

Legal Structures for DAOs – Proposal for a Roadmap

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Operating a DAO without any legal entity involved may not be good enough in some cases. The present article highlights some of the legal risks that may arise from the operation of Genuine DAOs and explores potential alternatives.

Introduction: The Quest for the Best Structure

From a legal perspective, communities seeking to establish a DAO have three basic options:

- Communities may choose to run a DAO without any legal entity involved. This structure may be called a "Genuine DAO".
- Communities may register their DAO in one of the few jurisdictions¹ that recognize registered DAOs as legal entities and provide a legal framework for establishing DAOs. This structure may be referred to as a "Registered DAO".
- Communities may set up a legal entity² in a jurisdiction of their choice which serves as a wrapper and formally runs the DAO. This structure may be dubbed a "Wrapped DAO".

The decision that communities face is a complex one: In many cases, the choice will not be limited to just the three above-mentioned options. As a consequence of their international nature, many communities lack both a home base and a main market.³ As a result, communities that consider a Registered or Wrapped DAO structure are typically free to choose from multiple jurisdictions. A Genuine DAO structure may compete with different Registered DAO structures and even more Wrapped DAO alternatives. The pros and cons of potential structures ought to be carefully analyzed in each individual case. This is a complex exercise: A concept that works in one case may not be suitable for others.⁴

To simplify the decision-making, communities could use a two-step approach for the discussion:

- As a first question, communities may want to ask themselves: Is a Genuine DAO structure good enough for operating a DAO?
- If the answer to the first question is no, the communities may ask themselves: Should we use a Registered or Wrapped DAO structure, and if so, which?

When exploring these questions, legal issues are not the only issues that should be taken into account. Among other things, costs are equally important. However, as will be highlighted in further detail below, the decision for or against a Genuine DAO structure is (and should be) mostly driven by legal considerations. Without wanting to sound overly dramatic, legal issues

¹ For example: Malta in the E.U. or Delaware, Montana, Vermont and Wyoming in the U.S.

² For example: a limited liability company, a corporation, a foundation, or an association.

³ Purely domestic DAOs are a notable exception.

⁴ The fact that the advice given by lawyers is typically limited to their own jurisdiction does not make the task any easier. While international law firms or networks of law firms do provide multijurisdictional advice, such advice is expensive.

can be a showstopper and, in a worst-case scenario, may turn a project into a non-starter. Turning a blind eye to evident legal issues may be risky.

Therefore, the quest for the best legal structure should not be easily abandoned for the simple reason that the task is complex. Indeed, it may be argued that every community makes a decision for or against a Genuine DAO structure (be it expressly through a vote or implicitly by not discussing the issue at all). In my view, this decision (even if implicitly made) should be an educated one.

The purpose of the present article is to provide some food for thought and a roadmap for further consideration and discussion. It is up to the communities to decide on the destination in each individual case. The views expressed in this article are entirely my own.

Genuine DAO Structures: Preferable vs. Good Enough

It is safe to assume that communities which are not composed of legal professionals tend to prefer a Genuine DAO structure. Many will even argue that the proposed first question is put in a wrong way. The relevant question should not be whether a Genuine DAO structure is "good enough", but rather whether it is "preferable over" a Registered or Wrapped DAO structure.

The preference for Genuine DAO structures appears to be driven by a selection or combination of the following three assumptions:

- It is assumed that a Genuine DAO structure is the best fit for a democratic, grassroots and bottom-up approach of decision-making that inspires most DAOs.
- It is assumed that the lack of a legal entity equates to a reduction of red tape.
- It is assumed that the lack of a legal entity is advantageous from a legal perspective.

Based on these assumptions, a preference for Genuine DAOs is plausible given that:

- *Registered and Wrapped DAOs are not fully decentralized organizations any more.* In exchange for their recognition as legal entities, Registered DAOs must comply with similar centralization requirements (such as a registered place of business) that are requested for the registration of all other legal entities, in addition to potential DAO-specific requirements. From a purely semantic perspective, it may be even argued that it is misleading to call Wrapped DAOs DAOs and that Wrapped DAOs should rather be called companies, associations, foundations (or whatever type of entity is used as a wrapper) instead.
- *The establishment and maintenance of a legal entity is costly, time-consuming and cumbersome.* Evidently, both Registered and Wrapped DAOs cover an organization with an additional layer of red tape which restricts its agility and, to some extent, may even limit a community's decision-making authority. The organization is equipped with bureaucratic overhead nobody really wants.

