DAOs and the law: Crafting DAO legal "wrappers"

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Why do we need legal wrappers?

**Legal uncertainty**

- Undefined legal relationships between
  - the members of the DAO
  - each member and the DAO
  - the DAO and third parties
  - the DAO and state authorities
- No defined legal regime means any legal regime can be forced upon the DAO
Before legal wrappers

E.g. **DAO.LINK**, founded in 2016 mainly to represent The DAO

E.g. **Decentralized Entities Foundation**, founded in 2020 to:

- promote decentralized entities
- represent their interests
- interact directly or indirectly with them
- serve directly or indirectly as an interface or representation between them and third parties
Two categories of DAO legal wrappers

Law specific to DAOs

- Technology legally recognized => adds legal certainty
  - Can bring additional technological and other requirements => burden

Existing legislation

- Easy to modulate legal schemes => flexibility
  - Uncertain legal relationship b/w the DAO and the wrapper => legal uncertainty
DAO legislation in the US

- Vermont: Blockchain-based LLC (BBLLC)
- Wyoming: DAO LLC
- Tennessee: DAO LLC
- Utah: Limited liability DAO (LLD)
  [passed, but not yet in effect and subject to further revisions until entering into force in 2024]

Additional efforts underway: Florida, Texas, New Hampshire
Vermont Blockchain-based LLC (BBLLC)

- Introduced in 2018
- Specific form of LLC
- BBLLC has legal personality and its members have limited liability
- Governance of a BBLLC can be fully or partially provided by blockchain technology
- Votes regarding the operation and activities of a BBLLC can be recorded on smart contracts deployed on the blockchain
- Must have a registered agent
- Operating Agreement of dOrg, LLC // dOrg’s structure
Wyoming DAO LLC

- Introduced in 2021
- Specific form of LLC
- DAO LLCs benefit from legal personality and their members have limited liability
- Articles of incorporation must mention the smart contract used to manage or operate the DAO
- Administration by the members or by an algorithm
- Members have no fiduciary duty to the DAO unless specified in articles of organization
- Must have a registered agent
Tennessee DAO LLC

- Introduced in 2022
- Specific form of LLC
- DAO LLCs benefit from legal personality and their members have limited liability
- Articles of incorporation must mention the smart contract used to manage or operate the DAO
- Administration by the members or by a smart contract
- Members have no fiduciary duty to the DAO unless specified in articles of organization
- Must have a registered agent
Other DAO legal wrappers

In the US

- Delaware LLC (often used)
- Unincorporated Nonprofit Association (UNA)
- Limited Cooperative Association (LCA)

Around the world

- Marshall Islands DAO LLC
- Swiss association + foundation
- Cayman Islands Foundation Company
- Trusts (Guernsey, Jersey, Cayman Islands etc.)
Delaware LLC

- Great business environment
- Most extensive case law + legal infrastructure, i.e., corporate lawyers and access to courts
- Very low taxes
- Uncertain how blockchain technology, smart contracts, and the DAO structure would be treated in a court case
Unincorporated Nonprofit Association (UNA)

- Provides **limited liability** to the members
- “Nonprofit” not specifically defined => could Protocol DAOs (e.g., Uniswap & MakerDAO) be qualified as nonprofit?
  *distributions to DAO members could hinder nonprofit qualification

[More with Miles Jennings]
Colorado Limited Cooperative Association (LCA)

- Hybrid between a cooperative and an LLC
- Offers **limited liability** to the members
- Flexibility in governance => allows for the integration of DAO based governance principles, such as rage quitting and quadratic voting
- Can have patron-members (similar to shareholders) => allows distribution of financial returns based on patronage activity
Swiss Association [Verein]

=> The general assembly and the management exercise their inalienable competences and delegate the rest to the DAO.

=> Treasury must be in control of the association, otherwise DAO tokens are securities.
Swiss Foundation [Stiftung]

=> The foundation board **executes** the decisions of the DAO insofar as they are consistent with the purpose of the foundation

=> Treasury must be in control of the foundation, otherwise DAO tokens are securities
Swiss association/foundation: general legal questions

- What is the legal relationship between the association/foundation and the DAO?

- What is the association/foundation’s liability for the DAO’s actions?

