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Decentralized Autonomous Organizations

By Ali Dhanani and Brian J. Hausman

Decentralized autonomous organizations ("DAOs") appear to be the next great development coming out of the ever-expanding field of blockchain technology. Blockchain technology has evolved since its inception in 2010 as a trustless exchange of value, to smart contracts, non-fungible tokens ("NFTs") and now smart governance platforms. DAOs present a fundamentally decentralized approach to governance, allowing for new types of organizations and approaches to business. This article explores the concept of DAOs, how they came to be, the parameters, examples and legal issues surrounding DAOs.

WHAT IS A DAO?

A DAO is an organizational structure with an objective that is maintained on a blockchain or distributed ledger. The objective can be any wide-ranging common goal shared by the members of a DAO, including donating to charities, collecting art, operating as an investment fund, etc.[1] Unlike most traditional organizational structures that require some sort of authoritative governance, there is no hierarchy among members of a DAO. Control of a DAO is spread among its members.[2] Any one member can submit a proposal for the DAO to perform a certain action, wherein the proposal is voted on by the members of the DAO.

If the number of votes approving the proposal exceeds a predefined threshold, such as 50 percent for a simple majority, the DAO automatically performs the action specified in the proposal through the blockchain.[3] As no central entity can oversee and control the DAO, the advantage of decentralization across the blockchain can be appealing to individuals. Proponents of the DAO structure associate it with being truly democratic across its members and transparent with regard to recordkeeping.[4]

DAOs can benefit from global accessibility and a low barrier of entry for potential members.[5] Any potential member can quickly connect to a DAO through the internet, provide authentication and start actively participating in the DAO. In contrast, the standard company structure has controlled access, can be regionally located and would not publish financial statements if regulations were not in place. While centralized leadership of a standard company can provide for quick decision-making and implementation,[6] many find this hierarchical structure undemocratic where a select few are making all the decisions. This viewpoint has contributed to the recent creation of numerous DAOs attempting to address this concern (Figure 1).

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HOW TO IMPLEMENT A DAO?

To implement a DAO, an individual has to create a set of rules for constructing the DAO and operational rules that the DAO will follow. These rules are written as a smart contract expressed through software or pieces of code for automatic execution.[7] Smart contracts are configured to enforce the terms of an agreement written in the software when predefined conditions are met.[8] However, smart contracts have yet to be confirmed in a court of law as constituting a valid binding agreement.[9] Some legal academics claim that smart contracts are not legal agreements[10] but rather means of performing the agreement, such as technological means for the automation of payment obligations.[11]

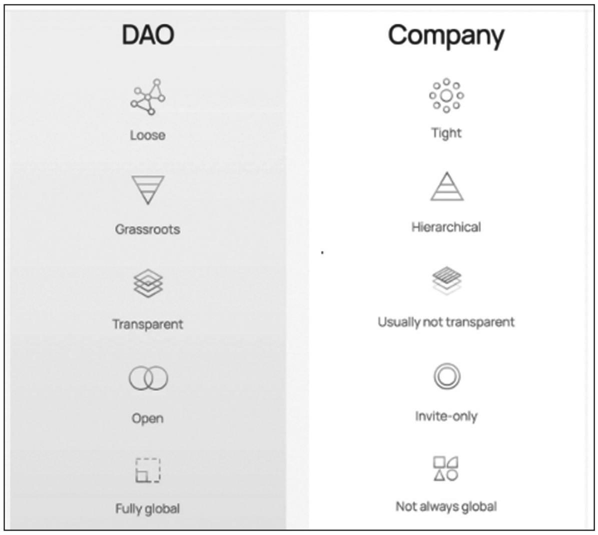
For a DAO, the smart contract can include rules for establishing a treasury, creating governance tokens, establishing voting procedures and a proposal deposit, and functional rules associated with the DAO's objective.[12]

After preparing the smart contract, the individual has to deploy the smart contract to a blockchain, wherein the blockchain will maintain and execute the smart contract. A blockchain is a distributed database that is shared among nodes operating within a computer network.[13] Any transaction to be stored on the blockchain is transmitted to each of the nodes, wherein each node has a copy of the distributed database. The blockchain collects information in groups of data that is verified through a consensus protocol by each of the nodes. If verified, each node updates its copy of the distributed database with the groups of data that is cryptographically secured to data already stored in the blockchain.

