

ENTITY SELECTION

ENTITY SELECTION: AN INTRODUCTION TO DAOs

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This article examines a new entity that has emerged in the last few years – Decentralized Autonomous Organizations (“DAOs”).

Introduction

More than 10,000 Decentralized Autonomous Organizations

- 1 As of February 2023, it is estimated that 11,000 DAOs are operating, and 6.4 million taxpayers hold tokens in DAO projects. See generally Post, Dennis and Wong, Jeff, “The Right Legal Wrapper Can Protect a DAO and Its Members,” Bloomberg (7/31/2023).
- 2 Even in the absurd case that the internet dies or DAOs ultimately face a mass extinction event of this new species of legal persons by regulators, over 10,000 algorithmically based organizations would need to be reorganized or unwound. On top of this, the dismantling of algorithmically-based organizations would thwart innovative organizational designs needed to embody intelligence, and termination would not be desired by the DAO communities themselves.
- 3 Vitalik Buterin, co-founder of the Ethereum protocol, by applying the mathematical constructs of convexity and concavity to worldviews about disposition of decisions.

(“DAOs”) have been formed over the past five years,¹ making DAOs a subject that must be reckoned with.² DAOs are algorithm-based organizations and are as like traditional organizations as a muscle-powered bicycle is to an internal combustion-powered motorcycle. DAOs operate like any business or nonprofit, and receive income for providing services, as well as paying vendors for services. The key difference between an algorithm-based organization and a meat-mechanism-based organization is that DAOs use many more automations to drive, manage, and govern the organization. In some cases, a DAO’s algorithms will reside on public or private distributed ledgers or blockchains. In other cases, a DAO’s algorithms will simply reside on the internet or cloud.

It is worth pointing out that the inimitable advantages an algorithmically based organization (DAO) can hold over a traditional organization in certain situations,³ is their ability

to reduce collusion and corruption, often in the forms of gatekeeping and rent-seeking⁴ behaviors. In an ironic twist, with respect to the anarcho-capitalists who originally conceived of the concept of cryptocurrency, DAOs promise to remove collusion by immutable transparency, rather than subversive and cryptic privacy. Given this use of the immutable distributed ledger, perhaps “transparocurrency” is a more suitable name than cryptocurrency. In sum total, Decentralized Autonomous Organizations promise to advance the zeitgeist of contemporary, organic organizational structures, and DAOs presage the emergence of intelligent agents into the embodiment of an organizational form.

Many of the earliest DAOs, sometimes formed by crypto anarchists, asserted that DAOs fall under no legal entity regimes, though U.S. tax law provides that DAOs with no formalized entities primarily default

Applying his own moderate tendencies to decision-making, basically a restatement of Aristotle’s golden mean, which Buterin would define as his “concave tendencies,” Buterin proposes that even his own generally espoused tendencies might break down in extreme situations (such as plague, war, or adoption of a foundational technology). Buterin proposes that in those situations, his tendency toward golden-mean, concave decision-making by the wisdom of the crowd may lead to suboptimal, ineffectual decision-making. In those extreme instances, traditional, centralized decision-making, helmed by a captain, may lead to better results. Buterin argues, however, that such circumstances are not ever-present in organizations, and DAOs should be the foundation to keep “the whole thing stable.” See <https://cointelegraph.com/news/ethereum-co-founder-vitalik-buterin-defends-daos-against-critics> ;

see also <https://vitalik.ca/general/2020/11/08/concave.html>

- 4 Rent-seeking, as used in this article, does not refer specifically to the act of seeking payment on a lease, but rather to Adam Smith’s division of incomes into profit, wage, and economic rent. In the context of a traditional organization, rent-seeking is referential to a human growing their personal wealth by manipulating the social or political environment of an organization without creating new wealth by their productivity. Rent-seeking is a concept of institutional economics and public choice theory. See Tullock, Gordon, “The Welfare Costs of Tariffs, Monopolies and Theft,” Western Economic Journal. 5: 224–232 (1967); See also Krueger, Anne, “The Political Economy of the Rent-Seeking Society,” American Economic Review. 64 (3): 291–303 (1974).

to general partnerships.⁵ Now that the U.S. legal regime and jurisprudence applicable to digital assets is being clarified, and many states are adopting DAO-specific entity legislation,⁶ founders of more recent DAOs are utilizing a spectrum of formalized entities as legal wrappers to embody DAOs with legal personhood. With greater clarification and legal consequences afoot, DAOs are being embodied into U.S. juridical entities, which include LLCs retooled with DAO specific statutory language, existing legal entities such as Delaware Limited Liability Companies or Corporations, and DAO-specific entities with specific statutory provisions for DAOs.⁷

Choosing Appropriate DAO Legal Wrappers

The choice of legal organization for DAOs should be based on the purpose of the DAO, as well as criteria such as whether the DAO will earn income that is taxable, the degree of centralization required, as well as legal liability for disputes and off-chain DAO activities.⁸ The purposes and uses of DAOs impacting entity selection can be broken down into some general categories: (1) charitable and social purpose (non-

profit), (2) shared property and collections, (3) governance or protocols, and (4) investment.⁹

For example, consider the hypothetical case of a DAO being formed by competitor U.S. for-profit domestic companies working in the same industry (the “group”), for purposes of holding and maintaining a shared computer program or protocol as well as a related database and repository of media files (“shared assets”).