- What is the DAO’s recourse if the association/foundation does not execute its decisions?
Cayman Foundation Company (used a lot)

- Initially incorporated with 1+ members, but resignation possible thereafter: usually orphaned
- Legal Personality and limited liability
- Board of directors (can also be corporate)
- [Optional] beneficiaries, e.g. class of token holders (usually without any powers, rights, or standing to sue the foundation, but also no liabilities)
- If memberless, there must be supervisor who enforces rules, but no ownership or economic entitlement
- Secretary, must be provided by licensed Cayman service provider
DAO legal schemes in practice

Typical:

1. Off-shore entity for token issuance in jurisdiction that does not regulate token issuances under VASP rules (e.g. Panama, BVI)
   a. Off-chain assets, IP rights, ecosystem grants
   b. Sometimes: Governance unwrapped in same structure
   c. Sometimes: Treasury in trust in low tax jurisdiction (same or different entity)

2. Operations/software development wrapped in limited liability company or corporation, wherever developer live
   a. Usually make heavy use of PEOs and consultant arrangements
   b. Enters into software development agreement with
DAO wrappers in practice: Swiss Foundation

**Safe Ecosystem Foundation** is a foundation registered in Zug, Switzerland

- Develops the Safe ecosystem
- Administers Safe Grants programme run by Safe DAO
- Holds all the IP rights (see here the [Participation Agreement](#))
- Minted SAFE token following proposal to spin-off from GNOSIS DAO

**Core Contributors GmbH** is a GmbH (limited liability corporation) registered in Berlin, Germany and provides:

- Interface of Safe
- Software Service Provider for the Safe DAO

**SAFE DAO** (unwrapped)

- Gnosis Safe wallet with Zodiac implementation, governed by the SAFE token holders (token not yet transferable)
DAO wrappers in practice:
With Cayman Island Foundation

Triparty structure:

Offshore corp issued OP token

**Optimism Foundation Company:**
- Cayman Island Foundation Company
- Stewarding the Optimism Collective
- Board of Directors (5 members)
- Holds IP
- Treasury
- **Optimism Collective:** bicameral community unwrapped organization, jointly governed by holders of the $OP and Optimism citizens (wallet addresses with specific NFTs)

**OP Labs PBC:** a Delaware Public Benefit Corporation with 52 full-time staffers
Wrapper considerations: Economic substance

If you hope for the tax liability of a DAO to move with the wrapper, economic substance needs to be established in the jurisdiction of incorporation (for further reading OECD BEPS):

- Management and core functions in the jurisdiction
- Employees in the jurisdiction (often finance department to access banking options)
Wrapper considerations: Banking relationships

The wrappers will dictate the potential banking relationships:

- Many offshore companies struggle to establish banking relationships
  - the separation of the setup is often broken by having the operating company pay for services (github, AWS, notion etc. claiming reimbursement thereafter).

-> Choose a jurisdiction that offers banking services and isn’t a grey/blacklisted jurisdiction by FATF
COALA Model Law for DAOs

- **Binding** but **flexible** rules of substantive law applicable to DAOs

- Must be **adopted by states** in their own internal law in order to harmonize the legal regime at the global level

- Two key innovations:
  - Grants **legal personality** to DAOs that meet the conditions set by the Model Law, without anchoring them into a specific jurisdiction
  - Provides for **automatic recognition** of DAOs in all states that have adopted the Model Law
Legal regime of the Model Law

- Acquisition of **legal personality** if the DAO fulfills a certain number of **technical requirements** (Art. 2 cum Art. 4)

- Members benefit from **limited liability** (Art. 5)

- In case of **hard fork** of the underlying blockchain, any **off-chain assets** belong to the DAO on the majority chain (Art. 16)

- **Smart contracts** of the DAO can be modified, improved or migrated in order to allow the entity to evolve and be updated (Art. 17)
Functional and regulatory equivalence

Meet existing legal requirements and principles through technology:

- **Develop the interpretation** of legal standards
- **Adapt** legal standards to technology
Functional equivalence

Analyses the function of a legal requirement (e.g., a handwritten signature)...

...to determine how this function can be equally fulfilled with technology (e.g., an electronic signature)...

...within a particular legal context (e.g., contract law).
Regulatory equivalence

Goes one step further by analyzing the **purpose** of a particular legal or regulatory provision (e.g., auditing for the purpose of verifying credit-worthiness)...

