

To Our Clients and Friends

Memorandum

August 17, 2022

A Primer on DAOs—A New Form of Entity, with Explosive Growth, that Some Envision as “The New LLCs”

In Colonial times, there were “joint stock corporations,” then came our modern-day corporations, then “limited liability companies” (LLCs). Now there are DAOs—“decentralized autonomous organizations.”

DAOs (pronounced “Dows”) are a new kind of entity, regarded by their enthusiasts not as “companies” at all but as collections of individuals organized around the decentralization, autonomous functioning, transparency, and bottom-up principles that characterize the digital universe. DAOs have been created for varied purposes, both charitable and profit-making. Although most have been focused on cyber-related projects, their presence has been expanding beyond the cyber realm. For example, “SPADs”—which are SPACs (special purpose acquisition vehicles) that are DAOs—have emerged to engage in the acquisition of physical target companies. Some investors, dubbing DAOs “the new LLCs,” expect that they will become a significant form of business entity in the very near-term. Indeed, DAOs have experienced explosive growth in the past couple of years.

At the same time, DAOs face significant challenges and present significant risks. While many DAOs have been successful in raising large amounts of money in short periods of time, most (at least those formed for non-crypto-related purposes) have had a notable lack of success in achieving the missions for which the funds were raised. Further, the technological infrastructure is complicated and the legal structures can be cumbersome. Most significant are the risks presented by continued legal uncertainty (with respect to liability issues; regulatory uncertainty (including treatment under the securities, tax, antitrust and insolvency laws); cryptocurrency price fluctuations; cybersecurity breaches; and still-nascent and varied industry customs and practices.

Thus, it remains unclear whether, how, and to what extent DAOs might displace traditional organizational structures. But they represent an increasingly popular and potentially transformational business idea, rooted in the mindset and methods of modern times—making them worthy of attention as they evolve.

In this primer on DAOs, we discuss:

- The recent growth of DAOs;
- How DAOs work;
- The advantages and disadvantages of DAOs;
- Key legal and regulatory issues that DAOs face;

- The Vermont, Wyoming, and Tennessee legislation covering DAOs, and other formats for providing DAOs with legally recognized status;
- Related practice points; and
- Case histories of some well-known DAOs.

The Recent Growth of DAOs

Significant interest in DAOs began in 2020, alongside surging interest in cryptocurrencies, NFTs, and “decentralized finance” (DeFi).¹ In 2021, the total value of crypto funds held in DAO treasuries reportedly surged from \$400 million to \$16 billion, and the number of holders of interests in DAOs rose from just 13,000 to 1.6 million. According to SnapShot Labs (a voting platform for DAOs that also provides analytic data), the number of DAOs increased from about 700 in May 2021 to about 6,000 as of June 2022.

Notably, since 2021:

- Wyoming and Tennessee have enacted statutes expressly recognizing DAOs as legal entities;
- two bipartisan bills recognizing DAOs as legal entities and creating a framework for their regulation are pending in Congress;
- the Wharton Business School and the World Economic Forum have issued a joint white paper on DAOs;
- numerous PACs, including two that are themselves formed as DAOs, have registered with the Federal Elections Commission, with plans to provide major funding to targeted pro-DAO candidates in the 2022 midterm and 2024 elections;
- new DAO-oriented financial products and services are being offered (such as “CryptoIRAs” to facilitate the investment of IRA funds in DAOs); and
- a DAO for DAOs has been launched—called DAODAO—which plans to facilitate streamlined formation of DAOs so that creating one will be “as easy as setting up an Instagram account.”

How DAOs Work

A DAO is an unincorporated business organization that operates on blockchain software and is run directly by those who have invested in it (the “contributors” or “members”). It is essentially an internet community with a shared purpose and the equivalent of a shared online bank account. Through a DAO, people can raise money (potentially large amounts) and organize energy aimed at a joint project, without a formalistic corporate overlay. DAOs have no physical headquarters, offices, or bank accounts; there are no directors, hired managers, other leaders, or employees. A DAO’s governance rules and the parameters for its decision-making are encoded into the blockchain software on which it runs, making management essentially self-executing (through so-called “smart contracts” created by the coding); and

¹ DeFi is an open financial system that uses cryptocurrency and blockchain technology to manage financial transactions, without third party intermediaries such as banks and brokerages. Almost all of the major DeFi platforms are run by DAOs.

all of the DAO's transactions are immutably recorded on the blockchain, providing transparency to its members. Once a DAO's purpose and rules are established and the code reflecting them is created, there is no need for human involvement unless a member wishes to propose for a vote of the members any change to the DAO's purpose or the encoded rules (such as those governing how the DAO's funds are to be spent).

Purposes for which DAOs are used. Common DAO projects have included supporting charities, providing seed funding for startups, facilitating the development of software, managing decentralized protocols, and buying artwork or historical artifacts.² In most cases, the missions have related to allocating cryptocurrency to crypto-related projects. Skepticism rightly abounds with respect to whether a leaderless entity with decision-making encoded into software can be successful in dealing with the complex issues that arise in running *non*-crypto businesses. DAO proponents believe that, as DAOs continue to be used more broadly outside the crypto sphere, successful examples will emerge, further fueling their growth.