The group might initiate the joint venture by creating a U.S. domestic C Corporation or LLC as a jointly owned subsidiary to act as a development company and compensate key employees. Otherwise, the shared risk of loss for the venture might be deemed a general partnership to the owner-companies for both vicarious liability and tax purposes.¹⁰

After the development company has created the shared asset, the group of competitors might identify that there are both industry-related uses for the protocol and database, as well as for-profit and nonprofit uses for the media repository. Assuming the group decides to carry out each of these disparate purposes and wishes to decentralize and auto-

mate governance and management of the shared asset to the greatest extent possible, the group should consider utilizing algorithmically based management protocols, the quintessential ingredients of a DAO.

However, housing these diverse industry, nonprofit, and commercial purposes under one DAO or one juridical entity would create a tangled up gordian knot of legal compliance. Rather than forming one DAO to control them all, the group should carve up, split-up, and/or spin-out DAOs from the development company for each of these purposes.

The group’s nonprofit use of the shared asset for their industry purpose might be spun out and embodied in a corporation wrapper that files for exemption determination with the IRS under IRC Section 501(c)(6).¹¹ If collectors were to acquire rights to display some of the shared media assets for nonprofit purposes, they might wish to wrap the DAO in a corporation that applies for tax exemption as a Section 501(c)(7) entity. The public nonprofit, charitable, educational, or scientific use of the asset could be split off as an unincorporated, nonprofit association (if low revenues) or formally organized as a corpora-

5 See *Sarcuni v bZx DAO*, No 22-cv-0618 (S.D. Cal. 3/27/2023), in which a U.S. District Court ruled that a negligence claim may be brought against the DAO as a general partnership, with the DAO token holders as the partners; see also <https://news.bloombergtax.com/tax-management-memo/virtual-decentralized-entity-taxation-needs-real-development>

6 See Morton, Heather Blockchain 2022 Legislation, National Conference of State Legislatures (6/7/2022), available at: <https://www.ncsl.org/financial-services/blockchain-2022-legislation#:~:text=This%20bill%20specifies%20that%20digitally,the%20provision%20of%20custodial%20services>

7 The scope of this article is limited to the emerging body of DAO-specific entities, and does not give treatment to DAOs organized as Cooperatives organized pursuant to IRC Section 216, IRC Section 501(c)(12), or IRC Section 521, or taxed under subchapter T of the Internal Revenue Code. Nor does this article provide treatment to the various unor-

ganized DAO options such as community chests or funds, unincorporated nonprofit associations, or common law trusts.

8 See Bud Hennekes, “The 8 Most Important Types of DAOs You Need to Know,” *Alchemy* (4/6/2022).

9 The breakdown of DAOs by purpose and the decision flow provided by Chris Brummer and Rodrigo Seira is a helpful tool in visualizing these concepts; see Chris Brummer and Rodrigo Seira, “Legal Wrappers and DAOs,” *Social Science Research Network*, at 30 (5/30/2022).

10 See *Sarcuni v bZx DAO*, No 22-cv-0618 (S.D. Cal. 3/27/2023), in which a U.S. District Court ruled that a negligence claim may be brought against the DAO as a general partnership, with the DAO token holders as the partners; see also <https://news.bloombergtax.com/tax-management-memo/virtual-decentralized-entity-taxation-needs-real-development>

11 In cases where a nonprofit DAO wishes to issue tokens to incentivize service providers to continue working on the shared asset, or if the shared asset is offered to non-U.S. members, the group might benefit by turning to

international jurisdictions for organizational wrappers to act as the incentive token issuer or as a parallel DAO to the U.S. DAO. International options for DAOs include DAO-specific laws (e.g. Swiss Decentralized Autonomous Association (DAA), Malta Innovative Technology Arrangements, Singapore DAOs, and Marshall Islands LLCs), ownerless foundation companies based on the laws of Switzerland or Cayman Islands, or foreign special purpose trusts, cooperatives, foundations, associations, or private trust companies based on the laws of the Cayman Islands, Guernsey, Panama, British Virgin Islands, Ireland, Liechtenstein, or the Cook Islands. See generally Chris Brummer and Rodrigo Seira, “Legal Wrappers and DAOs,” *Social Science Research Network*, at 30 (5/30/2022); see also <https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/>.

tion that files for tax exemption under IRC Section 501(c)(3).¹²

In a case where the shared media assets were used for investment or for-profit collection purposes, or if use of the shared assets generated profits, several of the entities discussed in this article, such as corporations, DAO LLCs, or unique DAO entities discussed below could be used as DAO wrappers to algorithmically manage for-profit uses of the shared asset.

