado Cash software citing North Korea’s use of Tornado Cash to commit cybercrimes, including laundering of stolen cryptocurrencies.

The District Court's Decision

- Six Tornado Cash users sued OFAC under three theories claiming that OFAC lacked the authority to designate Tornado Cash as an SDN:
 - Tornado Cash is not a foreign “national” or “person,”
 - The immutable pool smart contracts are not “property,” and
 - Tornado Cash cannot have a property “interest” in the immutable smart contracts.
- The district court granted OFAC’s motion for summary judgment and denied that of the Tornado Cash users, concluding:
 - Tornado Cash is an “entity that may be properly designated as a person under IEEPA,”
 - That smart contracts constitute “property,” and
 - That the DAO, which runs Tornado Cash, has an “interest” in its smart contracts because it derives profits from its crypto mixing and relaying services that run on smart contracts.

No Deference to the Agency's Interpretation of Statute

- The opinion on appeal entered by the Fifth Circuit was one of the first to consider agency deference after the Supreme Court's ruling in *Loper Bright v. Raimondo*.
 - The *Loper Bright* case eliminated deference to agency interpretation of rules and statutes and instructed courts to independently determine “the best reading of a statute,” and to ensure that agencies exercise their discretion consistent with the Administrative Procedure Act.
- The Fifth Circuit agreed with plaintiffs that the district court erred in giving “heightened deference” to OFAC's interpretation of the statutory term “property” and in finding that the immutable smart contracts met that definition.

Immutable Smart Contracts are Not “Property”

- Analyzing the “ordinary” and “plain” meaning of the term “property,” the Fifth Circuit concluded that “property has a plain meaning: it is capable of being owned.”
- The Fifth Circuit held that the immutable smart contracts at issue are not property because they are not capable of being owned. The court noted that no one can “exclude” anyone from using the Tornado Cash pool smart contracts.
- The Fifth Circuit highlighted the distinction between immutable and mutable contracts:
 - A mutable smart contract is one which is managed by some party or group and may be changed.
 - An immutable smart contract, on the other hand, cannot be altered or removed from the blockchain. Therefore, Tornado Cash developers cannot “**discard, change, disconnect, or control** smart contracts that are immutable”—like the ones listed on OFAC’s SDN list.

Immutable Smart Contracts are Not “Contracts” or “Services”

- The Fifth Circuit also held that the immutable smart contracts at issue are not “contracts” because they have “only one party in play” and thus do not constitute “an agreement between two or more parties.”
 - The Fifth Circuit reasoned that when choosing to use or interact with an immutable smart contract, a third-party user could make an offer, but there is no smart contract operator on the other side of the transaction to accept or make a counteroffer—just software code. Therefore, “[b]ecause no one can control immutable smart contracts (or the Ether deposited in the pools), there is no party with which to contract.”
- The Fifth Circuit further held that the immutable smart contracts are not “services,” but merely “tools” used by an individual digital asset owner to make the relevant input and withdrawal from the smart contract.

The Fifth Circuit Invited Congress to Update the IEEPA

- In closing, the Fifth Circuit remarked that there are “real-world downsides of certain uncontrollable technology falling outside of OFAC’s sanctioning authority.”
- However, the Fifth Circuit noted, “[m]ending a statute’s blind spots or smoothing its disruptive effects falls outside [its] lane.”
- The Fifth Circuit pointedly concluded that “legislating is Congress’s job—and Congress’s alone” and the Fifth Circuit must “decline the Department’s invitation to judicial lawmaking.”

Implications for the Digital Assets Space

- Although certainly significant, the Fifth Circuit's ruling is narrower than it appears at first glance.
 - The Fifth Circuit considered the narrow issue of whether the smart contracts at issue were property as defined in the relevant statute, finding that based on the plain language of the statute they are not property.
 - However, the court did not consider whether any party may be liable for the deployment or utilization of any of those smart contracts, and specifically did not consider whether any tort theories of liability, including vicarious liability, could be used to hold any third party responsible for the outcome of smart contract execution.
 - The Fifth Circuit discussed a deployed instance of open-source software, not the actual software code itself.
 - The holding does not suggest that that smart contract code itself is not property. Parties should consider appropriate licenses for their code notwithstanding the court's order.

Implications for the Digital Assets Space

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- The Fifth Circuit repeatedly emphasized that central to its reasoning is the Tornado Cash’s developers’ inability to “alter or remove” the immutable smart contracts from the blockchain, or to “discard, change, disconnect, or control” them.
- The precise meaning of “alter”, “remove”, “control”, “manage” and other verbs that are used to distinguish between a mutable and immutable smart contract are not clearly defined and may be the subject of further litigation.
- The Fifth Circuit invited Congress to act and address new technologies that fall outside the scope of legislation enacted “before the modern Internet was even invented.”