DAOs already are functioning, and are viewed as potentially significant disrupters of traditional models, in the insurance, real estate finance, and venture capital spaces. DAOs also have emerged that seek to acquire and run physical target companies—for example:

- **FriesDAO.** FriesDAO seeks to fund the acquisition of fast food restaurants by franchisees, who will then run them as part of a decentralized network of restaurants, governed by the DAO's members. FriesDAO has raised \$5.4 million so far and is commencing its efforts with Subway franchisees. (A BurgerDAO also exists, which plans to create "the world's first decentralized burger joint.")
- **BuyTheBroncos DAO.** This DAO recently sought to acquire the Denver Broncos football team when it was for sale. The plan was to raise \$1 billion from the DAO's members and the remainder from more traditional investors. There was speculation that the DAO had an advantage in the sale auction because the National Football League wanted the team to be partly owned by an investor from a minority group, and with the DAO's dispersed membership there would be many minority owners. The team's owners chose to sell to a different buyer, however.
- **BlockbusterDAO.** This DAO, with 8,000 members (including the daughter of the deceased long-time CEO of almost-defunct Blockbuster), was created with the mission of pressuring Dish Network, which owns the intellectual property of Blockbuster, into selling the intellectual property

² There also are DAOs with projects outside the business and charitable worlds. For example, Friends With Benefits is a DAO that functions as a social platform, with an online chat room and parties and meet-ups organized for its members. CityDAO, with more than 10,000 members, has acquired 40 acres of land in Wyoming, with a stated mission of creating "an on-chain, community-governed, crypto city of the future," with "[e]ach parcel of land [being] an NFT [(i.e., a digital representation of the physical land)] that can be governed collectively by the DAO." CityDAO's members ("citizens") are trying "to create web3 [(i.e., blockchain-based)] solutions for Dao governance, affordable housing, city building and more." Another example is DAOs that have been created to act as Political Action Committees, with their policy initiatives and their funding and other support for specific candidates guided by the DAO's members. These include 3OH DAO, which plans, among other things, to create a 3OH "reputation score" for candidates based on their track record in voting in accordance with the DAO's guidance); and Lobby3 DAO, founded by former Presidential candidate Andrew Yang, which is focusing on educating policymakers on the use of web3 to combat poverty.

to the DAO, so that the DAO could transform “Blockbuster” into a new kind of streaming video platform that is run on a blockchain. According to the DAO team, Dish Network ultimately refused to sell the asset to a DAO. The DAO still intends to proceed with launching a decentralized, blockchain-based streaming video platform, albeit without the Blockbuster brand.

How DAOs raise funds. Investors can send money (usually cryptocurrency, such as ether or stablecoins) to a DAO’s on-chain treasury from anywhere at any time (typically in exchange for governance tokens). The blockchain provides transparency with respect to what money has come in and where the money goes. Many DAOs have been effective in raising large amounts of funds in short periods of time. For example:

- *“The DAO.”* The very first functioning DAO (called “The DAO”), which was established in 2016 to invest in blockchain projects, raised \$150 million (in ether) in a matter of weeks. (It was closed, however, after hackers stole most of the money that was raised.)
- *ConstitutionDAO.* ConstitutionDAO, which was formed in 2021 to acquire a rare original copy of the U.S. Constitution, raised \$47 million (in ether) over a few days. (It was not, however, the winning bidder at the auction.)
- *Ukraine-related DAOs.* More recently, several DAOs quickly raised millions of dollars to support Ukraine after the Russian invasion. This included almost \$7 million (in ether) raised in just 72 hours by the UkraineDAO (through the sale of interests in an NFT³ of the Ukrainian flag).

Operation on a blockchain. DAOs are run on blockchain⁴ technology, such as Ethereum. When a DAO is created, its rules are encoded on the blockchain on which the DAO operates, so that specified actions and transactions occur automatically whenever a defined set of prerequisites are met. Third parties (who would have to be paid and who could make mistakes or act disloyally) need not be involved—as no directors or managers are needed to make or oversee decisions; no lawyers are required to negotiate and draft contracts; and no banks or brokerages are required to transfer or record transfers of funds. Generally, changes in the coding (and thus the smart contracts) can be proposed by any member and will be implemented if approved by the members.

Token-based membership and governance. Rather than receiving shares of stock as when investing in a corporation, DAO members typically receive “tokens” (a digital asset). Tokens can be obtained by direct purchase (usually a contribution made in cryptocurrency) or, in some cases, in exchange for some form of labor or services to the DAO. The token may be an existing cryptocurrency (such as ether or bitcoin), but

³ An NFT (“non-fungible token”) is a digital, tradeable financial asset that, because it is non-fungible (that is, unique and cannot be replaced by something else, and typically is scarce) can be used to represent other unique assets that are either online or in the physical world, such as physical or electronic works of art.

⁴ A “blockchain” is a database or ledger that stores information electronically in digital format and is available to a computer network. The data for each transaction is stored in blocks that are time-stamped and then irrevocably closed. Due to its structure, a blockchain maintains a secure record of all transactions, without reliance on a third party to input or maintain the data. When used in a decentralized way (that is, when the blockchain is made available to record transactions by any user), no single person or group has control of the record; the data entered is permanently recorded and irreversible; and the data can be viewed by anyone. Thus, through the blockchain, a permanent and irreversible timeline is established of all of the contributions to a DAO and of the use of funds by the DAO.

more often is a token created by and specific to the particular DAO (such as the MakerDAO's "\$MKR" token, or the Friends With Benefits DAO's "\$FWB" token). Although some DAOs are private, most issue tokens that are freely-tradable digital assets; thus, anyone can become a member and the tokens may be traded on centralized or decentralized exchanges. Tokens entitle the holder to participate in the governance of the DAO (*i.e.*, to make proposals to be submitted to a vote of the members and to vote on proposals made by other members), and/or to share in any profits the DAO generates. Tokens may provide other benefits as well (such as discounts on products or access to exclusive events). A DAO may require that a specified number of tokens be held to obtain these rights. Many DAOs grant tokens for free ("air drops") to founders, to members who provide services to the DAO, to members who have been most actively involved in governance of the DAO, or to users of the protocol that the DAO manages. Most DAOs utilize direct voting; but some use a representational governance structure due to the lack of continued interest in governance among many contributors (although this latter structure is generally frowned upon because it begins to look more like a centralized corporate model). Voting power is usually proportionate to the number of tokens held as a percentage of the total tokens issued; although, in some DAOs, in furtherance of democratic ideals and decentralization, voting may be based on one-vote-per-member or "quadratic" voting may be utilized.⁵

How DAO investors make a profit. In a DAO with a profit-making objective, an investor can realize a profit through an increase in the value of tokens the investor holds if the DAO does well (typically enabled through a mechanism whereby profits are used to buy back tokens on the secondary market), or through distributions of the DAO's profits to the members (similar to corporate stock dividends).