In each of these U.S. domestic use-cases of the group's shared assets, organization under emerging U.S. DAO laws provides the group (comprised of potentially hostile competitors) with an organization format that could reduce the potential of collusive gatekeeping and rent-seeking,¹³ and assures immutable transparency in their coordination and cooperation.

U.S. States with Enacted Statutory Entity Options for DAO Legal Wrappers

As of the time this article was written, Utah (2023), New Hampshire (2023), Tennessee (2022), Wyoming (2021), and Vermont (2018) have enacted juridical entity frameworks specific to the blockchain organiza-

tions known as decentralized autonomous organizations (“DAOs”), though each state's law is configured differently.

Even as the concept of a DAO itself was coalescing as an application for blockchain technology, in mid-2018, Vermont became the first U.S. jurisdiction to make provisions for limited liability company entity governance via the blockchain, using smart contracts. The Vermont statute branded its repurposed LLC statute the Blockchain-Based Limited Liability Company, or (BLLC). A Decentralized Autonomous Organization named “dOrg” became the first DAO to legally organize as a blockchain-based entity in the U.S. by using a Vermont LLC as a DAO wrapper.¹⁴ Internationally, Vermont falls in with Malta, which took a different approach to DAOs and passed DAO-specific entity legislation, creating a unique DAO legal regime in 2018.¹⁵

A couple of years later, with a backlog of DAO ventures seeking the certainty and protection of formalization as statutory entities, OpenAI (who later created ChatGPT) and other companies began using existing Delaware entity

law to implement existing legal entities as DAO legal wrappers, primarily administered via online applications and related smart contracts.¹⁶ While Delaware has not implemented a formal statutory regime, the state has a tradition of eliminating fiduciary duties and the vicarious liability issues inherent in general partnerships, making Delaware a preferred jurisdiction for the legal uncertainty attached to DAOs.

DAO LLC Approach

The forerunner U.S. jurisdictions to adopt DAO entity legislation all took the DAO LLC approach, like Vermont's DAO LLC, styled the “BLLC¹⁷,” then Wyoming's law, branded the “DAO LLC” or “LAO¹⁸,” and Tennessee's DAO LLC law that goes by the “DO LLC¹⁹.” By dressing up existing LLC statutes, these states allow the formation of DAOs with modifications to the incumbent limited liability company jurisprudence.

Wyoming's 2021 DAO LLC law statutorily authorizing DAOs²⁰ cuts the trail for blockchain-specific entities, following on the heels of Wyoming's early adoption of a slew of

¹² For further discussion on nonprofit DAO organizations, see <https://news.bloombergtax.com/tax-management-memo/how-virtual-decentralized-entities-may-obtain-tax-exempt-status>.

¹³ See Buterin, *supra* note 3.

¹⁴ See Vermont Limited Liability Company Act (the “Act”), 11 V.S.A. section 4173.

¹⁵ Note that the Maltese law providing a certification process and audit procedure for DAOs refers to them as “Innovative Technology Arrangements,” See Chapter 592 Laws of Malta.

¹⁶ For example, Openlaw created the Delaware LAO, reliant on Delaware's established LLC statute, which was not specifically authored

for DAOs, but well suited due to Delaware's minimal fiduciary liability standards. See OpenLaw, “The LAO: A For-Profit, Limited Liability Autonomous Organization,” 9/3/2019; see also *Miller v. HCP & Co.*, 2018 WL 656378 (Del. Ct. Ch. 2/1/2018) (noting the axiomatic principle under Delaware law that LLC or LLP agreements can “eliminate fiduciary duties that members or managers would otherwise owe to one another,” because Delaware law gives “maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements”); see also the DAO Ricardian LLC, which was formed in

Delaware as a garden variety limited liability company on 2/1/2021 with the registration number: 4949847; see also “Is Ricardian ‘Legal’?” Ricardian LLC, <https://ricardian.gitbook.io/ricardian-llc/is-ricardian-legal>.

¹⁷ Vermont is the first state to initiate DAO legislation with their July 2018 statute to “utilize blockchain technology for a material portion of its business activities.” See Vermont Statutes Annotated, Title 11, Chapter 25

¹⁸ See W.S. 34-29-101(a)(iv).

¹⁹ Tennessee Code Annotated, Title 48, Chapter 250.

