Digital Planning Podcast (Season 5, Episode 4): Exploring DAOs

Speakers: Justin Brown, Jen Zegel, and Ross Bruch

Ross Bruch:

Welcome to the Digital Planning Podcast, along with my co-hosts, Jen and Justin. I'm Ross, and today's topic is going to be DAOs, decentralized autonomous organizations. They're an emerging form of legal structure that have no central governing body and whose members share a common goal to act in the best interest of the entity. It's a new type of organization that we're seeing following the creation and use of blockchain. And we're going to dive in, explain what they are, how they operate, and some of the advantages and disadvantages of DAOs. With that introduction, Jen, can I hand it over to you? Can you explain a little bit more about how DAOs operate?

Jennifer Zegel:

Absolutely. I would love to. As Ross mentioned, DAOs are an alternative to the structure of traditional organizations. They are internet organizations with no central leadership, and they're collectively owned and managed by their members. And decisions are made via proposals the members vote upon during specified periods. Said another way, DAOs are governed by code and consensus using blockchain technology and smart contracts to enable trustless decision making amongst members, which can be located and populated throughout the globe. Smart contracts are lines of code that are programmed to automatically execute certain protocols when a specific set of criteria are met. Smart contracts essentially establish rules for how the DAO is going to operate, and the members of the DAO participate through the issuance of ownership tokens, which establishes their voting rights on the blockchain. Decisions can be made by a majority vote of stakeholders or require unanimous vote.

So, much like traditional organizations, the requirements for how unanimity or a majority is determined could vary based on the DAO. The intent behind these organizations is to operate transparently and efficiently and allow participants to have a direct say in the decision-making process through pre-established voting mechanisms without hierarchies. Based on a report from lifespan.io in April of this year, the DAO ecosystem collectively has an estimated value of $24.3 billion. We're starting to see a lot of use cases for DAOs that are being built on mainly the Ethereum blockchain.

Justin Brown:

Speaking of use cases, Jen, could you guys give a real world example of how a DAO would actually be used?

Ross Bruch:

Let me oversimplify this for a second and give an example of how we, collectively the three podcast hosts, might use a DAO. And then give a real world example, which is exactly what you asked for Justin, that we've seen implemented. In an imaginary world, let's say the three of us were going to buy a house. It's just three of us, so we can collectively make decisions together and we can vote and we can determine before we buy that house together, it's always going to be majority rules. That's going to work just fine with such a small group. Now let's say this was an investment property and we're going to expand it 100 fold. So, there's 300 of us and still we want the same rules to apply. What are we going to buy? How are we going to operate it? What decisions are we going to make in terms of capital improvements on that property?

If we want this to be a democratic and pro rata vote oriented purchase and operation and business, it's going to be really difficult to continue to get everyone's vote on every small issue that's created. So, we might instead, say we're going to have the Digital Planning Podcast coin, and everybody who wants to invest in this house is going to get what a pro rata distribution of votes based on how much they put into the pot. When a vote comes up, they can go on the blockchain, they can make decisions, we can understand everyone's vote is counted and you can see how the entire group votes. There's, there's a lot of benefits to that if we want to work in an organization like that, that doesn't necessarily have a hierarchy. It doesn't actually have just one person or one small group calling the shots.

Let's take that example into the real world. Back in 2021, a group of individuals formed what was called the Constitution DAO, and they set out with the goal to buy a private copy of the U.S. Constitution. One was coming up for auction at Sotheby's and they wanted to purchase this for ownership. One, to raise the money, they use this blockchain format to allow investors to also have a say in how that copy of the Constitution, if successfully purchased, would be held, would be managed, could be accessed, could eventually be sold or moved, how it would be displayed, and other decisions around things like security insurance and other administrative costs.

Together they raised over 47 million to purchase this copy. Eventually at auction, the copy went for $43.2 million. But unfortunately for that group, the Constitution DAO was not the ultimate winner of that auction. It went to another individual and you can say to yourself, well, they had 47 million. Why did they not succeed in this winning bid when it was only 43.2? And the answer is, the leaders of the DAO, or some individuals within the DAO realized that they did not have sufficient funds to cover those administrative costs, insurance, storage, security, and everything associated with the ownership of such a valuable copy of U.S. history. So, a couple problems were created. One, this DAO that was formed with a specific mission in mind failed on that mission, and then it became a question of what does the group do with the $47 million that's still in this entity?