A blockchain provides transparency to all the transactions stored on the database as each node has access to a copy of the database, and the blockchain provides decentralization by dispersing the data to a number of nodes across a computer network.[14] Within the past few years, private companies have implemented blockchain in various applications. With their successes, governments have also entertained ideas for implementing blockchain. Under smart governance, technology such as blockchain is being used to facilitate and improve how public services are being delivered to the public.[15]

Once the smart contract has been deployed to the blockchain, the DAO will typically undergo a funding phase where a potential member wishing to join the DAO purchases the governance

Figure 1: *DAO versus Company Structure.*



Source: Aragon

tokens created by the smart contract in exchange for authentication as a member of the DAO and/or for voting rights in the DAO.[16] The amount spent to buy the governance tokens is stored in the treasury, also created by the smart contract, and can be used in pursuit of the DAO's objective if there is an approved proposal. Usually, the amount of governance tokens owned by that member is correlated to the amount of voting power that member has for proposals submitted to the DAO.[17]

Depending on the rules constructed in the smart contract, any member owning a governance token may submit a proposal to the DAO for consideration. The governance mechanism for the DAO may be performed on-chain, off-chain or a combination thereof.[18] On-chain governance is the voting processes that happen directly on the blockchain platform based on the rules specified in the smart contract.[19] Off-chain governance involves voting processes that happen outside of the blockchain platform, such as through discussions on social media, online forums and other applications, which are then implemented on the blockchain platform.[20] Members may elect to vote using off-chain governance to avoid paying transaction fees.[21] Once a proposal is approved through the voting procedures established in the smart contract, the DAO will automatically execute the proposal by interacting with external data and executing instructions on the blockchain.[22]

JOINING AN EXISTING DAO

Joining an existing DAO can be surprisingly easy. Most DAOs are "permissionless" – not requiring authorization and open to participation from anyone.[23] An individual seeking to join a DAO can begin by performing a cursory search on the internet or browsing data analytics websites specifically geared toward DAOs, such as DeepDAO. The individual should then read a given DAO's charter, or whitepaper, which describes the DAO's objective, general principles and governing rules. If the individual wants to informally join, the individual can join the main community chat hosted by social media.[24] To formally join and be an active participating member, the individual will have to buy that DAO's governance token and provide authentication. Once authenticated, the individual will be able to submit and vote on proposals to be executed through the DAO.

HOW DAOs CAN BE USED

DAOs can fall under any one of numerous classifications depending on the objective. For example, an investment DAO can provide for collective pooling of capital by its members in order to invest in various matters.[25] There have been DAOs created to purchase fast-food restaurants,[26] to buy the Denver Broncos[27] and to buy land in Wyoming.[28] In another example, a collector DAO can be established to collect and manage a portfolio of NFTs.[29] Flamingo DAO launched in October 2020 with an initial round of funding of $6 million from its members to purchase NFTs.[30] To date, the Flamingo DAO's NFT portfolio contains over 800 NFTs and is worth approximately $1 billion.[31] In further examples, there may be grant DAOs, service DAOs, media DAOs, entertainment DAOs and others, where classification can be fluid and depends on the objective of the DAO.[32]

Sotheby's auctioned off an original copy of the U.S. Constitution, and a DAO had been involved in the bidding and nearly won.

In November 2021, Sotheby's auctioned off an original copy of the U.S. Constitution, and a DAO had been involved in the bidding and nearly won.[33] The ConstitutionDAO was created within a week of the auction, where its objective was to participate in this auction and bid on the copy of the U.S. Constitution.[34] If it had been successful, the ConstitutionDAO was to partner with a museum to exhibit the copy of the U.S. Constitution. Members contributed approximately $47 million in exchange for $PEOPLE tokens.[35] Ownership of the $PEOPLE tokens would enable members to vote on how to govern usage of the copy of the U.S. Constitution. In this example, proposals would be submitted on which museum was to display the copy of the U.S. Constitution, what the display would look like, any text to be displayed alongside the document, etc.[36] However, as ConstitutionDAO was outbid, an option was provided to refund each member. Alternatively, members could have sold their $PEOPLE tokens on a secondary market as the widespread popularity of this endeavor caused the price of these tokens to surge.[37]

