

Legal Wrappers and DAOs*

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Abstract

This white paper offers the first comprehensive overview and explanation of legal wrappers available to DAOs. It observes how the qualitative features of DAOs—including their dispersed and fluid memberships, and blockchain-based governance—are unanticipated by legal wrappers modeled after 20th century corporations, nonprofits and partnerships. It then surveys a diverse range of wrappers available to DAOs, and highlights how thoughtful legal engineering can help mitigate frictions that arise when attempting to wrap established legal forms around DAOs and DAO operations. To demonstrate, the white paper proceeds through a variety of fact scenarios spanning protocol, media, collector, social, and philanthropic DAOs to illustrate how wrappers might be employed to protect DAO participants from unlimited liability, optimize tax treatment, engage in contractual off-chain transactions, and enable compliance with key regulatory expectations.

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1 Introduction

Building a DAO involves more than just code; it also requires thoughtful legal engineering to enable the DAO to operate in the real world and protect builders and contributors. Yet the range and complexity of DAO legal structures can leave the best engineers (and their lawyers) dumbfounded. So below, we offer the first comprehensive overview of legal wrappers, and pair it with a framework for understanding how these legal elements interact with the purpose and operations of popular DAO applications.

Our focus is on clarity, and breadth. So in a twist, this white paper starts with the legal engineering first, by talking about the types of legal “wrappers” that are available for DAOs. The arc is a 360 overview, from the modern corporation to incorporated nonprofits and beyond. To provide context, the white paper explains how the issue of legal wrappers arises, and then, starting with the challenges presented by unincorporated DAOs, it reviews the basic for profit wrappers typically available to business associations like Delaware “C Corporations” and Limited Liability Companies, including recent attempts by state legislatures to address DAOs explicitly.

In a second step, the white paper turns to the often overlooked nonprofit wrappers available under state law, and the variety of options available to DAOs active in charitable, political and social activities. We also examine Unincorporated Nonprofit Associations (UNAs), Limited Cooperative Associations (LCAs) and international options like the Cayman Foundation Company and Guernsey Special Purpose Trust. Notably, we observe in virtually all cases, business and nonprofit, inherent frictions between organizational requirements for incorporation and the features of DAOs that make them novel—and the white paper offers insight into how in some cases thoughtful legal architectures may mitigate these challenges.

The white paper concludes with a variety of fact scenarios and hypotheticals to illustrate how legal wrappers might be employed with protocol, media, collector, social, and philanthropic DAOs.

Before jumping into the overview, two observations are in order. First, our points of emphasis

are on the essentials: formation, liability, structural flexibility, and some attention to tax treatment. We have very consciously left open, however, the critical question of fiduciary duty. We do so in part because fiduciary duty, perhaps more than anything else, is a matter of state law, and the ad hoc interpretation of judges when cases are brought to court. It also introduces novel questions beyond the scope of our research, like whether or not fiduciary duties can be satisfied by smart contracts—and, even more fundamentally, what automation means in the context of fiduciary duty, and for whom.

This in turn brings up our second caveat—that we seek to provide a helpful sense of legal wrappers available to DAOs, and not a prescriptive judgment as to what DAO law itself should look like. It looms, however, in the backdrop. Modern corporate law is premised on the “separation of ownership and control”—that is, the dominion of managers, not stockholders, in the operations of the firm.¹ DAOs offer a radically different template for organizational behavior, one where ownership and participation (and the prospect of control) are tethered, if not mutually dependent. If corporate law’s purpose is to modulate the principal-agent problems inherent to the corporation, the purpose of “DAO law” *should* be something different. We predict that the choice of legal wrapper is but the beginning of a longer journey ahead as questions of DAO law are untangled by founders, their counsel, legislatures, and courts.