...to determine how **technology achieves the same purpose** in a wholly different manner (e.g., using fully collateralized smart contracts to eliminate counterparty-risk).
=> Voting via snapshot and recording it on a blockchain is functionally equivalent to voting in person and recording the votes in minutes
Regulatory equivalence in the COALA Model Law

=> Blockchain technology fulfills the normative purpose of the business entity register
Utah Limited Liability DAO (LLD)

- Passed in 2023, effective Jan 2024
- Distinct legal regime for DAOs mirroring many COALA DAO Model Law provisions (and governs technological aspects more extensively)
- Offers DAOs legal personality and limited liability to their members and perpetual duration
- DAO is formed with filing of complete “certificate of organization” in which DAO's public (wallet) address is provided
- Members have no fiduciary duty unless DAO bylaws explicitly
- No requirement for administrator, board of directors, trustee
Utah Limited Liability DAO (LLD)

- Introduces role of
  - Organizer (person submitting certificate of filing)
  - Participant (not a token holder but someone who interacts with DAO)
  - Member (person with governance rights voluntarily assented to)

- Makes mandatory the appointment of:
  - a legal representative (anywhere)
  - a registered agent within Utah
  - the existence of a dispute resolution framework
Utah Limited Liability DAO (LLD)

- COALA team had advocated to drop registered agent + legal representation requirements based on regulatory and functional equivalence arguments.

- Fine tuning happening now until Jan 2024:
  - Consider interplay between Corporate Transparency Act and Utah DAO Law.
  - Tax provisions.
  - Burdensome requirements while also having to fulfil legacy system requirements (registered agents, annual tax filings).
General problems of legal wrappers

- Recentralisation
- Wrappers are expensive
- Additional onerous admin requirements going beyond LLC: insufficient compromise between decentralized technology and the legacy legal system
- Rent extraction by re-intermediation through lawyers, registered agents, secretaries
- Tax payments often only in fiat
Why DAOs are un-incorporating/dissolving?

- Due to
  - endgame of radical decentralisation
  - regulatory changes in their wrapper jurisdiction;
  - Fear of bankruptcy/inability to meet audit requirements.

- In case of regulatory chances:
  - Instead of redomiciliating elsewhere, some have opted to house critical operational functions in unwrapped multisigs, whereby the multisig owners are globally spread to avoid anchoring in any one jurisdictions.

  - **Any such solution should be carefully considered. It’s often a desperate move.**

→ This has opened up a job market for non-risk averse multisig-signers
COALA Model Law 2.0 - join the taskforce!

Efforts are underway to update the COALA Model Law:

- Taxation
- Limited Liability
- Privacy
- Sweep all tidy up

We are also working regularly with jurisdictions that want to implement the Model Law (e.g. Utah, NH).

Interested? Please reach out to Silke!
Next: Miles Jennings

Crypto Lawyer
GC @a16z
Partner @Latham & Watkins until 2021

Topics:
- Unincorporated Nonprofit Association (UNA)
- Views on the COALA Model Law and the Utah Limited Liability DAO (LLD)
DAOs and the law: Crafting DAO legal “wrappers”

Thank you!

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LEGAL FRAMEWORKS FOR DAOs

Miles Jennings, General counsel & Head of Decentralization - a16z crypto
Types of DAOs

There are numerous types of DAOs with varying purposes

**Protocol DAOs**
DAOs that administer and maintain the affairs of a given blockchain or smart contract protocol and any treasury associated with such protocol.

*Examples:* MakerDAO, Compound DAO, Uniswap DAO

**Social DAOs**
DAOs that are formed and operate as social clubs, often using token-based gating for attendance of events and access to content.

*Examples:* FWB, LinksDAO

**Investment DAOs**
DAOs that pool assets of members and allocate those resources to invest or to collect art, collectibles, real estate, etc.

*Examples:* PleasrDAO, FingerprintsDAO

**Collective DAOs**
DAOs that act as digitally organized collectives of artists, engineers, and others, who coordinate to provide services to web3.

*Examples:* VectorDAO, WorkDAO
There is no one size fits all approach.

You need the Right Tool for the Right Job.
Why do protocols need DAOs?

- The Internet began with the open source and decentralized protocols of web1 (http, smtp, ftp), but is now dominated by closed/captive/private web2 systems with the power to extract significant take rates.

- Web3 makes it possible for open source and decentralized web3 protocols to compete with the operational functionality of web2 systems.

- DAOs facilitate the decentralized ownership and operation of these web3 protocols, thereby enabling them to be “credibly neutral” and deliver on the promise of decentralization: the democratization of the Internet.
How do protocols form DAOs?