A DAO vs. THE DAO

For historical context, a DAO is not to be confused with The DAO, one of the earlier attempts at implementing a DAO. The DAO's goal was to act as an investment firm through crowdfunding, where the organization's tokens represented votes on where to invest.[38] During mid-2016, within a month and a half from launch, The DAO raised over $150 million from more than 11,000 members.[39] After the funding phase had closed, a bug in the software code of the smart contract deployed on the Ethereum network was detected. While The DAO was attempting to address the detected bug, a hacker exploited the bug and targeted The DAO's treasury to steal over $50 million.[40]

To remedy this action, the underlying network secured those stolen funds in a temporarily locked account, preventing access to the hacker, and provided a refund to the affected members.[41] This likely would not be the case if an attack were to happen now as the attack on The DAO occurred at an early stage in the life cycle of the Ethereum network, and The DAO contained about 15 percent of all ether; such a failure would leave a large negative impact on the Ethereum network and its cryptocurrency.[42] Although operational software in the smart contract was defective, the attack on The DAO brought widespread attention to DAOs as a new form of organizational structure with latent potential.

LEGAL ISSUES CONCERNING DAOs

Legal Entity Status

Without formal recognition as a legal entity, a DAO and its members are at risk of being classified as a general partnership, wherein each member may be held jointly and severally liable for actions taken by the DAO.[43] A general partnership is an arrangement of at least two people agreeing to share the profits and debts of the venture. As such, anyone attempting to sue the DAO could obtain jurisdiction over any one member and hold that member wholly responsible for damages brought upon by the DAO. There have been recent efforts in introducing legislation to formally recognize a DAO as some type of legal entity in order to provide protection to its members.

The Republic of the Marshall Islands recently amended their Non-Profit Entity Act, thereby allowing recognition of DAOs as legal entities and becoming the first country to do so.[44] While there may be advantages to now being able to incorporate in the Republic of the Marshall Islands as a legal entity, such as not being subject to U.S. federal laws, companies looking to initiate a DAO should nevertheless incorporate in the United States if there is any possibility of doing business with the United States.

The state of Wyoming passed and enacted a supplementary bill providing legal status to DAOs so long as they are organized as a limited liability company ("LLC") within the state, referred to as the Wyoming DAO.[45] The business structure of an LLC provides for many advantages, most notably that its members are protected from being personally responsible for the company. Wyoming is the first state in the United States to effectively recognize a DAO as a legal entity after passage of the bill on April 21, 2021.[46] Prior to the passage of the Wyoming bill, some DAOs have attempted to capture the protection provided by LLCs by incorporating in Delaware through a Series LLC.[47] Because each sub-Series within the Series LLC will be dependent on an initial Master LLC, many DAOs may opt to take advantage of the new Wyoming legislation or wait to see if and/or how other states start implementing legislation for legal recognition of DAOs.

Securities Laws

The U.S. Securities and Exchange Commission ("SEC") has remained relatively silent when it comes to how the government approaches regulation of tokens offered by DAOs as securities. On July 25, 2017, the SEC released a report on the token offering by The DAO, where the report determined that those tokens were securities subject to regulation.[48] The report emphasizes that "the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale."[49] DAOs may review the SEC's determinations as guidance in how they plan to operate and if they need to register a token offering as a security.

DAOs should be cognizant that securities include investment contracts, which have been determined using the "Howey" test: is there an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others?[50] If so, the DAO would have to register its issuing governance token with the SEC as a security or qualify for an exemption to registration. Certain DAOs are currently operating only with accredited investors to fall under one of the exemptions to registration or limiting membership to under 100 members to utilize the "investment club" exemption.[51] In deciding whether a DAO should operate safely under an exemption or risk regulation under the SEC, the DAO needs to analyze existing legislation and guidance to effectuate a successful funding phase without fear of legal repercussions further down the road.