²⁰ See W.S. 17-31-101 et seq.

cryptocurrency-related laws.²¹ Like Vermont, Wyoming's lawmakers chose to convert "The Cowboy State's" first-in-the-world limited liability company laws by layering over a patina of DAO-specific statutory language.

The most significant feature of Wyoming's DAO law is the application of the state's forerunner LLC statute as a chassis to hold DAOs.²² Wrapping a DAO in a Wyoming DAO LLC will, in turn, default to taxation as some type of taxable entity under federal laws.²³ As preliminaries to codifying the LLC status of DAOs in Wyoming, the statute begins by importing some of the definitional foundations from prior bills. Under the definitions section for Wyoming's DAO LLC law (for which the state coins the term "LAO"), the definitions for "Blockchain" and "Digital Asset" punt to Wyoming's 2018 Utility Token Act.²⁴ Because DAOs function using automated "Smart Contracts" to facilitate many of their operations, Wyoming references the "Automated Transactions" definitions under their 2011 Uniform Electronic Transactions Act,²⁵ and took some small pains to provide a short, non-exhaustive list of some of the functions the smart contracts might perform.²⁶ Additionally, like all Wyoming LLCs, the DAO LLC must

continuously maintain a registered agent, who must be a living human being over the age of 18, physically located at a street address in Wyoming.²⁷

Astutely, Wyoming did not define a DAO as an organization living on the blockchain; after all, not all DAOs live on the blockchain and may simply live online in cloud computing or as centralized computing applications.²⁸ Further, Wyoming wisely avoided many grotesque complications in their DAO LLC law by providing no obligations to furnish information available on the blockchain²⁹ (after all, it is unclear who would be responsible for providing such information in a disembodied DAO), and by providing that the provisions of the smart contracts preempt conflicting provisions in the operating agreement or articles of organization.³⁰

Apart from these generalized features of Wyoming's statute, as is the case with the published IRS notice and ruling, a gap again appears between the necessarily speculative forerunner Wyoming law, and the practical technical requirements of DAOs, as well as market uses of blockchain applications.

The operating agreement or articles of a Wyoming DAO LLC must provide a conspicuous notice of restrictions on duties and transfers in

the articles of organization or operating agreement, and the DAO LLC "may define, reduce, or eliminate fiduciary duties and may restrict transfer of ownership interests, withdrawal or resignation from the decentralized autonomous organization, return of capital contributions and dissolution of the decentralized autonomous organization."³¹ As a waivable default, the DAO LLC statute provides that no member shall have a fiduciary duty, and imposes on members the implied contractual covenant of good faith and fair dealing.³² In the case of a collusive attack or hard fork, both essential features anticipated by the nature of blockchain, it will be interesting to see how the default application of the covenant of good faith and fair dealing will be applied to a DAO that has not waived these covenants.

Management of the Wyoming DAO LLC is vested in the members by default, though a DAO LLC may be algorithmically managed by smart contracts.³³ The DAO LLC's articles of organization and smart contracts are required to embed nearly all of the governing features and functions of the LLC (such as voting, transfers, withdrawals, and distributions) that would normally be included in an LLC's operating agreement.³⁴ Wyoming's law re-

21 Wyoming's cryptocurrency legal framework currently includes: (1) Wyoming Limited Liability Company Act, Wyo. Stat. Ann. sections 17-29-101 to 17-29-1105 (2021) (recognizing DAOs as limited liability companies and providing a clear legal framework for their formation and operation); (2) Wyoming Digital Assets and Blockchain Technology Act, Wyo. Stat. Ann. sections 40-27-101 to 40-27-109 (2021) (defining digital assets as property and providing a clear legal framework for their ownership and transfer, as well as the operation of DAOs); (3) Wyoming Uniform Electronic Transactions Act, Wyo. Stat. Ann. sections 40-12-101 to 40-12-120 (2021) (providing for the legal recognition and enforceability of electronic transactions and records, including those involving

DAOs). See 2/2/2023 ChatGPT query: "Provide a list of all Wyoming cryptocurrency laws, including code citations in bluebook format."

22 See W.S. 17-29 Et. Seq.; see also W.S. 17-31-102 and W.S. 17-31-103

23 See <https://news.bloombergtax.com/tax-management-memo/virtual-decentralized-entity-taxation-needs-real-development>.

24 See W.S. 34-29-106.

25 See W.S. 40-21-102(a)(ii).

26 See W.S. 17-31-102(a)(ix), providing that a "Smart Contract" might perform functions such as "taking custody of and transferring an asset, administering membership interest votes with respect to a decentralized autonomous organization or issuing executable in-

structions for these actions, based on the occurrence or nonoccurrence of specified conditions."

27 See W.S. 17-31-105(b), incorporating the requirements of W.S. 17-28-101 through 17-28-111.

28 Instead, Wyoming provided a rather circular definition of a DAO, providing that "decentralized autonomous organization" means a limited liability company organized under this chapter." See W.S. 17-31-102.

