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Decentralized Autonomous Organizations: Governance Using Blockchain and Smart Contracts

Mitigating Ownership Risk, Limitations of DAO in Litigation, Ability to Raise Capital

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Today's faculty features:

Jonathan Bench, Attorney, **Harris Bricken LLP**, Seattle

Daniel L. McAvoy, Shareholder; Co-Chair FinTech and Blockchain Practice, **Polsinelli PC**, New York

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Decentralized Autonomous Organizations: Governance Using Blockchain and Smart Contracts

By: Daniel McAvoy, Polsinelli PC and Jonathan Bench, Harris Bricken Sliwoski LLP

Jonathan Bench

Attorney

801.900.4849 | jonathan@harrisbricken.com

Jonathan Bench is chair of Harris Bricken's corporate practice group and managing attorney of the firm's Salt Lake City office, where he helps public and private companies with international and domestic business transactions. His clientele includes companies from Asia, Europe, the Middle East, Africa, and the Americas. Jonathan has worked and consulted in the U.S., Asia, and South America and is fluent in Chinese and Cantonese. He is also on the board of directors for World Trade Center Utah. Jonathan co-hosts the Global Law and Business podcast, which covers legal and economic developments around the world. His most notable Web3 projects involve Bored Ape NFTs and helping developers with ensuring their projects comply with securities laws.

Daniel McAvoy

Shareholder

212.413.2844 | dmcavoy@polsinelli.com

Daniel McAvoy is a securities and corporate finance Shareholder in Polsinelli's New York City office and the co-chair of Polsinelli's FinTech and Blockchain Practice, where he focuses on the law of digital assets, private funds, securities, and other investments from a transactional, regulatory, fundraising, and formation perspective. He frequently works at the intersection of these areas, including the formation and launch of private investment funds, including those with a digital asset or FinTech strategy; offerings by and investments into organizations in the crypto space; structuring decentralized autonomous organizations; asset fractionalization and tokenization; navigating the launch of NFT projects; and regulatory compliance.

Presentation Roadmap

- What is a DAO?
- What is Distributed Ledger Technology?
- Blockchain Use Cases
- Smart Contracts
- Tokens/Coins and Other Digital Assets
- Types of Tokens/Coins
- How are DAOs Organized?
- What Problems are DAOs Attempting to Solve?
- What are the Legal Issues with DAOs?
- What are the Functional Issues with DAOs?
- DAO Case Studies
- DAO Structural Solutions
- Concluding Thoughts
- Q&A

What is a DAO?

- Decentralized: Works using blockchain or another “decentralized ledger technology”
- Autonomous: Operates via code on a “smart contract” while minimizing human interaction
- Organization: An organized body of people with a particular purpose
- As of January 2022, about 200 active DAOs that manage a total of around \$14 billion in crypto assets

What is Distributed Ledger Technology?

- When you think of a blockchain, think of it like computer software.
- Network of computers (nodes/validators) which creates a real time and permanent record of changes that gets distributed to and is maintained by the nodes.
- Operates largely in real time (updates every 10 minutes (Bitcoin) to nanoseconds (Solana)).
- These nodes verify the transaction is valid (*i.e.*, the person sending is authorized to send and the person receiving is authorized to receive).
- Series of transactions are grouped into blocks. These blocks are linked chronologically to form the chain.

Types of Blockchains

- Each blockchain has a separate ledger maintained by computers (nodes/validators) running that blockchain's software.
- *Public blockchain* = fully decentralized (*i.e.*, there is no single entity or group of entities required to keep the ledger running and accurate).
- *Private/permissioned blockchain* = some centralized elements, such as a company or group of companies which are required to maintain and update the blockchain, or a limited number of servers that function as validators.
- Different methods of data verification among the blockchain computers:
 - proof of work
 - proof of stake
 - other
- Nodes are generally rewarded for accurate confirmations and punished if inaccurate.

Use Cases For Distributed Ledger Technology (a/k/a Blockchain)

- Each blockchain and cryptocurrency/digital asset is a piece of software code
- Can be used to store any information digitally:
 - Financial transactions
 - Transfers of property (traditional (real estate) vs. web3 (NFTs))
 - Digital rights management (e.g., media: music, movies, TV shows)
 - Royalty payments
 - Verifications
 - Records

Use Cases For Blockchain: Common Cryptoassets

- Cryptoassets - Information and/or contract rights within a blockchain's software protocol
 - Cryptocurrency
 - A store of value
 - A medium of exchange
 - A unit of account
 - If you own 1 bitcoin, you own a portion of the bitcoin “software”
 - NFTs (non-fungible tokens)
 - Digital rights often associated with intellectual property
 - DAO Tokens
 - If you own a DAO's token, you own one unit of the smart contract rights associated with that particular DAO

What is a Smart Contract?