2 What’s a Legal Wrapper?

One of the more interesting aspects of Web3 is the way in which blockchain-based technology enables individuals to organize themselves in novel arrangements that potentially make problem solving more creative, efficient and communitarian. Inspired by open-source collaboration systems, DAOs are a case in point. They connect people with shared economic or social missions by leveraging blockchain protocols and tools. Often lacking formal systems associated with the modern business entities, DAOs utilize smart contracts to automate decisions and to govern members’ relationship to each other. In their most canonical incarnations, DAOs operate without any formal legal recognition, eschewing dependence on governmental authority for their existence, and resisting the rigidity imposed on them by

¹ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, Harcourt, Brace & World (1932).
Electronic copy available at: <https://ssrn.com/abstract=4123737>

regulations.² The result: pseudonymous, distributed, and ad hoc organizational structures.³

Yet for all the innovation enabled by DAOs, in the real world coordination and commerce invariably run on top of the rails of “legal personhood.” In order to easily engage with service providers like bankers, lawyers and consultants, as well as be able to pay taxes, DAOs need a legal wrapper endowing them with a legal identity. Furthermore, a formal legal wrapper is often required in order to limit legal risks to members, and protect them from the liabilities or damages caused by the DAO or other members.⁴

Deciding which wrapper to employ for any particular activity, or for any set of activities, involves keen legal engineering alongside thoughtful business strategy and operations. Different DAO wrappers impose varying degrees of centralization and other regulatory requirements that can cause friction with the way many DAOs seek to operate. This is in part because DAOs possess novel qualities not available to traditional business associations and firms. Among them, membership in DAOs is often transitory and tied to ownership of a freely-tradable token; governance is intended to be decentralized and in the hands of all members; and operations are often conducted via smart contract code.

DAOs adopting legal wrappers should also ensure that the legal entities they create properly protect the intended members, activities and assets.⁵ Tax and regulatory requirements should be observed. And founders should operate in ways that preserve the integrity of the legal entities they are creating—from respecting corporate formalities to avoiding commingling founders’ personal assets with that of the DAO—in order to avoid the risk that a court disregards the wrapper and “pierces the corporate veil.”⁶

² See Gabriel Shapiro, *Wyoming’s Legal DAO-Saster*, (Apr. 9, 2021) <https://lexnode.substack.com/p/wyomings-legal-dao-saster?s=r> (“True DAOs are not meant to be existentially dependent on a state charter or limited to compliance with a particular parochial set of laws”).

³ Aaron Wright, *The Rise of Decentralized Autonomous Organizations: Opportunities and Challenges*, 4 Stanf. J. Blockchain L. & Pol’y 152 (2021) available at <https://stanford-jblp.pubpub.org/pub/rise-of-daos/release/1>.

⁴ *Id.* at 155.

⁵ DAOs can form legal entities to embody certain of their operations or hold certain of their assets, but careful analysis should be done to delineate what is encompassed by the legal entity (i.e., what is the legal entity “wrapping”), because the DAOs’ membership, activities and assets may not always be coextensive with the legal entity. For example, the fact that certain DAO members have formed a legal entity, potentially even having those plans approved by a vote of the DAO tokenholders, does not necessarily make every token holder a member of the entity, nor does it necessarily insulate DAO members from activities that arise outside of the context of that entity.

⁶ US Courts may disregard the limited liability protections offered by entities in the event they find the entities to be undercapitalized, or a lack of “corporate formalities”, potentially resulting in direct liability for the principals involved (this is known as “veil piercing”). In addition, regulators and US Courts may impose “control person liability” or disregard the legal personhood of entities that are directly controlled by principals, potentially resulting in direct liability for the principals involved. See, e.g., Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991), available at: <http://scholarship.law.cornell.edu/clr/vol76/iss5/2>.

Finally, it is helpful to keep in mind that legal and operational timelines can vary considerably. In many instances, DAOs develop organically before their legal wrappers. DAOs can begin with a catalyst organizing a small community with a particular mission or goal. At the beginning stages, members coalesce around communication platforms like Discord and Telegram. As the DAO grows, members may, but certainly not always, choose to launch a token and potentially raise capital for the DAO's treasury by having members contribute assets. DAOs commonly also leverage blockchain technology to implement governance over the DAO, a process that can involve using any number of open-source tools⁷ and dapps that have preset and customizable organizational structures or protocols. DAOs operating in this model tend to start small, and legal wrappers are often only considered as DAOs scale—or after they run into trouble due to a hack or operational problems that create liability.

In other instances, DAOs are launched with the intention of decentralizing mature projects that have developed enterprise grade protocols. In this context, founders may start by creating an entity through which they receive outside investment which they use to hire and pay for the development of a particular protocol. This entity will issue investors equity in a development company or “DevCo” as well as the right to receive a portion of future tokens the DevCo or an affiliate may create. Once the DevCo has developed a functioning version of the protocol, it can deploy it on-chain and issue tokens to its employees and investors, as well as set aside a portion of the token supply to be distributed to the “community,” including through vehicles like foundations and trusts, with the ultimate goal being incentivizing future contributions to the protocol and turning over its governance to the token holders.