29 See W.S. 17-31-112.

30 See W.S. 17-31-115.

31 W.S. 17-31-104(c).

32 See W.S. 17-31-110.

33 W.S. 17-31-104(e).

34 See W.S. 17-31-106(c).

quires that a DAO's underlying smart contracts in which the algorithms are embedded must be capable of updates, modifications, and upgrades.³⁵ Further, the smart contracts used to manage, facilitate, or operate the decentralized autonomous organization are also required to be publicly identifiable in the DAO LLC's articles of organization.³⁶

If there is an update or change in the smart contracts, which are written in programming language (and may involve proprietary off-blockchain software objects and nodes), the DAO LLC must amend its articles to disclose the change in the smart contracts.³⁷ Disclosing these smart contract changes in a meaningful way, while protecting the public and the LLC members, could prove problematic. Wyoming might define and refine this requirement in further amendments to provide for publishing outlines of the smart contract syllogisms rather than leaving DAOs to wonder about the need to publish programming code.

Another instance where unanticipated consequences will arise with a Wyoming DAO LLC is the calculation of membership interests by contribution of digital assets,³⁸ as well as the default per capita membership assumptions if digital assets are not contributed.³⁹ In the founding and formation of many DAOs, as is often the case with service partners or shareholders in ordinary companies, equity (in this case digital assets) is often awarded for work contributions and participation. Ad-

ditionally, partners might contribute to a DAO non-digital property, such as intangible financial property, tangible personal property, or real property. Finally, airdrops of digital assets might also be made to DAO members for purposes of increasing membership in the DAO's growing community. Rather than focusing on contributions of digital property, Wyoming might consider that DAOs are viewed as environments to community (often artscapes at the time of writing),⁴⁰ and the statute instead counts DAO LLC membership by ownership, dominion, or control of the digital assets of the DAO.

A DAO LLC member must withdraw in accordance with the terms in the articles of organization, the smart contracts, or operating agreement, and a DAO LLC provides for full dissociation of a withdrawing member (without retention of governance or economic rights),⁴¹ and a withdrawing member may not have the organization dissolved for failure to return the member's contribution to capital.⁴²

As a forerunner statute dealing with a nascent technology, Wyoming was careful to provide for dissolution of a DAO LLC by expiration of a fixed duration, by vote of the majority of members, by occurrence of events specified in the underlying smart contracts, or by order of the Secretary of State. The plenary authority of Wyoming to dissolve a rogue DAO, while important to the state, may only push the DAO out of Wyoming's legal structure to continue running on servers

elsewhere in the quasi-stateless nexus environment known as cyberspace.⁴³

Wyoming, and the other jurisdictions that passed DAO LLC legislation based on LLCs, have received diverse criticism from blockchain technologists, who assert that the laws are based on broad misunderstanding of blockchain-based entities by requiring more disclosure from DAOs than standard LLCs, forcing DAOs to prematurely make difficult-to-change operational decisions, failing to resolve conflicts between operating agreements and smart contracts, and setting unrealistic default quorum requirements.⁴⁴

While the IRS has issued scarce guidance for the tax treatment of DAOs as entities, the DAOs restyled as LLCs, together with a couple of IRS rules and notices,⁴⁵ in addition to pending federal legislation before Congress, all point to an assumption that the partnership taxation regime will usually apply to DAOs by default.⁴⁶ The developing application of partnership tax laws to DAOs is likely to pose significant tax compliance challenges to the operation of many DAOs, and may further the uncertainty of DAO tax treatment (and the corresponding tax treatment of DAO members) due to the myriad of novel ways in which DAOs capitalize and function.⁴⁷ Put differently, the administration of DAO tax reporting under a pass-through taxation regime may be tantamount to putting new wine into old bags, and DAO tax compliance is already bursting at the seams.

³⁵ See W.S. 17-31-105(d).

³⁶ See W.S. 17-31-106(b).

³⁷ See W.S. 17-31-107.

³⁸ See W.S. 17-31-111(a)(i).

³⁹ See W.S. 17-31-111(a)(ii).

⁴⁰ Many DAOs will function to support communities, rather than seeking profits or carrying on trades or businesses. It is beyond the scope of this article to fully explore the uses

of DAOs for nonprofits and attendant uses, but as an example, see www.HoneyDAO.com as an Artscape DAO.

⁴¹ See W.S. 17-31-113.

⁴² See W.S. 17-31-113(b).

⁴³ See W.S. 17-31-114.

⁴⁴ See <https://thedefiant.io/starting-a-dao-in-the-usa-steer-clear-of-dao-legislation>.

⁴⁵ See Rev. Rul. 2019-24; see also IRS Notice 2014-21, 2014-16 IRB 938.