- A piece of code that allows for an agreement between multiple parties to be executed in a fully or partially automated manner
- While the complexity of smart contracts has been enabled by blockchain, smart contracts have existed for a long time (e.g., vending machines)
- Are not necessarily “smart” in that they can learn, but rather that they can execute in part without further human intervention
- Often “if/then” or a series of binary decisions, e.g., if Person A sends Ethereum, Person B sends monkey.jpg.
- Because the distributed nature helps eliminate the need for a trusted single counterparty, smart contracts typically are built on the software of a blockchain, similar to how cell phone apps are built on iOS or Android software.

Smart Contract Evolution

- Some blockchains (ETH/SOL) are easier and more cost effective to build on than others (bitcoin)
- Can build a “second layer” blockchain on top of another blockchain that can help create efficiencies or additional functionality (e.g., Polygon, Lightning Network, etc.)
- Some may be more “smart” than others, and often still require non-code based input (oracles) and enforcement mechanisms
- “Smart” still does not mean they can self-modify – human decisions are still needed to modify the code, and in a blockchain-based code, generally consensus will be required to modify the code
- Light vs. Heavy enforcement mechanisms

What Are Tokens (a/k/a Coins)?

- Digital representation / unit of use in respect of a smart contract.
- Fungible (cryptocurrencies) vs non-fungible (e.g., NFTs).
- Certificate of ownership/authenticity, like a digital stock certificate.
- Can be crypto itself or some other representation of ownership like an NFT.

Contractual Properties of Tokens

- Voting / governance rights
- Profits / economic ownership
- Access to on-chain platforms or off-chain venues
- Proof of identity
- Discounts for products and services

What Types of Tokens Exist?

- Recognized types of tokens in many jurisdictions:
 - Digital payment tokens
 - Stablecoins
 - Central bank digital currencies
 - Security tokens
 - Utility tokens
- Could have different regulatory treatment in different global jurisdictions

Other Types of Tokens

- Governance
- NFTs
- Non-infrastructure utility tokens (like VIP access to an off-chain concert/club)

What is a DAO?

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How Are DAOs Organized?

- Starting as a DAO
 - Requires broadening adoption over time
 - Increased risk that the desires of the founders are not honored
- Forming a DAO alongside a traditional entity
 - DAO typically has more limited power in this structure
- “DAOification”
 - Starting as a traditional entity and over time migrating the governance of that entity to a DAO
- Starting centralized and becoming decentralized over time

DAOs as International Organizations

- Governance participants
- Asset locations
 - Finances
 - Intellectual property
- Execution of operations
- Applicability of governing laws

How Are DAOs Governed?

- At its core, a DAO is a governance structure, so there are many varieties
 - 1 token = 1 vote on everything (pure democracy)
 - Board / council elections (closer to a corporation)
 - Sub-DAOs to deal w/specific business operations
 - Ability to determine certain aspects but not others
 - Whether submission of proposals can be by anyone or a subset of the DAO participants
- Smart contracts determine what happens automatically, what is voted on, who can vote, and how votes occur

What Problems Are DAOs Attempting To Solve?

- Democracy
 - Flattening traditional hierarchical governance and organizational structures
 - Lowering traditional barriers to participation in investment opportunities / capital markets by non-accredited investors
- Minimizing intermediaries
- Direct rewards of contributors. More you contribute (work or liquidity), more control and rewards over DAO.
- Transparency in information and governance

More Problems DAOs Are Attempting To Solve

- Liquidity. Market for tokens easier to navigate than market for interests in other closely held business.
- In certain jurisdictions may be less regulated than ownership in stock, etc. of traditional corporate structures
- Attempts at decentralization to avoid being a security
- Immutability
- Resistant to fraud/human errors
- Censorship resistance

Legal Issues With DAOs: Securities Laws Part 1

- Howey test
 - Investment of money
 - Common Enterprise
 - Expectation of Profits
 - Primarily from Efforts of Others
- Other US law securities tests:
 - *Reves v. Ernst & Young* – “Family Resemblance Test” for debt-like instruments
 - Risk capital test – used in California and a number of other states
- “DAO Report”
 - Original SEC Crackdown on digital assets
 - Ruled digital currency meets prong 1 of Howey
- Sale / dissemination of governance tokens
 - Bipartisan Responsible Financial Innovation Act (Bitcoin Bill) seeking to clarify