Comparing the two tracks, you'll notice that there is a range of different activities and entities that can be “wrapped” in the formation and operation of a DAO, a point we will return to below. In some instances, nonprofit structures may be wrapped and bundled together with de minimis for-profit activities. In others, fundraising entities may take one wrapper, while token issuers, or member collectives, another.

⁷ Popular open source DAO governance protocols include Compound, Aave, Nouns (fork of Compound) and MolochDAO.
Electronic copy available at: <https://ssrn.com/abstract=4123737>

3 The Spectrum of Legal Wrappers

DAO members have experimented with a wide range of legal wrappers, and the design space for DAO legal structuring remains broad. As a basis of orientation, we'll start with analyzing the default status of DAOs that do not take any action to form a legal entity, and then jump to the most well-known wrappers, the Delaware corporation and Delaware LLC. We will then explore some less well known entities such as DAO LLCs and non-profit wrappers ranging from foundations and charities to unincorporated non-profit associations and cooperatives, and end with two international options. We will place special emphasis on governance, and how DAO operations must be engineered in order to fit decentralized communities into a formal legal structure.

Unincorporated DAOs

Many DAOs choose to launch and operate without any legal wrapper. Doing so is *not* inherently violative of the law, but it does create important practical and potential legal consequences for participants in the DAO—and those more active and instrumental in its operations.

From a practical perspective, the absence of a formal legal identity can create any number of challenges for DAOs when interacting with the off-chain world. Hiring employees, contracting with services providers, opening bank accounts and paying taxes all become significantly more difficult, and in some instances impossible, without a formal legal identity.⁸

There is also the risk that in the face of legal action an unincorporated DAO with a profit motive could be deemed by a court to comprise an “unincorporated general partnership,”⁹

⁸ In particular, calculating how much tax is due, and by whom, is extremely complicated for an unincorporated DAO.

⁹ See *Sarcuni et al v. bZx DAO et al.* (S. D. Cal., May 2, 2022) (plaintiffs alleging that bZx DAO, its co-founders and its members are jointly and severally liable for negligence for failing to secure a protocol that fell victim to a \$55 million hack). See, e.g., under Section 202(a) of the Revised Partnership Act (“RUPA”) “the association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not the persons intend to form a partnership.”; OpenLaw, *The Era of Legally Compliant DAOs*, <https://medium.com/@OpenLawOfficial/the-era-of-legally-compliant-daos-491edf88fed0>, Medium (last visited May 25, 2022), “[T]he U.S. legal system must clarify the legal status of these organizations and as such should classify the DAO as a general partnership.”; Laila Metjahic, *Deconstructing the DAO: The Need For Legal Recognition and the Application of Securities Laws to Decentralized Organizations*, 39 Cardozo L. Rev. 1533, 1536 (2018). “[A] DAO’s decision to not create a legal entity does not offer protection from responsibilities that may arise in the operation of a DAO. From a legal perspective, when two or more individuals are engaged in even a tenuous business relationship, the imputed structure is that of a general partnership.”; David Kerr & Miles Jennings, *A Legal Framework for Decentralized Autonomous Organizations v2*, A16Z White Paper (Oct. 6, 2021) (“A Legal Framework for DAOs”), <https://bit.ly/3jYfiL1>. (“[E]xisting corporate law dictates that what the members of [a] DAO have formed is a general partnership.”); Dave Rodman, *DAOs: A Legal Analysis*, JD Supra (Apr.

potentially rendering DAO members liable for any debts or legal actions that the DAO may face. Notably, while legal commentators have highlighted the risk of DAOs being deemed unincorporated general partnerships dating back to the hack of The DAO, to date no US court has made this finding.¹⁰ There are also important unresolved questions about this theory, including whether each DAO member would be deemed to be a general partner just by virtue of being a token holder, or whether more formal involvement by DAO token holders is required to be liable as a general partner (for example, participating in governance). However, in a worst case scenario, a DAO member could be responsible for all of the liabilities facing a DAO.