⁴⁶ See <https://news.bloombergtax.com/tax-management-memo/virtual-decentralized-entity-taxation-needs-real-development>.

⁴⁷ See <https://news.bloombergtax.com/tax-management-memo/virtual-decentralized-entity-taxation-needs-real-development>.

Due to the legion of governance issues and tax issues, the case is strong that crypto-native legal entities are needed for the embodiment of DAOs, and many technologists are calling for DAO-specific legal entity statutory regimes.

U.S.-Based DAO-Specific Entities

In 2023, U.S. DAO legislation took a turn toward DAO-specific entities when Utah and New Hampshire adopted DAO statutes based on a uniform law developed by the Coalition of Automated Legal Applications (“COALA”).⁴⁸

COALA developed the model DAO law by reviewing blockchain laws, including the laws of Malta, and published a model law,⁴⁹ including a paper suggesting from the outset that Wyoming could benefit from providing a separate legal personality and legal entity status for DAOs.⁵⁰ The COALA Model Law purports to “allow a DAO that has not registered as a for-profit corporate entity or a non-profit entity to benefit from “equivalent standing”

and limited liability as a domestic company or cooperative.”⁵¹

Helpfully, the COALA Model Law acknowledges that DAOs often engage in a mix of for-profit and non-commercial activities pertinent to taxation.⁵² This mix of activities is spelled-out in Article 1, titled “Nature,” which provides that a DAO “. . . can be used for commercial, mutualistic, social, environmental or political purposes . . .”⁵³ A review of the most prominent DAOs by market cap shows that many DAOs are being created for commercial purposes (as market-makers and intermediaries to facilitate blockchain transactions).⁵⁴ However, many other emerging DAOs are being created to support communities with varying interests (often digital art on the blockchain, usually sold as “non-fungible tokens”),⁵⁵ or to provide for diverse public benefits and interests.⁵⁶

The COALA Model Law contains provisions for DAO continuity in the event of reorganizations that are contentious disagreements (most

commonly known as “hard forks”) or cooperative updates (most commonly known as “soft forks”), in addition to reorganizations due to technical or programmatic failure events. “Hard forks” of a token occur when the “miners” or “stakers” disagree on the outcomes of transactions in the blockchain, and so some of the blockchain participants form a new ledger, separate from the old ledger.⁵⁷

Hard forks can be contrasted with soft forks, which are short-lived updates to the ledger’s programming, and sometimes cause temporary (even accidental) duplications of the ledger that are later integrated back into the primary distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger, and transactions involving the legacy cryptocurrency continue to be re-

48 See Lamb, Scott, “Utah Passes Innovative DAO Legislation” (3/3/2023), available at: <https://www.jdsupra.com/legalnews/utah-passes-innovative-dao-legislation-3845323/>.

49 See Constance Choi, Primavera De Filippi, Rick Dudley, Silke Noa Elrifai, Fatemeh Fanizadeh, Florence Guillaume, Andrea Leiter, Morshed Mannan, Greg McMullen, Sven Riva, Ori Shimony, “Model Law for Decentralized Autonomous Organizations (DAOs)” (2021). (Herein referred to as COALA Model Law for DAOs).

50 “Note that some jurisdictions have adopted a different approach than our Model Law by creating new types of registered DAO forms (e.g., Malta, Wyoming) rather than providing a legal framework where unregistered DAOs qualify as legal entities if they meet certain conditions such as those outlined in the Model Law. In our opinion these approaches are limited in that they do not properly leverage the technological and cross-border characteristics of blockchain technology.” See COALA Model Law for DAOs, footnote 7.

51 The COALA Model Law for DAOs, in drawing from the laws of Malta and Wyoming, attempts to bridge gaps in legal systems by reliance on concepts of equivalence

from the field of language translation. This is outlined in the COALA paper as “functional equivalence” (previously known as dynamic equivalence) and “regulatory equivalence.” In both instances, the equivalence eschews exact translation of laws, discards formal, word-for-word equivalence, and essentially aims to create a model law by broadening the application of known laws or regulated processes to DAOs with functional equivalence and broadening the end objects and purposes of regulatory processes in regulatory equivalence. See COALA Model Law for DAOs pp. 7-8; see also Nida, Eugene A., and Charles R. Taber, “The Theory and Practice of Translation, With Special Reference to Bible Translating” 200 (1969).

52 COALA Model Law for DAOs p. 10.

53 COALA Model Law for DAOs p. 10.

54 Uniswap, SushiSwap, and Curve are the three most prominent DAOs by market cap that function to facilitate transactions, trades, and market-making. See CoinGecko, DeFi Pulse, <https://defipulse.com/> (providing rankings of decentralized finance projects by market cap).

