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The Future is DAO

by Christina Ribble and London Burns

Digital assets, including DAOs—Decentralized Autonomous Organizations—are increasingly growing in popularity in the global economy and becoming a mainstream investment vehicle due to the explosion of blockchain-based decentralized finance (DeFi) in recent years. The term "DAO" was coined by Vitaly Bukerin, the founder of the Ethereum network, in 2014. Although bitcoin could be viewed as a species of DAO, DAOs are generally defined as online communities that control a cryptocurrency wallet (a "treasury") to pursue common goals. Although there are many DAOs in operation today, there are a number of legal pitfalls to consider if you are planning on joining or organizing a DAO.

What is a DAO?

DAOs are member-owned communities that are built and maintained on a blockchain (most often, Ethereum) and that have a common purpose but without traditional, hierarchical leadership and organizational structure. Ethereum is a cryptocurrency network that allows tokens to be exchanged between wallets, and "smart contracts" to be written to control transactions. A smart contract is a piece of software that will execute a transaction or an event on a cryptocurrency network if conditions defined in the contract are satisfied. Smart contracts are the building blocks of DAOs.

A DAO is collectively owned and managed by the members, with transparent rules, decisions and transactions. DAOs usually have a treasury in the form of a cryptocurrency "wallet" that is funded by the members. Each DAO may have a different purpose related to an innumerable list of industries and possibilities.

Most DAOs issue a "token"—a cryptocurrency—that must be owned in order to become a member. Typically, you must obtain some ether (ETH) via an exchange like Coinbase or Binance, send it to a wallet and then swap it for the DAO token in Uniswap.

Interesting examples of DAOs include LexDAO, which creates smart contracts capable of carrying out legal services, and Decentraland, an online virtual world governed by a DAO. Decentraland is gaining traction among global brands like Morgan Stanley, Coca Cola, and Adidas as a means of reaching a wider digital audience. BitDAO, a decentralized investment fund backed by PayPal founder Peter Theil, was created to allow anyone to buy a stake in new digital finance initiatives. The members (i.e., the token holders) of BitDAO are able to vote on how to manage capital and whether to invest in various projects.

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A prominent local example of a DAO is Dash, started here in Phoenix in 2017 in a business incubator at Arizona State University. Dash is an open-source cryptocurrency that is spawned from the bitcoin protocol. It is operated by a DAO run by a subset of its members, which are called "masternodes," that manage, fund, maintain, improve and expand the project. Dash demonstrates the flexibility in DAO governance. Although member-managed, each member has a different weight to its votes.

What kind of liability may DAO members have for acts of the DAO?

In May 2022 a class action lawsuit was filed against a DAO and its members seeking to recover $55 million in cryptocurrency losses stolen during a hack of the DAO's platform. The bZx protocol (governed by a DAO) enabled users to lend cryptocurrency tokens and earn interest on those tokens when other users borrowed them. The lawsuit alleges that the bZx DAO, its co-founders, and all of its members are jointly and severally liable for negligence by failing to adequately secure the platform. Joint and several liability means that each person (each member in this case) is independently liable for the full extent of the damages. The legal theory behind this claim rests on the undefined legal status of the bZx DAO, which the plaintiffs assert to be a general partnership. Unlike a limited partnership, a limited liability company or a corporation, the members of a general partnership are personally jointly and severally liable for the debts and obligations of the general partnership, without limit. It is difficult to dismiss this kind of risk for a DAO that is, like nearly all of them, not organized as a limited liability company, corporation or other legal entity that offers protection from liability.

To address this problem, Wyoming's new DAO Supplement statute permits DAOs to organize and obtain legal status under state law as a form of limited liability company. See State of Wyoming ST0039. Following Wyoming, Tennessee's new DAO statute also allows DAOs to register as a type of limited liability company. See State of Tennessee Amendment No. 1 to HB2645. Wyoming and Tennessee are currently the only states that have created definitive legislative guidance for the legal status of a DAO. (It should be noted, however, that organizing as an LLC gives rise to tax issues that are beyond the scope of this article.)

In a future article, we will address securities law issues presented by DAOs, including the Securities Act of 1933 and the Securities Exchange Act of 1934.

Arizonans who are interested in becoming members of DAOs, are currently members of a DAO, or are considering creating another DAO, should make educated decisions about the risks and possibilities of this novel form of business organization. If you have questions, please contact any member of Kutak Rock's Scottsdale Corporate & Securities Practice Group. You may also visit us at www.kutakrock.com.