In addition, the application of securities and partnership laws to DAOs reveal limits to the current regulatory regime. US courts have long held that interests in a general partnership do not comprise securities where general partners retain enough control and have enough expertise that they are not dependent on the efforts of a particular party.¹¹ However, the SEC has argued that DAO tokens are in fact securities when token holders do not have effective voting rights or are dependent on a particular sponsor or an “active participant.”¹² The potential for the DAO interest to avoid classification as securities has reinforced some DAOs’ desire for a fully decentralized governance structure akin to a general partnership. In this sense, DAOs will struggle with finding a structure that does not either (i) risk the potential unlimited liability of general partnerships, or (ii) risk that the DAO interests are deemed securities.

The Corporation

Perhaps the most familiar legal structure for any business organization is the corporation— an independent legal entity that is owned by shareholders, but managed by a set of officers and Board of Directors, to which the shareholders delegate power.¹³ As a result of this “separation of ownership and control,” shareholders are typically afforded limited liability for the actions of the corporation and its employees; their economic risk is limited to the value of their

1, 2021) <https://bit.ly/3jYjnZI>.

¹⁰ A recent case filed in the US District Court for the Southern District of California is the first to allege that a DAO is operating as an unincorporated partnership. See *Sarcuni et al v. bZx DAO et al.* (S. D. Cal., May 2, 2022).

¹¹ *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981).

¹² Defined by the SEC as “a promoter, sponsor, or other third party (or affiliated group of third parties)” SEC, FRAMEWORK FOR “INVESTMENT CONTRACT” ANALYSIS OF DIGITAL ASSETS (2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref9 [<https://perma.cc/3G6P-GG85>].

¹³ See, e.g., DGCL §141(a) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors....”)

shares.¹⁴ Importantly, the directors of a corporation are subject to fiduciary duties, including a duty of loyalty and a duty of care towards the shareholders, which constrain self-serving behavior and subject them to potential liability.¹⁵

In the US, corporations are created and governed by state law, and legislators in each state lay out specific steps that need to be taken to create one. Forming a corporation can be very quick and most of the documentation has been standardized and is publicly available.¹⁶

Incorporation also allows sponsors to deduct business expenses, spread out tax losses, and more. Most corporations elect the IRS designation of “C Corp.”¹⁷ As such, the corporation pays taxes on business income—as do shareholders, who are taxed on dividends they receive. Though this results in “double taxation,” founders enjoy certain tax benefits. Salaries earned by operators of the corporation can, for example, be deducted from any tax obligations. Furthermore, because a C Corp. comprises a separate taxable entity from shareholders, owners are not automatically taxed on a personal basis from the (post tax) profits of the company. Corporations can thus accumulate earnings without the shareholders being taxed.

Still, few DAOs organize themselves as corporations. Organizationally, corporate structures require institutions like boards of directors and centralized management that do not accommodate fully decentralized environments built on trustless, much less pseudonymous, infrastructure.¹⁸ For some founders, such formality defeats the point of DAOs, which generally aspire to be non-hierarchical, employ “direct democracy” governance where participants are also decision makers, and have fluid membership bases.¹⁹

DAOs have, however, employed corporate wrappers for discrete parts of their overall legal structure. For example, DAOs often have “sub-DAOs,” or groups focused on specific projects,

¹⁴ Berle and Means *supra* note 1.

¹⁵ Emerald Partners v. Berlin, Del.Supr., 726 A.2d 1215, 1221 (1999); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d at 1162–63; In re Tri-Star Pictures, Inc., Litig., Del.Supr., 634 A.2d 319, 333 (1993).

¹⁶ See, e.g., *Incorporation Package (Delaware)*, CooleyGo, <https://www.cooleygo.com/documents/incorporation-package/> (last visited May 26, 2022).

¹⁷ Corporations can also in theory elect treatment for IRS purposes as an “S Corp.,” in which no taxes are paid at the corporate level—but because S Corps must stay under 100 shareholders, and are prohibited from having non-U.S. owners they are unworkable for most DAOs.

¹⁸ For companies incorporating in Delaware, the only required officers are the President and the Secretary. See Brett Melson, What is the Role of Officers in a Delaware Corporation, Harvard Business Services, Inc. (Mar. 15, 2022) <https://www.delawareinc.com/blog/what-is-the-role-of-officers-in-a-delaware-corporation/>.

¹⁹ Section 12(g) of the Securities Act requires companies to register if they have more than 2,000 shareholder and meet certain other requirements. 17 CFR § 240.12g-1 available at <https://www.law.cornell.edu/cfr/text/17/240.12g-1>.

which could benefit from setting up a corporation separate from the broader DAO. In addition, some DAOs employ corporate affiliates for fundraising, whereas others have formed corporate subsidiaries to mitigate tax obligations or other liability risks associated with certain activities, such as a token issuance or sale.