Yet, all of these considerations should be taken with a grain of salt:

- *First*, it is understandable that many communities fancy the ability to proudly call their pet a DAO. Still, purely semantic arguments should not be decisive for choosing a Genuine DAO as a legal structure over any other form.

- *Second*, it goes without saying that any project or start-up (whether crypto-related or otherwise) should be wrapped in as little red tape as possible. Yet, this does not mean that decentralization should be treated as a dogma:
 - *Decentralization is not a binary issue.* Even Genuine DAOs often exhibit different forms and levels of centralization.⁵
 - *The assumption that more decentralization always trumps less decentralization remains to be proven.*⁶ The same is true for the assumption that less centralization necessarily leads to less red tape.⁷

While the benefits of full decentralization may thus be debatable, it is still fair to conclude that, assuming all options are viable, a Genuine DAO structure will always be preferable to a Registered or Wrapped DAO structure, if there are no other reasons for deciding against it.⁸

This is why the first question reads: Is a Genuine DAO structure good enough?

First Question: Is a Genuine DAO Structure Good Enough for Operating a DAO?

Non-lawyers often like to think that the lack of a legal entity is advantageous from a legal perspective. This line of thought is typically based on one or more of the following assumptions:

- Assumption No. 1: For lack of a registered place of business, Genuine DAOs are not subject to the laws of a certain state and do not have to comply with the regulations of any state for that matter.
- Assumption No. 2: Today, most states do not stipulate laws specifically governing DAOs. Until states do, Genuine DAOs operate outside the law (not in the sense that their operation is illegal but in the sense that they are not subject to any regulation).
- Assumption No. 3: Governments will need to accept the reality of Genuine DAOs or face their *nokia moment*. People will simply opt out of any governmental control and establish self-regulating parallel businesses, economies or even societies.
- Assumption No. 4: The law is red tape. For DAOs, the code is the law. DAOs do not need the law as a base layer.
- Assumption No. 5: Company law prevents people from self-organizing and self-regulating their affairs in a form they consider fit. Legal entities cannot be set up in the same way as a Genuine DAO using a bottom-up approach.

⁵ Genuine DAOs are often managed by various bodies and committees. It may be argued that a Genuine DAO that is factually controlled by one or more opinion leaders is merely a decentralized organization on paper.

⁶ Until today, enterprises, states and societies have never been run in a fully decentralized way. People used hierarchical structures for centuries. While new technologies may enable large groups of people to organize themselves as a DAO, the use of DAOs as a form of organization for entire states or societies is an utopia that still needs to stand the test of time. As far as enterprises are concerned, it remains to be seen whether DAOs are indeed superior to traditional forms of governance and organization, and, if so, in which cases.

⁷ Arguably, some aspects of corporate governance (regulations and procedures) are required for Genuine DAOs as well. The need to hold regular votes in a decentralized environment could even increase the overall red tape.

⁸ That is explored in the next section.

- Assumption No. 6: Genuine DAOs cannot be sued.

Most of these assumptions are not accurate from a legal perspective, unfortunately:

- Assumption No. 1: It is true that Genuine DAOs have no registered place of business and, accordingly, are not subject to the laws of a certain state. Yet, this does not mean that Genuine DAOs do not need to comply with the regulations of any state. Rather, Genuine DAOs must adhere to all regulations applicable in any state in which the Genuine DAO operates.⁹ In fact, the lack of a registered place of business may produce the opposite effect. It may trigger more states to regulate the same business or transaction, by assuming jurisdiction based on the domicile of the members of the community.
- Assumption No. 2: It is true that most states do not stipulate laws specifically dealing with DAOs. Yet, this does not mean that a Genuine DAO operates outside the law. Laws are typically drafted in a way that allows for their application to new developments (e.g. by relying on fundamental principles of law, by stipulating general rules, by applying specific laws analogously, or by leaving the gap-filling to the state courts). It cannot be concluded from the absence of specific laws that Genuine DAOs operate in the *wild wild west*.
- Assumption No. 3: For the reasons explained above, communities cannot opt out of the application of the law by running a Genuine DAO. Opting out of the rule of law requires a true revolution (not just a technical one). This is not what most people want, for good reason:
- Assumption No. 4: All transactions between different parties (including those composed of or executed by smart contracts) are inherently based on a legal framework which serves as the solid foundation required for their execution.¹⁰ Be it contractual relations or partnership arrangements, such legal framework provides guidelines (even for cross-border cases) whenever issues arise which the parties have not foreseen and where the parties have failed to agree on specific terms and conditions for their resolution. It is this legal framework which enables parties to conduct business without the need to draft terms and conditions for each and every transaction.¹¹ The code cannot be the law for as long as the law is needed to fix issues arising out of its operation.¹² Operating outside of the law would not lead to a reduction of red tape, but force DAOs to reinvent the wheel.
- Assumption No. 5: Company laws provide different rules for the establishment and management of different legal entities. Some are more flexible than others. Some may allow for a bottom-up approach, others do not. To find the right wrapper is precisely what the second questions is all about.