Ultimately, it was decided to return the funds. And that creates another problem because whenever we're using blockchain technology to move funds from a fiat currency like the U.S. dollar to crypto, there are often fees associated with that. So, there have been reports of things such as, for me to make a $200 donation to the Constitution DAO, it would cost me additional $70 in fees. When the Constitution DAO tried to return those $200 to me, there was an additional $70 worth of fees, and that quickly erodes most of those funds that were in this entity. I'm getting a little bit off track here, but it's a good real-world example of how the intent can be there to find a democratized business organization. In this case, it was a nonprofit oriented organization, but that doesn't mean it can't be for-profit as well. There's also problems that could arise in such situations when a DAO doesn't meet its original mission statement.

A second attempt to purchase a copy of the Constitution was formed. The not so creatively named Constitution DAO 2 in 2022, which created... It only raised about $313,000 and like the original, failed to purchase a copy of the Constitution. That's one of many examples, but let me hand it back over to Jen for reactions, thoughts... What do you take away from that failed attempt?

Jennifer Zegel:

I think the Constitution DAO raised a lot of awareness in more mainstream channels about the potential use of DAOs for specific purposes. Like the Constitution DAO had a single purpose to acquire the rare Constitution and then manage its use, but there can also be DAOs that are created for more general business purposes. For instance, a DAO that is for-profit is Decentraland. Decentraland is an online virtual world that's governed by a DAO, and the platform token is called MANA, that's used to have governance rights over Decentraland. Decentraland has a lot of virtual properties that are able to be bought and purchased within Decentraland and other blockchain ecosystems for virtual properties and parcels. But it is pretty successful so far in that it is making a profit for its token holders.

A real-world example of another nonprofit DAO that is actually quite successful is the Ukraine DAO. This was established to help fundraising efforts to collect and distribute donations for those impacted by the war in Ukraine. Millions of dollars have been raised through this DAO. They also created a Ukrainian flag that was converted into an NFT that sold for millions of dollars. So, it has been a worthwhile effort for this Ukrainian DAO initiative to help those impacted by the war. I think that's a great use case of something successful. But there are a lot of issues with the operation of DAOs. To touch upon that, there's a lot of unique legal challenges and concerns on recognizing whether DAOs are legal organizations. Traditionally in the United States, the legal status of an organization is determined at the state level. And there's only two states that recognize DAOs from a legal standpoint, and that's in Wyoming and Tennessee.

Justin Brown:

I'm going to be the skeptic of the group today because I hear everything that you guys are saying. And the big question that I have is, why can't you just do this with a traditional business entity such as an LLC? If we want to create an entity where the governance is spread out among all of us, why can't we just structure our entity, our LLC, to do the exact type of governance that is in a DAO?

Jennifer Zegel:

I think what's unique about DAO is, and you can absolutely structure an LLC in different manners that would achieve similar results, but are you implementing blockchain technology? Because there can be private blockchains that have private DAOs, there can be public blockchains that have public DAOs, like the Constitution DAO, the Ukrainian DAO, Decentraland. Those are all on public blockchains. But there are definitely the capabilities of private organizations or even a consortium of private organizations coming together to form a privately owned and operated DAO. I think inherently with using blockchain technology, you are going to be able to have protocols memorialized and locked in place that are transparent that might not always occur in traditional corporate structures, forgetting all of the other concerns that we'll get into with DOAs.

Justin Brown:

But is having all of the rules locked in place, always the best thing? I think sometimes with having entities in place that have shareholder agreements or operating agreements or partnership agreements or whatever their governing documents are, they can be changed. They can be amended as the business changes or as the parties in the entity change. So, there might be great benefit to having the flexibility to change the entity over time.

Jennifer Zegel:

100%. I think a classic lawyer answer, it depends. It depends on what the intent is for the use of a DAO or for a general organization, purpose for a corporation, and a DAO may not be appropriate. I think there are so many issues with this technology in general that it could be cost prohibitive for a lot of businesses, might not efficiently carry out their purposes or missions, or could be done in another way. So, I think those are all completely valid considerations. But I also want to introduce what I likely see coming down the pike, which could be some type of hybrid DAO where you have a traditional structured corporation that's using a DAO for a specific purpose or forming a subsidiary for specific discreet tasks that would be operated by a DAO.

Ross Bruch:

Let me go back to your question, Justin, of the skepticism because I actually share quite a bit of it, especially on the for-profit entity discussion. Let's go the other way. Let's talk about nonprofits. And where I think there's some value to some individuals, some investors, some donors, is it could theoretically create, through that democratized structure, a better sense of trust of watching where dollars are going, feeling like you're participating in more of the decisions around where dollars are going. It's, I think, an avenue towards transparency for certain nonprofit organizations. If the three of us collectively formed a DAO and then found other investors, they could see our actions more clearly on the blockchain than they could if we were any other type of nonprofit that's obviously non-blockchain oriented because they're going to play a more participatory role in that.