Legal Issues With DAOs: Securities Laws Part 2

- Investment Company Act
 - Generally, an “issuer” is an investment company if:
 - Is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities
 - Issues face-amount certificates of an installment type (e.g., annuities)
 - Greater than 40% of its assets consist of investment securities (e.g., securities of companies that are not subsidiaries)
 - Most typical exceptions would be difficult for DAOs to comply with
 - 3(c)(1) – 100 or fewer beneficial owners (250 or fewer for small venture funds)
 - 3(c)(7) – All “qualified purchasers” – usually individuals with \$5M or more of investments or entities with \$25M or more of investments
 - 3(c)(5)(C) – Real estate and mortgages

Legal Issues With DAOs: Unintentional Partnerships

- General partner liability / conspiracy
 - When there is no formal legal structure, the default rule generally is that a joint venture will be treated as a general partnership
 - Joint and several liability by all partners for any action of any partner
 - A general partner has full liability for the acts and omissions of the enterprise, not liability that is limited to the equity capital that they put into the enterprise
 - Initial case alleging general partner liability against all DAO participants - *Sarcuni et al v. bZx DAO et al.* (S. D. Cal., May 2, 2022)
 - Participants in an entity-less DAO may have an advantage if they own the tokens through their own personal entity, such as an LLC

Legal Issues With DAOs: International Payments

- Anti-money laundering (AML) / anti-terrorism
 - More control over how tokens are sold, less liquidity benefits
 - Difficult to keep bad actors out
 - May not be able to establish beneficial owners to be able to interact with parties that are required to establish it
 - Internationally, the Financial Action Task Force (FATF) has provided guidance on prevention of money laundering with respect to virtual assets, and many jurisdictions require a virtual asset service provider (VASP) to register and comply with customer due diligence requirements

Legal Issues With DAOs: No Legal Personhood

- Bringing claims / lack of plaintiff
 - Without legal personhood, cannot bring a claim against others in most courts, unlike a traditional business
 - May not be able to qualify to do business in a way that creates jurisdiction to bring a claim
 - Potential for greenmail
- Attorney-client privilege
 - May be unclear who the client is
 - Governance may require public disclosure of otherwise privileged information

Legal Issues With DAOs: Jurisdictional Questions

- Taxes
 - Uncertainty as to jurisdiction
 - Ownership “shifting”
 - US tax reporting
- International treatment
 - How tokens may be treated in other parts of the world
 - Might be a security for US purposes but not foreign purposes
 - Foreign token frameworks

Legal Issues With DAOs: Intellectual Property

- DAO cannot file formal patents or trademarks
- No trade secret protection because no confidentiality or other limits on publication of info
- Hard to protect any IP from outsiders or even members from usurping personally (*e.g.*, ability to front run while matters are being voted on).
- While the code of the DAO itself generally would be open source software, the DAO itself may have intellectual property that it may want to protect or exploit (*e.g.*, SpiceDAO, which originally wanted to create a film version of Jodoworsky's Dune)
- Also, difficult to ensure that DAO participants will comply with the terms of open source licenses comprising the DAO code

Functional Issues With DAOs: Decentralization

- How to achieve true decentralization and avoid control by oligarchy
 - Often takes an extensive period of time
 - Unclear how decentralized one must be to be deemed decentralized for US and foreign regulatory purposes
- Streamlining governance versus level of decentralization
 - Orderly voting
 - Quorum thresholds
 - Councils and guilds
 - Stewards, trustees, and others with authority to act on behalf of the DAO

Functional Issues With DAOs: Connecting to the Real World

- Cryptocurrency and native asset “treasuries”
- Entering into contracts
 - Determining due authorization
 - May take time to make decisions
 - Difficulty agreeing on minutiae
 - Examples: law firm engagement letter, payment of fees, etc.
- Payments in fiat currency
 - May require an individual to assume liability, or formation of an entity that is authorized by the DAO to deal with off-chain payments
- Making small decisions quickly
 - Often requires granting authority to an individual or small group of individuals

Functional Issues with DAOs: Dealing With Complicated Situations

- Internal dispute resolution
- Fraud / rug pulls
- Dissolution
 - Assets on-chain vs off-chain
 - Giving DAO members a piece of the treasury on dissolution may make the governance tokens securities