Federal Taxation

In 2014, the Internal Revenue Service ("IRS") issued Notice 2014-21 ("Notice") that provided guidance on how general taxation principles were to be interpreted for virtual currencies.[52] The Notice states that a virtual currency "is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value" and has an equivalent value in real currency.[53] The IRS determined that virtual currencies should be treated as property, similar to other capital assets.[54] With reference to DAOs, the issued governance tokens qualify as a virtual currency and should be treated as property for tax purposes.

DAOs should be cognizant that securities include investment contracts, which have been determined using the "Howey" test.

The question of how a DAO is to comply with federal tax laws remains unsolved. The IRS has not addressed this issue and has only published one other instance of guidance related to taxing virtual currencies, Rev. Rul. 2019-24 ("Ruling"), which is related to "hard forks" and "airdrop" events.[55] A hard fork is a protocol change in the underlying blockchain platform resulting in a divergence in the blockchain, and an airdrop is an event where a virtual currency or token is distributed directly to multiple users. The Ruling provides that if a virtual currency experiences a hard fork but the owner does not receive any new virtual currency, there is no taxable event.[56] If a subsequent airdrop distributes a new virtual currency due to the hard fork, the owner has to report the new virtual currency as taxable income.[57] Many have misconstrued this guidance to convey that airdrops therefore produce a taxable event. However, this is incorrect. Hard forks do not automatically prompt an airdrop, and not all airdrops occur as a result of hard forks. Airdrops can also be used as a marketing initiative for new blockchain-based projects. In cases where an airdrop does not follow a hard fork and can be categorized as a bona fide gift, the owner of the new virtual currency has not received income until they sell or exchange that new virtual currency.[58]

DAOs can be considered separate entities for taxation. Similar to the issues regarding legal entity status, guidance is needed on how best to classify DAOs. The general types of classifications are as a corporation or partnership. As described earlier, because DAOs had not previously been able to organize as a legal entity, they were considered as general partnerships by default. As such, any income generated by the DAO would effectively "flow-through" to its members for reporting at their individual tax rates.[59] With Wyoming's bill allowing registration as an LLC and other attempts at securing the advantages of an LLC, DAOs can elect to be taxed as a partnership or as a corporation. With the option to be taxed as a corporation, DAOs can benefit from a lower corporate tax rate.

Members of DAOs should exercise caution in how they manage their governance tokens in association with involvement in a DAO. The IRS is actively engaging in pursuits to enforce the filing and reporting of taxes on cryptocurrencies, including DAO governance tokens. The IRS previously filed a lawsuit, and won, against Coinbase to obtain information on "anonymous" account holders as the customer base for Coinbase was about six million users, but only 800-900 had filed tax returns reporting gains through cryptocurrencies.[60] The IRS further announced an audit campaign and has implemented a program dedicated to cryptocurrency tax compliance where its agents will analyze blockchains to identify fraudulent activity.[61]

To accurately report taxable events to the IRS, a member of a DAO must disclose a transaction when: there is an exchange of a governance token for real currency, for another virtual currency, or for other property, the member receives or spends a governance token as payment for services or goods, and the member receives a new virtual currency through an airdrop after experiencing a hard fork.[62] Regarding a DAO and its objective, there will be issues regarding member tax compliance for certain events, such as when a DAO sells a collection of NFTs, with an initial investment collected from its members, at a higher price. Does the received capital from the sale "flow-through" to the members for reporting? Does the DAO distribute proceeds through ownership of its governance tokens, wherein the DAO has to report the profit and the members have to report the distributed proceeds as dividend earnings? There are many unknowns, but increased enforcement by the IRS and opportunities for establishing legal entity status may provide guidance in the near future.

THE FUTURE OF DAOs

With the rise of web3 and the metaverse, the popularity of DAOs has grown at an exponential rate. The structure of DAOs can allow for transfers of capital with little to no oversight or regulation. There is still a risk of fraud or simply negligence with a mistaken transfer to the wrong address that can subject members to a substantial loss. With the passage of the Wyoming bill and the formal recognition of a DAO as an LLC, further guidance on regulation by the SEC and additional state legislation may contribute to recognition of the DAO as an established organizational structure to be used in further pursuit of a common goal. In addition, increased enforcement by the IRS and differences in legal entity status may provide for needed guidance on taxation of a DAO and its constituent members in compliance with federal law.

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