Is that attractive to some? Apparently. As evidenced both by examples of the Constitution DAO or the numbers that Jen was giving before about the size of the current ecosystem, there's another DAO nonprofit called the Big Green DAO, which was created by Kimbal Musk, Elon Musk's brother, also in 2021. That was set up as a 501(c)(3) and the original founders donated funds into it, but others were allowed to participate as well. And in exchange for your financial participation, you were able to vote on where the dollars from that DAO were donated to. It's sort of like the modern day giving circle where you're having a little bit of say in where things are going.

To me, that makes sense on the nonprofit world. It might make sense on a B Corp where you have a social impact mission along with the for-profit that you as a donor or as an investor, I should say, want to have some input as to how the business operates. If it's a straightforward for-profit entity, that's where I struggle a little bit as well because, I think lack some economies of scale or some of just the streamlined nature that having a hierarchy, having one or a small set of people in charge who know the business, who know what the operations are and can make decisions quickly where that benefits not using a DAO. I'm yet to be won over on the for-profit world as well.

Jennifer Zegel:

Let's talk a little bit about some of the other concerns with using DAOs in our current climate. I mentioned the fact that most states in the United States don't officially recognize a DAO as a legal entity. So, not only can that have implications from a legal corporate structure perspective, but it also can have impacts and ramifications with taxes as well as general liability issues because in a lot of states, if an organization isn't recognized as a corporation, it could be defaulted to a general partnership. And then in most general partnerships, if there are issues or liabilities that can have ramifications personally for all of the general partners, which could have huge implications if things go wrong. The example that Ross gave with the Constitution DAO and what happened when they couldn't accomplish the mission of purchasing the Constitution from Sotheby's, there were an extreme amount of issues and I think lawsuits are still ongoing about recouping some of those funds. There also could be SEC issues with DAOs that are raising capital and that gets into a whole other world of challenges and potential compliance issues.

Justin Brown:

Okay. I'm still skeptical because now you're saying that if you don't do things properly or you establish yourself in a state that doesn't recognize DAOs, you could potentially have a general partnership, and now everybody in the DAO could potentially have some liability exposure. In addition, I've got SEC problems as a member of this DAO because I have no idea what the other people in my DAO or entities in my DAO are or are not doing or reporting to the SEC. So, how do I protect myself if I am part of this DAO and I've got all of these potential problems and liabilities potentially hanging out there?

Jennifer Zegel:

I'm not advocating for DAOs. I think generally it's a very interesting technology that's in its infant stages, and I think we're going to see a lot more development across the board, global regulation, state, federal regulation. We're going to see a lot more development in this area, so we're not in such murky waters. But I think anybody who is considering and contemplating creating or investing or being part of a DAO has to recognize that there's inherent risk in these types of activities first and foremost. Once they've realized and recognize those risks, if they still want to proceed forward, I would suggest that they're not investing anything that they couldn't otherwise lose.

It gets even more complicated and the issues become even more problematic because with blockchain technology in some ways, some of the investors in a DAO could remain anonymous. As I mentioned, Wyoming does recognize DAOs at a state level, but Wyoming also has gone a step further in that they will allow official stock ledgers that are maintained online in court record form to include numerical addresses for shareholders and not legal names or addresses, which is essentially allowing members through a DAO in Wyoming to hold this interest in some type of an anonymous fashion. I think that can pose a lot of risk if there are issues that come about as to how people can be held accountable,

Justin Brown:

If there is anonymity, then how is there liability for the members of the DAO? If the members of the DAO make some kind of decision, which is a poor or negligent decision and the DAO is sued later on, how are those anonymous members brought into a suit and held accountable for their decisions and actions?

Jennifer Zegel:

I think it can get very difficult and very expensive to try to prove identities later down the line. So, I don't have an answer for you except that this is just more of risk awareness that people need to be aware of if they're getting involved in these types of organizations. There also can be jurisdictionally different laws if you have members that are participating in other countries.

What would happen to lawsuits in that regard? And then you get into cross-border issues and things along those lines which further complicate and exacerbate the issues.

Justin Brown:

Do the DAOs have governing contracts like smart contracts or operating agreements in the form of a smart contract that would list the rights and obligations or restrictions on transferability of an individual's interest in a DAO?

Jennifer Zegel:

I'm sure some do, but there's no uniformity across the board here. And there's not really regulation that's requiring certain things like the jurisdiction that would be controlling if there are issues and also transferability if that's allowed at the outset or not. So, you're raising great questions and I think there can be varied answers depending on who's creating the DAO because there's no uniformity here.