DAO Case Studies: The Good

- Ethereum
 - Ethereum Foundation operates alongside the protocol, but decisions ultimately are made by stakeholders
 - “DAO Fork” in 2017 – 1:1 voting, with 85% approval on CarbonVote platform; split into a new chain with certain holders maintaining “Ethereum Classic”
 - Over time, there has been a series of other forks that were either pre-planned or approved by the Ethereum community, which in essence has become its own DAO
 - The “Ethereum Merge” – move from “proof of work” to “proof of stake” validation
 - With Bitcoin, ETH is one of two cryptocurrencies the SEC staff has stated is not a security
- MakerDAO
 - Originally conceptualized as a DAO to build a stablecoin on Ethereum

DAO Case Studies: The Bad

- SpiceDAO
 - DAO created for the purpose of purchasing a manuscript of and commercializing Jodoworsky's Dune
 - After successfully purchasing the manuscript, realized they did not have the IP rights needed to actually make the film
- Wonderland
 - Treasury manager was “doxed” as having been one of the co-founders of QuadrigaCX, an exchange (and probable scam) that lost all of its value when the CEO died under mysterious circumstances
 - DAO voted on whether to continue; despite the community voting to continue the protocol (overwhelmingly so when measured by total number of wallets rather than total number of tokens), the founders nearly wound up the protocol anyway
 - Has shifted to something more akin to a venture capital fund

DAO Case Studies: The Ugly

- JunoDAO – DAO Members voted to confiscate \$35M worth of tokens from a whale to enrich other DAO members
- Merit Circle – Cancelled the lead seed investor's SAFT in breach of the contract and voted to pay them back only \$0.32 on the dollar of what they originally paid

DAO Case Studies: The To-Be-Determined Outcomes

- Decentraland
- ApeDAO

DAO Structural Solutions: Domestic DAO Laws

- Wyoming and Tennessee
 - Similar in many ways to LLC structure
 - Allows organization to be “algorithmically managed” or defer functions to smart contract
 - Waives members’ fiduciary duties to other members/DAO allowing more permissive governance structure.
 - Does not allow for member-management
 - Vermont’s BLLC also allows for blockchain based governance models
 - Limitations: folding DAO into LLC code rather than dealing with unique DAO qualities

DAO Structural Solutions: International DAO Laws

- Marshall Islands
- Switzerland
- DAO Model Law
 - Attempts to address unique DAO qualities
 - Functional and regulatory equivalents of traditional entities
 - Unique DAO provisions
- Limits on international proliferation of DAOs
 - Individual country adoption
 - Consensus via UN treaty, then individual country implementing legislation
 - Most likely to see patchwork adoption in next ~10 years rather than mass adoption

DAO Structural Solutions: Partnerships, Corporations, and LLCs

- Unincorporated
 - No wrapper. Likely treated as joint partnership.
 - All legal issues above re: IP issues, lawsuit issues, etc.
- Traditional Corp./LLC with C corp. taxation
 - Solves many tax/IP/lawsuit issues
 - Counter to decentralization goals
 - Hard to do with largely anonymous members
 - Typically only done for sub organizations or affiliates within DAO's, to mitigate tax obligations and other liability risks such as token issuance.
 - Federal/state crowdfunding exemptions

DAO Structural Solutions: Nonprofits and Foundations

- Private Foundation/Public Charity
 - Must have approved purpose (e.g., 501(c)(3) and (c)(4)) and operational test
 - Must get public funding to show public support for IRS for public charity
 - Needs certain level of “doxing” and centralized control to seek and maintain status
 - Limitations on profit sharing
- Ownerless foundation
 - Offshore (Swiss/Cayman)
 - Flexible governance and solve issues with maintaining IP/lawsuits and other issues which require legal personhood
 - US actors still subject to US taxes
 - Complex/expensive to set up

DAO Structural Solutions: Trusts, Cooperatives, and More

- Trusts, cooperatives and business associations
 - Need “doxed” trustees willing to subject themselves to fiduciary duties and regulatory scrutiny
 - Can create purely discretionary trust to overcome expectation of profits standard under Howey potentially
- Public benefit corporations
- Structural combinations
 - Bifurcating on-chain protocols and off-chain traditional entity structure, governed by contract
 - Litigation defense fund

Concluding Thoughts

- Better use cases for DAOs
 - Where able to automate a greater portion of functions
 - Where can serve as a “base layer” for other more centralized organizations to build upon
- Less compelling use cases for DAOs
 - Regulated activities
 - Serving as an investment vehicle (at least in the US)
 - Projects requiring hierarchical structure
- Solving impediments to widespread DAO adoption:
 - Taxation / jurisdiction of treasury
 - Flexibility of governance models

Thank You and Q&A

Jonathan Bench

801.900.4849 | jonathan@harrisbricken.com



Daniel McAvoy

212.413.2844 | dmcavoy@polsinelli.com





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