⁹ For example, a Genuine DAO must comply with the Security Exchange Act if it intends to cater the U.S. market. The SEC will shut down any enterprise that fails to comply with financial market regulations, no matter whether the enterprise has a seat or not, and whether or not it has its seat is in the U.S. or abroad.

¹⁰ For further analysis from a U.S. and Swiss legal perspective, see e.g. LEVI/LIPTON, An Introduction to Smart Contracts and Their Potential and Inherent Limitations (<https://corpgov.law.harvard.edu/2018/05/26/an-introduction-to-smart-contracts-and-their-potential-and-inherent-limitations>) and TRÜEB, Smart Contracts (https://www.walderwyss.com/user_assets/publications/2283.pdf).

¹¹ This does not mean that transactions involving DAOs should be executed without any contractual terms and conditions. It means that the parties may focus on the so-called *essentialia negotii* and the most fundamental aspects of their contractual relationship (such as e.g. on jurisdiction and applicable law).

¹² For example: What happens if a DAO becomes insolvent?

- Assumption No. 6: It is true that Genuine DAOs cannot be sued. However, this is a bug and not a feature (as will be explained below).

This being said, a Genuine DAO comes with two significant disadvantages from a legal perspective:

- No liability shield: In contrast to recognized legal entities, a Genuine DAO lacks a liability shield. Under most jurisdictions, Genuine DAOs qualify as general partnerships. Members of the community are at risk of qualifying as fully liable partners who may be held accountable for all actions and obligations of the partnership. The liability of partners is unlimited and personal (which means that a creditor may exploit all of a partner's personal assets to cover debts of the partnership).¹³ Moreover, Genuine DAOs lack a tax liability shield: General partnerships are typically viewed as pass-through entities: the partnership itself is not taxed, but its partners are.
- No legal personality: A Genuine DAO lacks legal personality. It cannot enter into contracts, and it is barred from engaging in real-world business relationships as a consequence.¹⁴ For this reason, the Genuine DAO structure has been called a "maverick DAO" structure by other authors.¹⁵ While a Genuine DAO itself cannot be sued, it cannot sue other parties either and, as a consequence, cannot enforce its claims in court.

In many cases, these disadvantages will be red flags and may lead to the conclusion that a Genuine DAO structure is not good enough for operating a DAO.

Second Question: If a Genuine DAO Structure is Not Considered Good Enough, What Structure Should be Used?

If Genuine DAO structure is not considered good enough, DAOs must choose from available Registered and Wrapped DAO structures.

As mentioned above, there is no one-size-fits-all solution. A concept that works in one case may not be suitable for others. However, the following general remarks may be made:

Registered DAOs

Today, only few jurisdictions provide specific company law for the establishment and management of Registered DAOs. More jurisdictions are likely to join the club in the future. While a DAO Model Law¹⁶ has been drafted by legal scholars as a proposal for a unified solution, such model law is not in force anywhere in the world and should not be confused with an international treaty.¹⁷

¹³ This may be problematic in particular for community members who participate in the decision-making with their real name (though even "anonymous" participants are at risk of being identified by authorities or creditors).

¹⁴ A Genuine DAO cannot employ staff, it cannot open bank accounts, it cannot engage service providers, it cannot own property rights, it cannot grant or receive loans, etc.

¹⁵ Riva, Decentralized Autonomous Organizations (DAOs) as Subjects of Law (<https://libra.unine.ch/export/DL/40516.pdf>).

¹⁶ <https://coala.global/reports/#1623963887316-6ce8de52-e0a0>.