Ross Bruch:

My takeaway from this conversation is the tokenization of investments could be a viable and useful tool. If I start a business and I want to raise money, putting SEC issues aside, putting issues aside of am I at all doing a different form of an IPO or ICO, an initial coin offering, can I raise money through the blockchain, through the use of smart contracts? Could both of you invest in Ross Co. and could I demonstrate that interest that each of you have, and could I display it on the blockchain so that you have an investment in a private entity that's not SEC regulated, that is still giving you transparency in what your investment is, what your ownership is. But I want to fall short of that, giving you voting rights. I want the fiduciary duty of somebody to be in charge and not have everything decided by majority rules in the smart contract format because I fear that there's not enough flexibility.

We're not going to think of all the business situations down the road. We're not going to know enough to make wise decisions as the group collectively as an individual who's at the helm of the business is going to. And that's where I, again, on the for-profit world, just see too many problems associated with this. But I remain pretty bullish on the nonprofit world using this because I don't think those same rules apply when we're just deciding where money goes and how to donate money collectively. The value of us working together, we can make a bigger impact on whatever we choose to donate to and thus we need a structure to guide us than I might be able to by myself. That's where I'm drawing the line of my both understanding of its usefulness and my desired application of where I think these will take off more in the future. I think it's a nonprofit or a business, a B Corp where it has a social angle to the investments getting the most value out of DAOs.

Justin Brown:

But I'm going to challenge you on that one, Ross, because on a nonprofit perspective, there's so much more that goes into running a nonprofit than simply making decisions about where the money is going to be distributed.

Ross Bruch:

Well, then simplify it and just assume it's a grant-making nonprofit rather than a operating business.

Justin Brown:

Okay, but there's still things that have to be done in the administration of that grant-making foundation. They still have to file tax returns. They still have to do their due diligence on who or what they are giving grants to. It's not as simple as just getting together and making a decision once a year of who are we giving money to.

Ross Bruch:

That's where we can introduce the concept of fiscal sponsorship arrangements in DAOs. Let's go back to the Constitution DAO for a second. Let's say that we were the ones who formed Constitution DAO. We could create the structure, we could create the bylaws, we could create the hierarchy of those questions and the democracy of voting. But at some point, if we're successful, we're actually going to have a physical copy of the Constitution. We're going to have to enlist the help of third parties at some point in time to actually have a bank account to actually deal with real world situations. The Constitution DAO wasn't going to take direct physical ownership of the Constitution.

They worked with what's called a fiscal sponsorship organization. It was a separate entity that is or was a 501(c)(3). The Constitution DAO was merely the voting structure around how those dollars flowed into, and then out of the fiscal sponsorship entity. They go side by side and work together. That's not always going to need to be the case. And in that case, the Constitution DAO didn't need to get 501(c)(3) approval because the other entity did. The DAO could have sought it itself and thus take on more of the challenges you're identifying there. But there are ways around it that you can outsource some of these elements that give you concern, but I think it's a valid point.

Justin Brown:

So, the Constitution DAO was designed to figure out how to spend the money. And then once they spent the money, it was going to a non-DAO organization where the people who were all members of the DAO no longer had any control whatsoever over the item that they just purchased?

Ross Bruch:

There would need to be a contract between the fiscal sponsorship organization and the DAO. And the fiscal sponsorship organization had to agree to the fact that we are just going to follow your orders.

Justin Brown:

So, it was a continuous vote whenever anything needed to be decided once they had possession of the Constitution.

Ross Bruch:

Once the fiscal sponsorship organization had physical ownership of the Constitution, yes.

Justin Brown:

Who is in charge of getting the bank account? Is that the fiscal organization or would that be the DAO?

Ross Bruch:

It could be structured either way. I don't know in the case of the Constitution DAO which one it was, but I'm going to guess it was the fiscal sponsorship or organization because anything that's not going to be something that's needed to be put up for a vote, I think that would be outsourced in the most efficient way possible. But then again, you could argue what bank are we going to use is something that we should vote on. You can get into the minutia of every single minor decision that needs to be made by a corporate entity, whether it be for-profit or nonprofit, then needs to be put up for a vote. And then it gets really arduous as to how much we're relying upon our token holders to vote on things.

Justin Brown:

That's where I was going, and my question was going to be who signs the checks? Do all of the token holders sign the check from the bank? Is the bank going to permit that or is the bank going to require one signatory on behalf of the entire DAO? And if the bank is requiring one signatory, you've just defeated the whole purpose of having a democratic organization to make decisions by committee.