There is also a growing range of strategies envisioned to reduce the friction and centralization inherent in a corporation's governance structure. For example, a corporation could revise its charter and bylaws to provide that, to the extent possible under law, the results of the DAOs smart contract protocol are determinative of the rights and obligations of the shareholders.²⁰ But the constraints would be significant. Corporate law gives directors control of the entity, and subjects them to fiduciary duties requiring them to act in the best interest of the shareholder. It would therefore not be possible (at least in the US) to amend a corporation's constitutive documents to strip authority entirely away from directors and give it to the DAO members. Attempting to thread this needle, corporations could establish an advisory committee that is directed by DAO members which presents non-binding recommendations to the board.

Limited Liability Company

LLCs are legal wrappers that offer the same liability shield available to corporations—while providing the flexibility and tax benefits associated with partnerships. As corporations do with their shareholders, LLCs shield their owners (called “members”) from personal responsibility for the debts or liabilities of the LLC or other members. If the business gets tangled in legal troubles or is sued by a debt collector or employee, the plaintiff or creditor can only go after the business's assets, not the personal assets of the LLC members.

LLCs also avoid double taxation inherent with C corps where both the corporation and shareholders are taxed; instead, LLCs are treated like partnerships by default, with tax liability passing through the business to the LLC members themselves, who report their share of profits—or losses—on their personal tax returns.²¹ However, pursuant to IRS rules, LLC members may have to pay a self-employment tax.²²

²⁰ *Simple Code Deference Agreement*, LexDAO, <https://github.com/lex-node/SCoDA-Simple-Code-Deference-Agreement/blob/master/DAO%20Charter%20with%20Qualified%20Code%20Deference.md> (last visited May 26, 2022).

²¹ *What is a Limited Liability Company (LLC)?*, Nolo, <https://www.nolo.com/legal-encyclopedia/what-is-a-limited-liability-company.html> (last visited May 26, 2022).

²² The self-employment tax, which includes a 12.4% tax for Social Security and a 2.9% tax for Medicare. *Self Employment Tax (Social Security and Medicare)*, Electronic copy available at: <https://ssrn.com/abstract=4123737>

What makes LLCs particularly interesting for DAOs, however, is that they are well suited, and in many ways built, for decentralized governance.²³ In contrast to corporations, which require boards of directors and centralized management that are afforded discretion to make the day-to-day operational decision of the company, LLCs can be run by a board of directors like a corporation (a “manager managed LLC”) or they can enable all owners of the business to participate equally in the management (a “member managed LLC”).²⁴ LLCs also allow their members to waive fiduciary duties to each other and to the company.²⁵ These features collectively provide flexibility for arranging decisionmaking in ways that are “flatter” and more decentralized, and in many ways better approximating DAO infrastructures than the traditional corporation.

Yet the LLC structure—born of the early 1990s and the early days of the web—still poses significant challenges for blockchain-based DAOs with fluid, constantly changing participants who seek to remain pseudonymous. Generally speaking, adding new members to LLCs requires amending the LLC's operating agreement in order to make it possible to bring in the new member. Transferring membership interests can also be restricted, and in some states amendments to operating agreements are necessary to reflect new members in an LLC. There are also some inevitable points of centralization for LLCs, such as the required tax representative.

DAO LLCs

As is the case with corporate law rules and regulations, most state LLC statutes do not specifically permit blockchain-based business organizations or reference how and whether smart contracts can act as substitutes for traditional governance mechanisms like voting. This has led to some debate as to whether LLC statutes are permissive enough to enable DAOs to form as LLCs.²⁶ Some states have taken steps to try to fill in the gaps.

Security and Medicare Taxes), Internal Revenue Service, <https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes> (last visited May 26, 2022).

²³ See Daniel Kleinberger, *Examples & Explanations for Agency, Partnerships, and LLCs* (5th Ed. 2017) at §15.1.1 (“With regard to internal structure, the LLC is ‘almost ineffably flexible.’”)

²⁴ While flexible, LLC statutes do force some centralization in the governance structure of a DAO, such as by requiring a person to serve as the tax representative of the entity. See *id.* at §15.3.1 (“Regardless of which LLC statute applies, member management is inherently decentralized. The members as a group hold the right to manage the business; the statute prescribes that, when management decisions are to be made, the members act collectively.”)