- Traditional C-Corp DevCo creates a smart contract protocol (e.g., Uniswap, Compound, Aave, etc.) that is deployed to a blockchain (e.g., Ethereum, Optimism, Solana, etc.).

- DevCo gives up control of the protocol by forming a DAO and distributing governance tokens to employees, investors and users. The token enables holders to govern the protocol.

- The DAO also often has control over a “treasury” (a stored pool of unissued governance tokens) that it can use to fund improvements of the protocol or on business development efforts.

- This decentralization makes the protocol “credibly neutral” - builders can now have greater confidence building on top of such protocol, knowing that it will not be arbitrarily changed.

- The handing of control of the protocol helps turn the protocol into a decentralized internet infrastructure.
The Future of Web3

Web3 will ultimately consist of proprietary clients operated as ordinary internet businesses (c-corps), but they'll be built on top of public infrastructure comprised of smart contract protocols and blockchain networks that are run and controlled by DAOs.

Clients launched by independent businesses using traditional legal entities (c-corps, s-corps, LLCs, etc.)

DAO–based Decentralized Governance of Public Infrastructure

Proprietary Client Operated by Dev Corp
Software or Company?

The three characteristics of web3 protocols and the DAOs that govern them that are driving the need for DAOs to make use of legal entity structures are:

1. the ability of such protocols to autonomously generate income;

1. the need to rely on decentralized governance to administer the affairs of such technology (through a DAO); and

1. the use by DAOs of treasuries to deploy capital to further develop the underlying protocol.
Existing Legal Entity Structures

**Corporations**
Fundamentally incompatible with the requirements of DAOs (CTA, Securities laws, Fiduciary duties).

Corporations utilize shares to denote ownership, which are securities.

**LLCs**
Solve some of the corporate issues, but are still unsuitable for protocol DAOs (CTA, Securities laws).

LLCs utilize membership to denote ownership, which are typically securities.

**Partnerships**
Lack of limitation of liability in partnerships makes them unsuitable for protocol DAOs (Securities laws, Liability, Voting).

Partnership interests are not necessarily securities, but distributions could make such interests securities.

**Co-Ops**
Provide many benefits, but most protocols are not structured like Co-Ops, and outside investments can jeopardize the structure (CTA).

Co-op interests are not securities.
Key issues for DAOs without legal structures

For DAOs with no legal entity structure (i.e., Entityless DAOs), the key challenges are:

1. **No legal existence** – No ability to contract – Can’t hire services providers to administer the affairs of the DAO (e.g., can’t hire auditors to perform code audits).
2. **No ability to pay taxes** – Income for DAOs can arise through operation of the protocol or the treasury over which they exercise control, but Entityless DAOs have no way of paying taxes.
3. **Potential unlimited liability** – Lack of clarity on liability could result in any number of potential harms that could arise through the operation of the protocol.
Enter foundations…

To overcome certain of the challenges facing Entityless DAOs, some DAOs utilize foundations for a variety of purposes:

- Ecosystem funds and grant programs
- Legal defense
- Community management
- Ongoing development
But not so fast…

Foundations come with their own challenges because they:

- require real-world human control, so **cannot be truly trustless and decentralized**
- are **extremely complicated, costly** and **difficult to establish**
- subject DAOs to **uncertain tax treatment**
- are **politically unfavorable** and could be challenged by the U.S. and foreign governments
Mature ecosystem structure

- **DAO** controls any protocol upgrades, protocol parameter changes or use of protocol treasury.
- Foundation administers grant program from initial endowment and organizes community.
- Small ecosystem fund run independently of foundation.
- Multiple frontends deployed by independent parties.
- Initial DevCo is one of many working on tooling and other projects for the ecosystem.
Tennessee & Wyoming DAOs

- **Benefits**: Include DAO-friendly provisions, including:
  - Mandatory disclaimer of the limitations on the rights of members
  - Implicitly accepts on-chain documentation
  - Clear rules on membership rights upon withdrawal

- **Drawbacks**: Contain elements that are more restrictive than their general LLC statutes, potentially hindering decentralization with unworkable requirements:
  - make DAO smart contracts amendable,
  - dissolve if no activity after a year has taken place,
  - requires operational decisions be made prematurely to comply with reporting,
  - fails to resolve conflicts between smart contracts and operating agreement and
  - leaves many essential areas unaddressed.