Notably, all of this continues to be somewhat amorphous—as DAOs' structures, commercial and other applications, and industry norms, as well as the applicable legal and regulatory schemes, are just in the nascent stages of development.

Advantages and Disadvantages of DAOs

Advantages. So long as a DAO has a valid purpose and properly programmed rules and smart contracts, it can offer its members direct control, transparency, efficiency, and trustworthiness.

- **Direct control.** DAOs give their members more direct control over the company's operations, without reliance on third-party agents or leaders (directors, managers, banks) who may make mistakes or act disloyally.
- **Transparency.** Every action taken is recorded on the blockchain and blockchain data by its very nature is easily accessible online to every member.

⁵ "Quadratic voting" is a collective decision-making procedure that involves individuals not just voting yes or no but allocating votes to express the degree of their preferences (in other words, weighted voting by a member to reflect how strongly the voter feels about the matter on which the vote is being taken). Voting systems that allow one vote per member may rely on "soulbound tokens," which are non-transferable digital tokens that are issued to a person or entity and are stored online in that person's or entity's unique "crypto wallet," representing a kind of digital personal identification. A voting arrangement that has garnered some recent attention combines soulbound tokens with quadratic voting. Under this scenario, a choice on which members vote that has received, say, an allocation of one voting unit from each of ten unique crypto wallets would prevail over a choice that has received an allocation of ten voting units from a single crypto wallet.

- **Efficiency.** DAOs (in their pure form) can be set up more quickly and easily than traditional legal entities; have easy access to individuals worldwide to become members; and can be run without the significant overhead costs of traditional companies. Also, without an unwieldy process, they can commence instant discussion of issues by, and receive widespread and varied input from, actual stakeholders, ostensibly leading to better decision-making. In addition, individuals who contribute their time, attention and efforts to a DAO do so autonomously (that is, on a self-determined basis, without the direction and supervision to which an employee would be subject), and can contribute to multiple DAOs at the same time, which potentially enhances DAOs' ability to attract top talent.
- **Trustworthiness.** Operation via the self-executing smart contracts helps to ensure that DAO funds cannot be used in violation of the DAO's operating rules. Also, as the smart contracts exist on an open-source blockchain, with every transaction, modification or audit also recorded on the blockchain, and because the blockchain data is available to anyone, a comprehensive, immutable record is maintained, making it more difficult for any single member or other stakeholder to hide a fraudulent transaction or other wrongful activity.

Disadvantages. The nature of DAOs gives rise to the following inherent risks:

- **Potential fraud.** The more freewheeling nature of DAOs lends itself to investors being defrauded or misled when funds are raised. Because most DAOs so far have been focused on raising funds to spend on crypto projects, there have been accusations that these DAOs are akin to Ponzi schemes, with their objectives being little more than to bolster the value of the crypto tokens they have issued.
- **Crypto-related risks.** DAOs face the risk of (i) significant fluctuation in the value of the funds held in their treasuries, given the instability in pricing that has been associated with cryptocurrencies⁶; (ii) coding flaws in the blockchain software on which they run; and (iii) hacking and cybersecurity breaches (which have led to several high-profile debacles involving the theft of substantial amounts of funds from DAO treasuries and member accounts⁷).
- **Lack of legal status—and potential for unlimited liability.** As discussed further below, unless a DAO is organized as a legally-recognized entity (which inherently defeats DAO-related principles to some extent), as a legal matter it may be considered, by default, to be a general partnership, with each member potentially having unlimited legal liability if something goes wrong. The lack of legal status also makes entering into and enforcing contracts more difficult and uncertain. (Accordingly, some DAOs are organized as (“wrapped” in) LLCs or other recognized

⁶ Most notably, in May 2022, there was a major crash in cryptocurrency values. While financial markets in general declined significantly, the effect on crypto was amplified—with the cryptocurrency market losing approximately \$2 trillion of the \$3 trillion value it had just three months before when it was in the midst of a boom.

⁷ For example, in late 2021, BadgerDAO experienced a cybersecurity incident that led to losses of at least \$120 million. In March 2022, in one of the largest cyberhacks ever, more than \$600 million was stolen from accounts of online gamers playing the blockchain-based game Axie Infinity (which has over a million daily users). Binance, the world's largest cryptocurrency exchange, stepped in and made the Axie Infinity account holders whole (as it had done after several other hacking incidents involving its users' accounts). As discussed below relating to the Tornado Cash DAO, this past week, another cyber-related risk was highlighted—regulatory responses to the use of cyber protocols used to facilitate criminal activity.

legal entities and try to adapt those formats to integrate as much as possible the DAO-based principles of decentralization and autonomous functioning. Other DAOs have established legal “bridges,” such as Cayman Islands foundation companies, whose organizational documents require their directors to comply with DAO votes, to execute contracts and take other off-chain actions on behalf of the DAO.)

- **Securities law compliance.** As discussed further below, the SEC has indicated that DAO-issued tokens usually will be considered “securities” subject to the registration regime of the U.S. securities laws; however, a DAO’s radically decentralized structure makes compliance with the registration, disclosure and reporting rules virtually impossible.
- **Governance-related issues.** First, a DAO’s decentralized governance model does not always work as advertised, as a small group of founders, holders of significant amounts of tokens, and/or others interested in being actively involved may become a *de facto* control group (either because the size of their holdings is sufficient to control the vote or, as often occurs, other members lose interest in participating). Second, decision-making through smart contracts on the blockchain can stifle change and needed adaptation, as it requires consideration and voting by the members and re-coding of the software every time a change is to be made. (To address these two issues, some DAOs have instituted subgroups, dubbed “sub-DAOs,” which are effectively committees comprised of groups of the DAO’s members, to consider and accomplish specific tasks and thus avoid the necessity of votes by the full membership on every small decision.) Third, arguably, decentralized governance may not produce good or timely decision-making as compared to professional management with relevant expertise, particularly when complex issues are involved. Fourth, there is the potential for “governance attacks,” in which a single actor or a group, whose objectives are not aligned with the DAO’s stated mission, might take control of the DAO (pursuant to the DAO’s own governance procedures) and drain the DAO’s treasury or otherwise deploy it to their own ends.
- **Difficulty returning funds.** Due to fluctuating and often high fees incurred to conduct on-chain transactions, it is often not practical for a DAO to return funds to the members (when, say, the DAO fails in its purpose or there are irreconcilable disagreements among the members). To address this issue, many DAOs now provide for “rage-quitting” (meaning that a member can exit at any time and receive its pro rata share of the DAO’s funds)—however, ease of exit and the withdrawal of capital can lead to instability and constraints on the DAO’s business.
- **Environmental concerns.** The intense energy usage and related carbon emissions created by the blockchain infrastructure supporting some DAOs has raised environmental concerns. (Although, reportedly, the Ethereum blockchain, which hosts most DAOs, is expected to adopt in mid-September 2022 a new protocol that will be more eco-friendly—involving a transition away from the data “mining” protocol that is so energy-intensive to a “staking” protocol.)