55 See FlamingoDAO, <https://www.flamingodao.xyz/>; see also Known-

Origin, <https://knownorigin.io/>; see also SuperRare, <https://superrare.co/>.

56 COALA Model Law for DAOs points out “Hutten-DDO” (formed to support collaborations between a group of Siemens employees, such as their charitable donations), “YangDAO” (formed to support decentralized content creation for former U.S. Presidential candidate Andrew Yang) and “OrochiDAO” (formed to coordinate around the creation of side events at blockchain conferences). See COALA Model Law for DAOs, footnote 9, p. 10.

57 The forking or bifurcation of a DAO’s network nodes can result in the emergence of the double spending problem, in which users cannot detect spending on the post-fork blockchain and spend the same tokens again on the pre-fork blockchain, resulting in potentially significant economic losses. See Wulf A. Kaal, “Decentralized Autonomous Organizations — Internal Governance and External Design,” Social Science Research Network (“SSRN”) at 29, 7/17/2020, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3652481.

corded on the legacy distributed ledger.”⁵⁸ The COALA Model Law further provides that following a hard fork, a DAO might “choose to split into multiple legal entities, each on a separate chain.”⁵⁹

The COALA Model Law provides that “during a Contentious Fork, there is an absence of an authority that makes a definitive choice of a chain and thus, there is a lack of an authoritative counterparty for a DAO.”⁶⁰ Forks occurring in a DAO holding property can be a particularly acute problem when dealing with off-chain assets and persons because the existence of a single, “authoritative counterparty” is routinely required to deal with the people, property, and governments in these instances.⁶¹

In the case of a “contentious fork,” resulting in potentially competing forks in the underlying blockchain,⁶² the COALA Model Law provides that “[by] default, the legal representation of the DAO remains on the majority chain and any off-chain Assets will belong to the DAO on the Majority Chain.”⁶³ However, a DAO might “choose” to maintain legal presence on the minority chain and keep the assets, or a DAO could split into multiple legal entities on separate chains and divide the assets between the majority and minority chains.

As noted earlier, the Wyoming DAO LLC Law determines membership by capital contribution, rather than by representation of per capita membership in the DAO.⁶⁴ The Wyoming Law is completely

silent on reorganizations, and in many instances, the capital contribution provision could leave it unclear which of the organizations resulting from a divisive hard fork is the majority. The COALA Model Law first provides that where it is not clear whether a resulting chain is the majority or minority chain following a “hard fork” reorganization, determination of the authoritative Majority Chain uses factors such as “hash power” in the case of a DAO that runs their ledger reconciliations based on computing “proof of work,” or the DAO with the greatest assets in a DAO utilizing a “proof of stake” ledger reconciliation system.⁶⁵ Next, the COALA Model Law provides majority status to the DAO with the greatest service providers, market capitalization, community recognition (per capita), or with the DAO that retains the name or trademark.⁶⁶ The multitude of ambiguities potentially resulting from each of these methods of determining a successor DAO (in both authority over assets and assumption of transferred liabilities) is beyond the scope of this brief discussion.

In both of the “hard fork” divisive reorganizations laid out in Article 16, the COALA Model Law suggests that the DAO must “express its intent” or “communicate” by “public signaling,” which “means a declaration authorized by way of Proposal of the DAO in a Public Forum.” However, the COALA Model Law definition for a “Proposal” is a “suggestion for actions . . . to be decided in accordance with the By-Laws of the

DAO.” Unfortunately, these reorganization provisions provide little in the way of certainty, as the DAO by-laws themselves may be at issue in the fork, leaving the DAO members to seek redress in court or with regulators.

In the case of a cooperative “upgrade, modification, or migration” to the “technological infrastructure of a DAO,” a cooperative “soft fork,” as opposed to a contentious hard fork, the COALA’s Model Law “requires that DAOs maintain certain minimum standards throughout updates and upgrades to the underlying blockchain programs to ensure that ‘restructurings’ do not subvert the standards and protections provided by this Model Law.”⁶⁷ COALA’s rationale in introducing cooperative reorganization standards was “to allow DAOs to continue to have legal personality and their members to retain limited liability as the DAO evolves.”⁶⁸ The cooperative reorganization (update and modification) provisions of the COALA Model Law for DAOs provide sparse guidance concerning soft forks, and are primarily focused on publishing the changes, “public signaling” to ensure compliance with notification requirements typical to any juridical entity.⁶⁹

DAOs have experienced a fitful start from the beginning, kicked off with the looting and pillaging of the world’s first DAO, a venture investment fund failure that was unfortunately named “THE DAO.”⁷⁰ The COALA Model Law describes such a “failure event” as an occurrence rendering a DAO “unoperational or

⁵⁸ See Rev. Rul. 2019-24, 2019-44 I.R.B. 1004.

⁵⁹ COALA Model Law for DAOs, Article 16(4), p. 44.