¹⁷ The authors of the model law suggest that "*States should hew as closely as possible to the letter and objectives of the Model Law*" when adopting or transposing the model law into their domestic law. In my humble opinion, this is highly unlikely to happen.

The fact that a specific DAO company law exists does not mean that a Registered DAO structure is necessarily more suitable than a Wrapped DAO structure in a given case, for the following reasons:

- Some DAO company laws are impractical.¹⁸ Others appear to be primarily motivated by the intention to attract new business that can be taxed.¹⁹
- In exchange for their recognition as legal entities, Registered DAOs must comply with similar centralization requirements (such as a registered registered place of business) as all other legal entities.²⁰

Arguably, the choice of a suitable jurisdiction, in which the DAO sets up shop with its registration, is even more important. For instance, despite the emergence of several DAO company laws in some U.S. states, it must be concluded that the cluttered regulatory environment in the U.S. makes the establishment and management of a DAO difficult. The situation has been described as follows:

*"The United States regulatory environment surrounding digital assets presents an extraordinary challenge for blockchain and smart contract-based protocols. In the absence of comprehensive legislation addressing the complexities of this developing technology, individual regulatory agencies have been forced to provide their interpretations of how regulations should be applied to situations and technologies, well beyond what was considered when the current laws and regulations were enacted. Although it is universally agreed that comprehensive reform and new legislation is a necessity, the reality exists that the developers and users of blockchain technology have been left to navigate a patchwork regulatory environment insufficient to address relatively simple issues related to digital assets, let alone the additional complexity accompanying the decentralized alternatives to traditional financial service offerings available through smart contract-based protocols."*²¹

For this reason, communities with no specific link to the U.S. should carefully evaluate whether the benefit of a Registered DAO in the U.S. is worth the trouble of being fully regulated by U.S. law.

Wrapped DAOs

For communities that consider neither a Genuine DAO nor a Registered DAO structure good enough, a Wrapped DAO structure may be an option.

¹⁸ For example: Malta's certification process requires a "*rigorous technical audit*" (GANADO/ELLUL/PACE et al., Mapping the Future of Legal Personality, MIT Computational Law Report; <https://law.mit.edu/pub/mappingthefutureoflegalpersonality/release/1>).

¹⁹ For example: Wyoming's DAO law has been called "*unworkable vaporware optimized for hitting headlines rather than aiding innovation*" (DURHAM, Wyoming Built a Home for DAOs—Why They Won't Come; <http://ipjournal.law.wfu.edu/2021/06/wyoming-built-a-home-for-daos-why-wont-they-come>).

²⁰ For example: Malta requires for the recognition of DAOs "*to have a 'technical administrator' with the power to intervene and address losses and breaches of mandatory laws*" (GANADO/ELLUL/PACE et al., *ibid.*). Arguably, the role of the technical administrator is not fundamentally different from the role of a director in a traditional legal entity.

²¹ KERR/JENNINGS, A Legal Framework for Decentralized Autonomous Organizations (<https://a16z.com/wp-content/uploads/2021/10/DAO-Legal-Framework-Jennings-Kerr10.19.21-Final.pdf>).

Using a Wrapped DAO structure comes with two advantages:

- The choice is not as limited as in the case of Registered DAO structures. There are alternatives to setting up shop in the U.S. or Malta. The broader selection enables communities to take into account other criteria (such as taxation and requirements/preferences of funders for example).
- Most jurisdictions have decades of experience with the management of traditional legal entities. Setting up a traditional legal entity as a wrapper may prove to be quicker and produce less headaches than setting up a Registered DAO.²²

When it comes to Wrapped DAO structures, the first task is to find a type of legal entity that provides the required flexibility for the operation of a DAO in the most possible decentralized way, in a jurisdiction that offers the best legal environment for the specific DAO. The second task is to define by-laws for the wrapper that ensure to the largest extent possible that the community remains always in control (by specifying that the representatives of the legal entity are bound by any decision taken by the community and obliged to execute it).

Some legal entities that may be suitable for use as a wrapper will be explored in a future article. Watch this space!

²² OPENLAW, The Era of Legally Compliant DAOs (<https://medium.com/@OpenLawOfficial/the-era-of-legally-compliant-daos-491edf88fed0>), claims "to enable the creation and deployment of 'limited liability DAOs' in minutes", by forming a Limited Liability Association in Colorado.