Legal Issues Facing DAOs

Lack of recognized legal status—leading to potential unlimited liability of members and other issues. Except where DAOs are structured in the form of (or “wrapped” in or “bridged” to) a legally recognized entity (such as an LLC, cooperative, or foundation—as discussed below), it is unclear what

laws and regulations apply to them—and, thus, whether the members face unlimited personal liability⁸; how they can enter into or enforce contracts or conduct other traditional business activities; what jurisdictional authority applies; and on what basis they may be subject to taxation. As discussed below, DAOs “wrapped” in or “bridged” to a legally recognized entity try to adapt the framework to the extent possible to incorporate DAO-related principles.

Applicability of the U.S. securities laws. The SEC provided guidance in a 2017 Release that indicated that in most cases it will view tokens issued by DAOs (other than bitcoin and ether) as securities, requiring compliance by DAOs with the federal securities laws, including potentially registration of the tokens and ongoing public reporting requirements. This view has been reinforced in recent public comments made by SEC Chair Gary Gensler and by other indications by the SEC that the regulation of all things crypto-related is now one of its priorities. As noted above, however, if a DAO’s tokens are deemed to be securities that must be registered under the Securities Act of 1933, and the DAO is subject to reporting requirements under the Securities Exchange Act of 1934—which is likely for most of the more broadly held DAOs—it will be difficult or impossible for the registration and reporting requirements to be met. The SEC’s regulatory requirements assume that there exists some central body of control, information-gathering, and decision-making—an assumption that is completely inapposite to the pure DAO structure. For example, registration and reporting require that audited financial statements be provided (while auditing by DAOs necessarily is accomplished on the blockchain) and that the names of independent directors be disclosed (while DAOs have no directors). SEC Commissioner Caroline Crenshaw, who has been pro-crypto, has emphasized that there must be a dialog between tech innovators and the SEC so that an appropriate regulatory scheme can be developed.

In determining in each specific case whether DAO-issued tokens are securities, the applicable legal test is the “*Howey* test”—under which a critical issue is the degree to which management of the DAO is decentralized (that is, “whether the efforts made by those other than the investor are the undeniably significant...managerial efforts which affect the failure or success of the enterprise”). In the SEC’s 2017 Release, which was issued after it investigated the first functioning DAO (“The DAO”), the SEC staff, applying *Howey*, concluded that The DAO’s investors had relied on the managerial efforts of The DAO’s founders to manage The DAO and to put forth project proposals that could generate profits for The DAO’s investors; and, therefore, that The DAO’s tokens were securities that should have been registered. The SEC did not commence an enforcement action against The DAO, which was already defunct at that time, but it emphasized in the Release that DAO-issued tokens that are securities are subject to the registration

⁸ The presumed status of DAOs as general partnerships, with the members all having unlimited joint and several liability, is now being tested in a class action lawsuit, *Sarcuni v. bZx DAO*, which was brought on May 2, 2022 in federal court in California. The plaintiffs have made claims (against a DAO known as bZx, its alleged successor (Ooki DAO), and its founders, members and protocol and platform operators), contending that the DAO, as an unincorporated business entity, is a general partnership and that the defendants all are jointly and severally liable for the loss of funds from the plaintiffs’ accounts that resulted from one of the operators being fooled by a typical phishing scam. The plaintiffs state that their contributions to the DAO were made in reliance on the founders’ statements that members would “never need to worry” about theft from their accounts because the platform was the accounts would be “non-custodial” and the DAO utilized “World Class Security.” We note that, in a 2017 SEC Release, the SEC’s view was that the DAO it was investigating, The DAO, was *not* a general partnership. The SEC reasoned that The DAO bore “little resemblance...to a genuine general partnership,” in light of the dispersion and anonymity of its token holders (which made it difficult for them to join together to effect change or to exercise meaningful control) and the fact that thousands of people and entities traded the tokens in the secondary market. Thus, clarification of this fundamental legal issue awaits further development.

requirements of the U.S. securities laws—requiring either registration or structuring the DAO and its tokens so as to fit within various exemptions from registration (which would require the putting in place of various structural limitations on resale and widespread distribution). Moreover, while in the 2017 Release the SEC focused on the management aspects of The DAO, other factors may also be relevant in the SEC’s consideration, under *Howey*, as to whether a DAO’s tokens are securities.

As discussed below, proposed legislation has been introduced in the U.S. Senate to clarify when digital assets would be securities requiring registration and subjecting DAOs to reporting requirements; unfortunately, however, neither proposed bill appears actually to provide the needed clarification.

Applicability of the Investment Company Act. DAOs that make investments in “securities,” including digital assets that are securities, may be “investment companies” as defined in the Investment Company Act of 1940 (the “ICA”). Under the ICA, an “investment company” must register with the SEC before it can offer its securities in the public market or if it has over 100 holders unless those holders are limited to purchasers permitted under Section 3(c)(7) of the ICA. While a DAO may not be required to register as an investment company if it complies with these limitations, such limitations would require strict limits on the ability of DAO members to transfer interests in the DAO.