Ross Bruch:

But if it's one individual from that fiscal sponsorship organization who can only sign with the direct instruction from the voting members of the DAO, it solves for that problem. It might make it much more difficult than it would be if the DAO didn't exist period. If the goal is to provide transparency and if the goal is to provide democracy in the ownership, there's a balance there because you're giving up some of the ease of administration that would otherwise be prevalent in a more streamlined organization.

Justin Brown:

If I put my estate planner's hat on for a second and look at DAOs from a planning perspective, do DAOs have value? If so, how do you determine what the value of an individual's interest in a DAO would be?

Jennifer Zegel:

Great question, Justin. I think the value of the interest in the DAO would likely have to be determined by valuation specialists familiar with this area. There are some appraisal companies that are familiar with valuing blockchain and cryptocurrency interests and NFTs that may be qualified to make such a determination. But the planner is going to have to vet appraisers in the community and find out who would be appropriate to undertake such valuation for either gift or inheritance or estate tax purposes. If the interest can be transferred, there could be situations where somebody may only have lifetime rights in an interest, so I think that's also going to vary per how the DAO is structured because that can change from DAO to DAO. But from a practical perspective, in theory, if an interest is able to be transferred and its value can be ascertained, these interests are through operations on a blockchain.

So, the private keys that the individual has are going to need to be able to be accessed, and that's where the planner's going to need to work with their clients on how that type of information can be securely stored and then retrieved. There's a lot of different schools of thought around that. We have gone into that in some past episodes where we've also taken a deeper dive into blockchain platforms, public, private, and hybrids in past episodes of the Digital Planning Podcast. So what the estate planner's going to need to counsel their client on how private keys can be stored and accessed to make sure that their loved ones can manage those assets as intended.

Justin Brown:

Jen, what I'm hearing you say is that the members of a DAO need to have a private key in order to exercise their vote, so to speak. Can you structure the DAO so that you would need maybe a majority of the decision makers or unanimity? I guess my concern becomes if you've created this structure that is dependent upon getting everybody's buy-in, but then people start losing their keys and their votes are now inaccessible, what mechanisms do you have in place to prevent that from happening or if it happens to combat that so that your DAO doesn't fall apart?

Jennifer Zegel:

I think a lot of that is going to depend on how the initial DAO is established and then how changes can be made once it is up and running. A lot of that could require a majority consent of vote holders to either rule back transactions or reissue ownership interests for defunct keys. I think that's also going to come down to how specific DAOs structure themselves. So, I think the answer can change. In a private DAO, there's going to be a lot more wiggle room to roll rollback transactions than in a public DAO.

Going back to accessing private keys, the planner's going to need to be familiar with how those keys are stored if they're in digital wallets and they're if they're in hard wallets, and that's going to be specific for each client. But this is such a nuanced area and the technology is ever-increasing that if a planner knows that their client has this type of interest, the plans are going to have to be reviewed, I think, more frequently as this technology can change and the legal landscape surrounding it may also change, which could impact planning and transfer rights.

Justin Brown:

I have one other question for you guys, which is if there's anonymity in a DAO and we want to create a DAO where everybody has a say in the organization and the running of the entity, how do we know that the other members of the DAO actually have the expertise that's necessary in order to make the decisions that they're going to be required to make through the DAO?

Jennifer Zegel:

I don't think we do, and that's part of the inherent risk.

Ross Bruch:

Think back to the recommendations we gave when we talked about NFTs. You only want to be involved in projects where someone has a proven track record where somebody has displayed that ability and that knowledge that's necessary not only pertaining to the blockchain, but also just to business organizations themselves. So, I think that trust is an important foundation of DAOs. People who are interested in DAOs are often looking for a greater form of trust of other actors in the project. But to that end, you also need somebody who has demonstrated that they are trustworthy to feel confident to be involved in the DAO to begin with.

Jennifer Zegel:

Just following up on that, Ross, and the concept of trust. A lot of people look at these types of alternative organizational structures as being trustless in that they don't need to trust the other participants. They just need to trust the code. And I think that's also a whole other host of issues that can come up because technology is inherently filled with coding issues and bugs and smart contracts naturally could have a lot of vulnerabilities. So, on top of all of these other risks and concerns is just a lot of technological potential issues and cybersecurity concerns.

Justin Brown:

This has been a great conversation with you guys. I really do appreciate you taking the time to explain everything to me and to all of our listeners. For Ross and for Jen, I'm Justin and I hope you enjoyed this episode of the Digital Planning Podcast and we'll see you again next time.