⁶⁰ COALA Model Law for DAOs, p. 42.

⁶¹ COALA Model Law for DAOs, Commentary to Article 16, p. 45.

⁶² Article 3(6) of the COALA Model Law for DAOs defines that a “Contentious Fork” in

the underlying blockchain “means a Hard Fork that results in two divergent and potentially competing blockchains.” See COALA Model Law for DAOs, p. 12.

⁶³ COALA Model Law for DAOs, Article 16(1), p. 44.

⁶⁴ See W.S. 17-31-111(a)(i).

⁶⁵ COALA Model Law for DAOs, Commentary to Article 16, p. 45.

⁶⁶ COALA Model Law for DAOs, Commentary to Article 16, p. 46.

⁶⁷ COALA Model Law for DAOs, p. 42.

⁶⁸ COALA Model Law for DAOs, p. 42.

⁶⁹ COALA Model Law for DAOs, p. 47.

⁷⁰ Shakow, David J., “The Tao of The DAO: Taxing an Entity that Lives on the Blockchain,” Tax Notes Volume 160, Number 7 (8/13/2018).

frustrating a DAO's expected operation."⁷¹ The COALA Model Law provides for continuity of legal personality and limited liability to DAOs under a failure event, but only to the extent necessary to protect DAO Members and Participants from personal liability.⁷² However, under the COALA Model Law, a failure event may trigger personal liability on the particular bad actors deploying the upgrade actions where they acted in manifest bad faith, or engaged in gross negligence.⁷³

Beyond providing an outline for DAO formation and governance as juridical entities, the COALA Model Law for DAOs specifically does not aim to "secure any special tax status" or address taxation.⁷⁴ While avoiding the topic of DAO taxation dodges the myriad of DAO types, DAO members, and the particular tax policies of the governing authorities to which a DAO might be subject, it is left to the imagination of the DAOs to navigate the disparate taxation regimes that a DAO might choose or to which DAOs may be subject by default.

Utah's DAO specific entity dared to tread into the realm of DAO taxation, where the first COALA model law had remained silent on the issue of taxation. Utah's current approach to DAO taxation was to codify the default taxation of Utah DAOs as partnership entities (but not trust or community funds or chest), and to provide for Utah DAOs to make an election to be taxed as a corporation.⁷⁵ While the author of this article conferred with

the drafters of the Utah DAO legislation, suggesting that it could be more flexible and beneficial to permit Utah DAOs to make all available tax elections under the U.S. check-the-box tax elections, Utah has determined to offer an attenuated use of DAO entities as LLCs or corporations until the state can determine how to harmonize the full range of federal entity tax elections with Utah's state entity taxation regime. This approach is understandable and prudent, as the taxation of a DAO as an S Corporation, Cooperative, or Mutual Company would pose many unanswered questions. However, it is plausible that the design of DAO governance algorithms could make governance and compliance under these entity tax regimes even more transparent and secure. Ultimately, U.S. jurisdictions restricting DAO-specific entities to partnership or corporate entity taxation will suppress some of the flexibility needed for a full flowering of DAOs.

Conclusion

As the forefront in the currently unfolding layer 4 and layer 5 applications for digital assets and blockchain technology, Decentralized Autonomous Organizations give legal personhood to a new species of human cooperative structures. The choice of entity selection depends largely on the purposes of the DAO, profit motives, and the tax and liability regime.

The legislation for DAO LLCs and legislation for DAO-specific

U.S. entities will ultimately need to address common law and statutory fiduciary concepts such as duty of loyalty, the business judgment rule, or any of the fiduciary duties in the Revised Uniform Partnership Act, the Restatement 3rd Agency, and the Model Business Corporation Act.

Now that the U.S. legal regime and jurisprudence applicable to digital assets is being clarified, and many states are adopting DAO-specific entity legislation, founders of recent DAOs are utilizing a spectrum of formalized entities as legal wrappers to embody DAOs with legal personhood.

By dressing up existing LLC statutes, some states allow the formation of DAOs with modifications to the incumbent limited liability company jurisprudence.

The developing application of partnership tax laws to DAOs is likely to pose significant tax compliance challenges to the operation of many DAOs, and may further the uncertainty of DAO tax treatment (and the corresponding tax treatment of DAO members).

In 2023, U.S. DAO legislation took a turn toward DAO-specific entities when Utah and New Hampshire adopted DAO statutes based on a uniform law developed by the Coalition of Automated Legal Applications ("COALA").

⁷¹ COALA Model Law for DAOs, p. 42.

⁷² COALA Model Law for DAOs, p. 42.

⁷³ COALA Model Law for DAOs, p. 48.

⁷⁴ COALA Model Law for DAOs p. 10.

⁷⁵ See Utah Code Annotated 45-5-406.