Antitrust uncertainty. The antitrust agencies have not yet issued any guidance relating to DAOs. To the extent that a DAO may be deemed, for purposes of the antitrust laws, not to constitute and function as a single entity (but, rather is viewed as a collection of individual members acting jointly), antitrust issues may be implicated. Depending on the DAO’s structure and governance, issues may arise with respect to, for example, the sharing of competitive information among, and collaboration by, individual members who may be competitors. Certain antitrust violations carry with them the potential of criminal liability. In addition, mergers involving companies providing blockchain-based services may be subject to review to consider whether they are anticompetitive. Thus, even a DAO formed as a legal entity must consider how it will ensure antitrust and other legal compliance by the DAO.

Taxation uncertainty. The tax treatment of DAOs remains subject to substantial uncertainty. Many DAOs are likely to be treated as business entities for tax purposes, meaning that they might have tax filing, reporting, and/or withholding obligations. Maximally decentralized DAOs might not have a practical means of complying with those obligations. Moreover, the characterization of a DAO as a partnership, “passive foreign investment company,” or “controlled foreign corporation” could require taxpayers to pay tax on their share of the DAO’s income on a “pass-through” basis or otherwise be subject to onerous consequences, but many taxpayers might not be able to determine their pass-through share of a DAO’s income without sophisticated chain analysis. For a more thorough discussion of the tax considerations applicable to DAOs and their shareholders, see Fried Frank tax partner Jason Schwartz’s article, *Squaring the Circle: Smart Contracts and DAOs as Tax Entities*, published by BanklessDAO and available [here](#).

Pending federal legislation to regulate digital assets—the RFIA. In June 2022, the first proposed federal legislation that specifically addresses DAOs—“The Responsible Financial Innovation Act” (RFIA)—was proposed in the U.S. Senate. In August 2022, another proposed law—the Digital Commodities Consumer Protection Act of 2022 (DCCPA)—was announced in the Senate. While these proposed laws, both of which have bipartisan support, are intended to clarify the regulation of digital assets, both are unclear in various respects, most notably with respect to when digital currencies would be considered to be securities. Both bills purport to favor regulation of digital currencies as commodities and not securities, thus subjecting them to regulation by the Commodity Futures Trading Commission

(CFTC) rather than the SEC. However, both effectively continue to rely on the *Howey* test to determine whether a digital asset is a security—thus perpetuating the inherent uncertainties under that test.⁹ Other proposed legislation addressing DAOs and crypto-related issues is also expected. (For more information about RFIA, see Fried Frank’s article, *The Digital Assets Bill: Lummis-Gillibrand Responsible Financial Innovation Act*, available here.)

Other regulation—Tornado Cash. Events this past week highlight the uncertainties associated with the still-emerging development of regulatory responses to crypto-related issues. In an action that has shaken the crypto world, on August 8, 2022, the U.S. Treasury Department’s Office of Foreign Assets Control (OFAC) banned all Americans from using, or “interacting” with, a DAO called Tornado Cash—resulting in the freezing of accounts totaling hundreds of billions of dollars, and involving even accounts on other crypto exchanges that never engaged directly with Tornado Cash. OFAC determined that Tornado Cash, which is a crypto “mixer,”¹⁰ has been used to launder billions of dollars of cryptocurrency stolen by persons outside the U.S. (including hacker groups with ties to North Korea), posing a “significant threat” to U.S. national security. OFAC’s action has caused rampant uncertainty as to how the funds in the frozen accounts can be accessed by their owners without violating the law.

Following OFAC’s action, authorities in The Netherlands arrested and detained the 29-year old alleged to have created the privacy-enhancing software that Tornado Cash uses. In a related development, an anonymous Tornado Cash user, apparently to underscore the difficulties in enforcing regulation and sanctions in the cyber space, has distributed small amounts of ether, using Tornado Cash, to celebrities (including Jimmy Fallon and Shaquille O’Neal) and hundreds of others with accounts on the Ethereum network—thus causing the recipients technically to have violated the government’s ban, although the account holders have no way to control funds being distributed to them via the blockchain.

OFAC’s decision has been decried by many in the crypto community as a governmental overstep that impinges on their core values of privacy and autonomy. They point out that physical cash transactions are

⁹ The *Howey* test, as discussed above, centers on the question whether the managerial efforts of others are critical to an investor’s expectation as to whether the digital asset in question will be profitable. To deal with the uncertainties under this test, the SEC suggested a long list of characteristics that market participants should consider—the more of such characteristics that apply, the more likely the asset is to be a security. Rather than clarifying the fundamental uncertainty under this approach, the two proposed bills, in different ways, effectively perpetuate it. The RFIA provides a definition of a “digital asset,” stating that it is an “ancillary asset” (constituting an “investment contract” rather than a security). However, the proposed definition of “ancillary asset” excludes any asset that gives its holder a profit in an entity “solely from the managerial efforts of others”—thus reintroducing the essential lack of clarity presented by the *Howey* test. The DCCPA introduces a definition of “digital commodity,” which provides that it includes “cryptocurrency or virtual currency, such as Bitcoin and Ether” but excludes any “security.” Leaving “security” undefined, the bill thus apparently continues reliance on *Howey* to make that determination. Accordingly, under both bills, it seems likely that the SEC would continue to take the position that most DAO-issued tokens are securities subject to registration with the SEC and that the DAO is subject to SEC reporting requirements. This appears to be an unintended consequence of the bills, as both purportedly favor regulation of digital assets by the CFTC as commodities—a result that would seem to be sensible given that digital assets, unlike securities, do not represent a promise to pay or a claim on a business entity’s earnings or assets (and thus should not necessitate that audited financial statements be provided so that the asset can be understood).