- **Verdict**: Progress, but LLC DAOs are not suitable for protocols as LLC interests are typically securities and they don’t permit maintenance of anonymity (CTA).
COALA & Utah DAOs

● **Benefits**: Novel approach that is specifically designed for DAOs. Flexible governance accomplishes many goals.

● **Drawbacks**:
  ○ The law borrows from existing corporate, partnership and trust law in such a way as there is no clear tax treatment.
  ○ As a practical matter, this type of conformity (which is necessary for a model international law) largely looks past the need for treaties within the international system.
  ○ In order to be effective in the U.S., state law must be consistent with other laws and should be consistent with federal law.

● **Verdict**: Good progress, but new entity structures face significant hurdles, and any reliance on LLC statutes could result in LLC challenges applying.
UNA: Unincorporated Non-profit Associations

● **Benefits:**
  ○ Simple formation requirements and flexible governance enabling a DAO to function however it’s smart contracts specify that it should function.
  ○ Infinitely scalable and transferable, while preserving anonymity
  ○ Securities laws haven’t historically been applied to members.

● **Drawbacks:**
  ○ The key distinction between general partnerships and unincorporated associations is the “non-profit” purpose. Not for-profit does not mean tax exempt, but it does mean there are restrictions in how distributions of UNA assets can be made to members.
  ○ Not clear that states intend for DAOs to be able to utilize UNAs.

● **Verdict:** Quickest pathway to solving all of the key legal entity challenges facing DAOs (legal existence, taxes and limited liability).
UNA: Tokens \(\neq\) equity

No contractual or statutory rights

Holders of **equity** are entitled to contractual and statutory rights than ensure management maximizes the value of the equity.

No one is under an obligation to maximize the value of **tokens**.

Protocols \(\neq\) companies

**Equity** is about company ownership.

**Tokens** afford a much broader design space, and ownership is only one potential characteristic. Others include community membership, consumptive use, preferential access, etc.

Voting rights are limited

**Equity** entitles holders to control a company.

**Tokens** typically only enable holders to control limited elements of a protocol (fees, collateral types, grant programs, upgrades, deployment to additional chains, etc.).
UNA: Stakeholder capitalism

Equitable value accrual

Digital assets can be distributed broadly and protocols can be designed to reward stakeholders more equitably.

Virtuous incentivization

Protocol design can utilize specific incentives to encourage participation, engagement and value creation for all stakeholders.

Individual empowerment

Decentralized governance can empower individual stakeholders with influence over a given ecosystem.
DUA: Decentralized Unincorporated Associations

Several states are currently considering modifications of their UA entity forms to create a new category: **Decentralized unincorporated associations (DUAs)**

- **Minimize Deviations from Existing Laws** – DUA statutes should contain only deviations from applicable UA/UNA statutes that are critically necessary.

- **Minimize Conflicts of Law** – DUA statutes should minimize conflicts with existing laws. A DUA statute should not encroach on general partnership law and should create a clear delineation between existing partnership, UA and UNA laws and DUAs.

- **Forgo Special Treatment** – DUA statutes should be technologically neutral and DAOs should not receive special treatment as compared to other UA forms.

- **Suitability for Decentralized Organizations** – DUA statutes should be tailored specifically for use by decentralized organizations and be best suited for organizations formed for purposes of administering the affairs of an autonomous blockchain network or smart contract protocol.
DUA: Decentralized Unincorporated Associations

● **Benefits**: All the benefits of an UNA, plus:
  ○ Clarifications on member anonymity
  ○ Recognition of on chain records
  ○ Clarification on contributions of members
  ○ Re-examination of management function
  ○ Decentralization

● **Drawbacks**: Not for-profit status means that distributions cannot be made pro rata, so they must adopt token models that reward stakeholders for contributions.

● **Verdict**: Solves all of the key legal entity challenges facing DAOs (legal existence, taxes and limited liability) without conflicting with existing rules.
DAO Legal Entity Decision Tree

**Is your DAO…**

- …an investment DAO?
  - Consider LLC
- …a Cooperative or Collective DAO?
  - Consider LCA
- …a Network or Protocol DAO?
- …a Collector or Social DAO?
  - Consider LLC or UNA

**Does your DAO…**

- …generate income or losses from activities that are the result of U.S. member efforts or decisions
  - Entityless
- …exercise dominion and control over income generated by network or protocol?
  - Consider LLC or UNA
- …exercise dominion and control over a treasury?
  - Consider LLC or UNA
QUESTIONS
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