¹⁰ A crypto mixer is a service that, to increase the privacy of transactions, mixes different streams of cryptocurrency such that the origin and destination of specific funds, and the counterparties involved in transactions, become harder to trace.)

done with anonymity, and that most investors using crypto mixers have entirely legitimate reasons for seeking privacy of their financial transactions that otherwise would be public and easily traceable on the blockchain. Free speech issues also have been raised, as OFAC's action effectively banned a piece of computer code rather than sanctioning an entity (with Tornado Cash's defenders emphasizing that Tornado Cash, as a DAO, is not a formal entity). Others, however, view OFAC's move as reasonable and welcome regulation that should reduce crypto platforms' vulnerability to cybertheft and to being used to facilitate criminal activities and money laundering. While the debate ensues, and the continued viability of crypto mixers is questionable, the Tornado Cash episode highlights the still-nascent stage of development of the regulatory framework for DAOs.

Formation of DAOs

Only three U.S. states—Vermont, Wyoming and Tennessee—currently recognize DAOs as legal entities. In each of these states, DAOs can choose to register as a type of LLC. As noted above, if a DAO is not registered as a DAO-LLC in one of these states, then, in an effort to obtain limited liability and facilitate regular business operations (such as entering into and enforcing contracts with third parties), the DAO may be “wrapped in” or “bridged to” some other form of entity that is legally recognized. The optimal structure and jurisdiction will depend on numerous considerations, many of them related to the balance between pure DAO principles on the one hand and the protections of the corporate-type structures on the other hand.

Vermont, Wyoming and Tennessee LLCs. Vermont legislation (enacted in 2018) does not mention DAOs specifically, but permits any company that “utilizes blockchain technology for a material portion of its business activities” to register as a “blockchain-based LLC” (BBLLC).¹¹ Both Wyoming's DAO legislation (enacted in July 2021 and amended in March 2022) and Tennessee's DAO legislation (enacted in April 2022) specifically recognize DAOs as legal entities, permitting them to register as a type of LLC.¹²

Delaware LLCs. Although Delaware has not recognized DAOs as legal entities, many DAOs have been formed as Delaware LLCs. While this structure impinges on the autonomous and decentralized nature of DAOs to some extent, the Delaware LLC format permits adaptation to DAO principles and procedures to a significant degree. As typically structured, an LLC owns and is the beneficiary of the funds raised in a DAO's token sale; the LLC operating agreement specifies the many functions that will be operated through smart contracts (such as issuing interests, acting as custodian for assets, registering membership

¹¹ The Vermont law requires that a company registering as a BBLLC must state in its articles of organization that it is a BBLLC; and must include in its operating agreement a summary of its mission or purpose, as well as information about the blockchain technology to be used, voting procedures, protocols for responding to security breaches, procedures for becoming a member, and the rights and obligations of each group of participants. Like other LLCs, a BBLLC can restrict fiduciary duties and provide for limited liability in its operating agreement.

¹² The Wyoming and Tennessee laws permit an LLC to state in its articles of organization that it is a DAO. Both laws provide that: a DAO will be considered to be member-managed unless its articles state that it is algorithmically- or smart contract-managed; the articles must include information about the DAO's smart contract; and the DAO will automatically dissolve if it does not approve any proposals or take any actions for one year. The Wyoming law provides that DAO members have no fiduciary duties unless otherwise specified in the articles; and that there is no obligation to furnish information or provide inspection rights to members (except to the extent that they are available on the DAO's open blockchain). The Tennessee law provides that DAO members do not have fiduciary duties to the DAO except under the implied covenant of good faith and fair dealing.

interests, counting members' votes, and providing notice); and the operating agreement provides for restriction of fiduciary duties, limitation on liability, and other DAO-oriented features. While Delaware LLC law and jurisprudence is well established and familiar, and its flexibility makes it useful for DAOs, not all DAO principles and objectives can be accommodated within this format. (Among other issues, for example, Delaware LLCs under certain circumstances may not be able to preserve the anonymity of their members.)

Other available formats.

- **Colorado cooperatives.** While not specifically recognizing DAOs, Colorado's Uniform Limited Cooperative Association Act provides a useful framework for them. The Act regulates "limited cooperative associations" (LCAs),¹³ defined as "autonomous, unincorporated association[s] of persons united to meet their mutual needs through a jointly owned enterprise primarily controlled by those persons." Under the law, an LCA can distribute profits to patron members in proportion to their services and can permit members to vote on governance matters. DAO-based governance principles and limitations on liability can be incorporated into the articles and bylaws. Generally, cooperatives tend to reward participation rather than only capital commitment—with members usually having one vote each or their voting power decided by the level of their activity in the governance.
- **Cayman Islands foundations.** Cayman foundations have been used as "bridges" to facilitate off-chain actions by DAOs. The foundation has limited liability; and the foundation's bylaws can set forth bespoke rules with respect to how the foundation will seek to achieve its objectives. The bylaws can establish limitations on the roles and duties of the foundation's directors and managers; and the foundation can choose to have beneficiaries (for example, a DAO's token holders), who will have only those rights and powers that are specified in the bylaws. Arrangements between the foundation and the DAO associated with it generally provide that the foundation will execute the DAO's protocols. The Caymans also recently enacted the Virtual Asset Service Providers Act (VASP Act), which provides a regulatory framework that also can be useful for many DAOs. The foundation-bridge structure is less than perfect, however, as it necessitates off-chain actions to be taken by individuals who are not members of the DAO (such as the foundation's directors or trustees), and the trust-like format evokes centralization.
- **Formats under British Virgin Islands, Guernsey, Ireland, Liechtenstein, Malta, Singapore, and Switzerland laws.** These jurisdictions also provide useful (albeit, again, imperfect) formats for "bridges" to DAOs under their laws regulating cooperatives, foundations, associations, and/or private trust companies.
- **Marshall Islands LLCs.** In February 2022, the Marshall Islands amended its Non-Profit LLC Statute to officially recognize DAOs. Under this law, token holders of DAOs can be LLC members and the LLC's bylaws can be encoded into the blockchain. A domestic Marshall Islands company has been created to facilitate the organization of DAOs under Marshall Islands law. This format has not yet been much utilized by DAOs.

¹³ LCAs are an alternative entity structure that is a hybrid between an LLC and a corporation. One way in which an LCA is different from an LLC is that it can have two types of members: (i) investors who make contributions and (b) patrons who conduct business for the company.

- **Corporations.** A DAO can form as a corporation and state in its articles of incorporation and bylaws that certain decisions are delegated to the DAO members and that the corporation will abide by those decisions. However, in light of the many inconsistencies between a DAO and the corporate form, this route tends to be avoided and best practices for implementing a DAO in corporate form have not been established.
- **Non-Profit DAOs.** DAOs that have a non-profit purpose or do not distribute profits to members have other reasonable (but imperfect) options as well in various jurisdictions—including, for example, an “unincorporated nonprofit association,” a “public benefit LLC,” or (in Singapore) a “company limited by guarantee.”

Practice Points

- **Anyone creating, investing in, or interacting with a DAO should (together with legal counsel having experience with DAOs) carefully evaluate and consider the following risks:**
 - **Cybersecurity.** Appropriate due diligence should be conducted to confirm that state-of-the-art cybersecurity safeguards and protocols are in place and that upgrades will be made on an ongoing basis as appropriate.
 - **Fraud.** Potential investors should take necessary steps to confirm the validity of the purpose of the DAO, the reputation and history of the founders, and other factors that could bear on the possibility of fraud by the founders. Founders should offer a specific product or service to avoid accusations that the DAO is the equivalent of a Ponzi scheme.
 - **Potential liability and enforceability of contracts.** Founders should consider organizing the DAO in one of the jurisdictions with laws that recognize DAOs as legal entities; and investors should consider not investing in a DAO, and third parties should consider not providing services to a DAO, unless the DAO is organized in one these jurisdictions.
 - **Regulatory compliance.** Legal analysis should be conducted to determine whether the U.S. securities laws will require registration of the DAO’s tokens, and, if so, how compliance with the rules relating to registration (and ongoing reporting requirements) will be achieved. Founders also should keep in mind that statements made by them or others when marketing a DAO potentially could give rise to securities law liability and/or civil litigation with claims arising from alleged misinformation. Consideration also must given to the effect of the DAOs design and governance on various other regulatory issues (including, for example, antitrust issues) and to how ongoing legal compliance by the DAO will be ensured.
 - **Tax.** See Fried Frank’s article addressing tax issues, available [here](#).

Legal counsel should ensure that they are keeping current on developments in these rapidly evolving areas.

- **Founders of and potential investors in DAOs should consider whether the DAO format is best suited to the intended purpose.** One can acknowledge the tremendous potential of DAOs while still recognizing that it may not be the optimal structure for certain purposes. Consideration should be given to whether the particular purpose of the DAO at issue is one that will be best pursued with a DAO structure (with decentralized and autonomous management through smart contracts and/or

member voting) or, instead, a more traditional format (with centralized, professional management by human beings).

- **A DAO’s format, operational approach, and rules should be tailored to the specific purpose of the organization and other relevant facts and circumstances.** Strict adherence to DAO principles is not the best course in cases where deviations from them can avoid foreseeable problems relating to the specific project at hand. While DAOs strive to be simple, free-wheeling, self-executing organizations, in many cases relying almost exclusively on blockchain technology for their management, founders and investors should consider whether there are specific areas in which the limits of technology or other factors make deviations from pure DAO principles advantageous as a practical matter. Bespoke rules and protocols should be considered for matters relating to governance, management, compensation of non-financial contributors, and so on.

DAO CASE HISTORIES:

“The DAO”—Highlighting cybersecurity, legal, and governance concerns.

Created in April 2016, this DAO (known as “The DAO”) was a platform for collective for-profit investment in blockchain-based projects. The DAO raised \$150 million in ether in just a few weeks in exchange for tokens that entitled the members to vote on which projects would receive funding. The DAO’s plan was to invest funds in blockchain companies and projects, with profits flowing back to the token holders (similar to stock dividends issued by a corporation). After \$150 million of The DAO’s tokens were sold, but before The DAO had commenced funding projects, a hacker exploited a bug in The DAO’s smart contract code and was able to route to himself about one-third of the funds held in The DAO’s treasury. As the blockchain code was immutable, there was no way to cause the funds to be returned. A period of uncertainty followed, with the members’ remaining funds essentially immobilized within the DAO. Ultimately, and controversially, the theft was reversed (and the funds returned to the contributors) through a process known as “forking,” in which the blockchain was essentially split into two separate chains (Ethereum and Ethereum Classic). The DAO then closed down. A year later, the SEC issued its 2017 Release (discussed above) stating that The DAO’s tokens were in fact securities and should have been registered under the federal securities laws. After The DAO closed, the Ethereum blockchain code was modified to include improved security and protocols for auditing the

code. In addition, with this experience in mind, many DAOs adopted a “rage-quitting” mechanism to avoid immobilization of contributors’ funds in this type of situation (or in the event of disagreement following a members’ vote). This mechanism permits a member to exit the DAO by exchanging its tokens for a pro rata claim on the assets in the DAO’s treasury.

* * *

ConstitutionDAO—Hybrid model featuring a partnership form, together with legally recognized entities to facilitate the DAO’s activities.

Created in November 2021, the ConstitutionDAO was formed for the single purpose of bidding in a Sotheby’s auction to acquire one of the thirteen remaining original copies of the U.S. Constitution. In less than a week, the DAO received a total of \$47 million in ether contributions from almost 17,500 contributors. The tokens the contributors received in return gave them the right to vote on what the DAO would do with the copy it acquired. As Sotheby’s did not at that time allow DAOs to bid directly at its auctions, nor did it accept digital currencies, ConstitutionDAO partnered with a cryptocurrency exchange to convert its ether to dollars, partnered with a non-profit organization to make the bid on its behalf at the auction, and formed a corporation to facilitate the transfer. ConstitutionDAO was outbid at the auction and, after a period of uncertainty about next steps, it ultimately offered full refunds to the contributors. However, due to

the refunds being made net of it the fees charged by Ethereum for converting the ether, most of the money raised was not returned to the contributors.

* * *

Moloch—Providing grants and profit-making loans.

This DAO, which runs on the Ethereum blockchain, was created in 2019 to provide a sustainable and speedily obtainable source of capital to fund open source development on the Ethereum system. It was initially funded by the founder of ConsenSys, a co-founder of Ethereum, and individuals at ConsenSys and the Ethereum Foundation. It has distributed about \$1.4 million in grants to about 70 recipients. Contributors deposit ether and receive voting power to vote on which projects the DAO should fund. To become a member, the candidate must be endorsed by existing members, pass a member-driven evaluation, and be approved by the economic majority of members. Moloch DAO has modified its original code and now makes for-profit loans in addition to making grants.

* * *

Pleasr—Collecting NFTs and donating sale proceeds.

This DAO was formed by 74 crypto artists, DeFi leaders, NFT collectors and entrepreneurs to bid on works by high-profile digital artists, with a focus on pieces that the members believe represent important ideas and causes. Once a work is purchased, it is the property of Pleasr’s members, who can vote on what to do with it (for example, exhibit it somewhere, sell it to the public, or retain it in a physical or virtual vault); and Pleasr donates any proceeds to charities. Pleasr was formed when its creator wanted to buy a particular NFT that he viewed as “a piece of history” but he could not afford to buy it alone. The original members contributed \$525,000 for the purchase. (The NFT was an animated ad depicting a pink unicorn moving toward an oasis that was formed by the Ethereum logo.) Pleasr has since purchased other NFTs—paying \$4 million for an NFT of the image that inspired the cryptocurrency known as dogecoin, \$5.5 million

for activist Edward Snowden’s “Stay Free” NFT, and \$4 million for an unreleased album by the Wu-Tang Clan.

* * *

MakerDAO—Using a foundation to develop Maker’s protocols before turning control over to a DAO.

Maker is a lending platform deployed on the Ethereum blockchain, which enables users to access loans collateralized by cryptocurrency. It currently has a market cap of about \$2 billion. Initially, the Maker Ecosystem Growth Foundation was established (in 2018) to oversee the protocol’s early development, with the objective that control would later be turned over to a DAO (which occurred in July 2020). The Foundation’s role was to enable a small, highly-skilled group to collaborate to accomplish the necessary development before the decentralized DAO structure was put into place. The Foundation (as a legally recognizable entity) also ended up effectively shielding the members from liability when, in April 2020, following a major slump in cryptocurrency prices, a \$30 million class action was filed alleging that the terms of service had deliberately misrepresented the protocol in order to downplay the risks associated with its use.

* * *

Spice—Apparent inexperience derailing a project.

Spice was formed to raise funds to purchase the rare art book Jodorowsky’s Dune, which is a book about an ill-fated film adaptation of the classic science fiction book called Dune. Spice’s plan was to make a version of the film, with the creative decisions made by vote of its members. Spice raised over \$12 million. It bought the book at auction for \$2.7 million. It then set up formal corporations and a bank account to enable it to arrange for the book to be shipped from Paris to Delaware and to be maintained in a storage facility with climate-control. Spice stated that it planned to make a scanned copy of the book, which it would release online as an NFT; and then that it would burn the actual book and sell a video of the burning as an NFT. Reportedly, Spice then discovered that the purchase of the

book did not convey the intellectual property rights necessary for it to produce the film. Spice changed its plan to production of an animated television series unrelated to Dune but evoking its spirit. After dissension among the members about the series that the founders proposed, Spice conducted a writing contest and the members voted to select the series to be produced. After complications with that project, Spice decided not to operate as a DAO, to allow members to cash out their tokens, and to transform itself into a “members only club” called “Spice Club.” Spice Club plans to sell the book and possibly enter into an NFT collaboration with an artist who makes comics.

* * *

Cabin—A community with creative energy searching for a purpose.

The Cabin DAO was established when its founder (a tech innovator) built a cabin in the countryside outside Austin, Texas, brought friends to stay there, and the idea occurred to them to start a residency program at the cabin for other tech creators. The group allows its almost 300 token holders to vote on who is granted residencies at the cabin. The founder describes Cabin as a “decentralized city” that aims to build spaces around the world and connect them through digital tools.

* * *

Friends With Benefits—A successful (but arguably not “democratic”) social DAO.

Friends With Benefits provides a social platform for members. It requires the purchase of \$4,000 of the DAO’s tokens to become a member (and so has been described as the equivalent of an online country club). It recently raised \$10 million from thousands of members (including the venture capital firm Andreessen Horowitz). Members socialize by chatting in an online room (with a focus on crypto topics, job leads and investing tips), and hold town halls to discuss future plans. The DAO also hosts parties for its members at crypto conferences and organizes in-person meet-ups where members live.

* * *

ShapeShift—A private corporation effectively going public by transforming itself into a DAO.

ShapeShift, a cryptocurrency trading company, was established as a corporation in 2014, with the goal of permitting instant exchange of one cryptocurrency for another (making the exchange of crypto coins “as easy as buying a drink from a vending machine”). In July 2022, the company announced that it would dismantle its corporate form and transform itself to become an unincorporated DAO. The CEO, a cryptocurrency industry veteran, emphasized the advantages of decentralization and the fluid market permitting anyone in the world to become a token holder. He stated that he will reduce his current one-third ownership of the company and hold just 5% of the DAO’s tokens. He said that, while he will no longer be an employee of the company, he will stay actively involved in the DAO’s ventures. He has acknowledged that a future investor could purchase a majority of the tokens and re-centralize the company—a result that he noted the DAO’s rules could have been, but were not, designed to prevent.

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Decentraland—A DAO popular with major global brands.

Decentraland is a DAO that has created an online virtual world that functions as something like a combination of a game and a marketing channel. Owners of Decentraland’s token govern the organization, making decisions democratically. The funds contributed by investors in exchange for plots of land in the virtual world are used to sponsor community grants and to help grow the Decentraland platform, as the token holders determine by vote. A plot of land costs at least \$10,000, with the most expensive plots costing well over \$1 million each. The platform has become popular with celebrities and global brands as a way to reach digital audiences. It has become known as an “online home” to Morgan Stanley, Coca Cola, Adidas, Samsung, and Snoop Dog, among others.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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