²⁵ See, e.g., Section 18-1101(e) of the Delaware LLC Act.

²⁶ See Shapiro *Supra* note 2 “For example, a major pain point for Moloch-based DAOs is that members of the LLC who receive distributions
Electronic copy available at: <https://ssrn.com/abstract=4123737>

Wyoming, the most prominent example, has passed an amendment to its LLC statute explicitly permitting the formation of DAO LLCs. Under Wyoming's law, DAOs LLCs can be "algorithmically managed" (which is notably undefined in the statute) and defer many functions to its smart contract, and have its results prevail if it is ever in conflict with its articles of organization.²⁷ In addition, the Wyoming law waives LLC members' fiduciary duties to each other and the DAO by default, providing for a more permissive governance structure than corporations.

A DAO LLC is formed very similarly to a traditional LLC by filing a certificate of formation with the Wyoming secretary of state. However, Wyoming's DAO LLC law also includes some additional rules. Notably, a DAO LLC cannot be manager-managed, which can limit certain DAOs that wish to delegate some authority to a core group. In addition, a DAO LLC's articles of organization must specifically include the words DAO, DAO LLC or LAO (for "Limited Autonomous Organization") in the name, along with a publicly available identifier of any smart contract directly used to manage, facilitate, or operate the DAO, a requirement not imposed where DAOs incorporate as ordinary LLCs.²⁸

A Wyoming DAO LLC must also have in its articles of incorporation the following disclosure:

"The rights of members in a decentralized autonomous organization may differ materially from the rights of members in other limited liability companies. The Wyoming Decentralized Autonomous Organization Supplement, underlying smart contracts, articles of organization and operating agreement, if applicable, of a decentralized autonomous organization 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"

Finally, the DAO's articles of organization must also be amended whenever a change to the smart contract arises, if the DAOs name changes, or if there is an error that needs to be—or has been—fixed.

that impair the capital of the LLC to the detriment of the LLC's creditors may face personal liability to the creditors, breaking the limited liability veil for which the entity has been established in the first place."

²⁷ Wy. Stat. § 17-31-101 through 17-31-115 available at <https://www.wyoleg.gov/Legislation/2021/SF0038>.

²⁸ This has been argued to create potential privacy issues. See, e.g., Shapiro *Supra* note 2.

Nonprofit Wrappers

Some legal wrappers like LLCs that had traditionally focused on business purposes, can have broader social missions. The Delaware public benefit corporation, for example, allows for-profit corporations to prioritize producing a public benefit or public benefits and requires managers and directors to consider the public benefit in all decision-making without running afoul of traditional fiduciary constraints. But even more important for many organizations is a large spectrum of legal wrappers that cater exclusively to nonprofit activities. As such, they provide not only liability protection, but also offer the prospect of tax exempt status for donations they receive and even, in some circumstances, the ability for donors to deduct their donations from their federal and state income tax returns.²⁹ Below we provide an overview of options potentially available to DAOs.

Private Foundations and Public Charities

The most visible and familiar nonprofit wrappers are nonprofit private foundations and public charities. Their creation involves three steps: 1) the incorporation of a nonprofit entity under state law; 2) a specific election under the IRS code for tax treatment as a 501(c)(3) organization, and 3) an election as to which of the two classifications (private foundation or public charity) the DAO will adopt.

The first step in many ways resembles the state incorporation process detailed above.³⁰ As with corporations, nonprofits must select board members and officers. Additionally, they must file articles of incorporation, which should include a purpose accepted by the IRS for favorable tax treatment. A nonprofit also has to articulate how its assets will be disposed of in the event that it is shut down. As with corporate wrappers, incorporation as a nonprofit enables an organization to operate while enjoying the protections of limited liability.

The second part of the process includes filing an application necessary for a nonprofit to become 501(c)(3) tax-exempt. Here the nonprofit must demonstrate to the IRS that the reason

²⁹ *Top Five Reasons to Incorporate a Nonprofit Organization*, FindLaw, <https://www.findlaw.com/smallbusiness/incorporation-and-legal-structures/top-five-reasons-to-incorporate-a-non-profit-organization.html>, (last visited May 26, 2022).

³⁰ Audrey K. Chisholm, *Start a 501c3 Nonprofit that Doesn't Ruin Your Life*, (2018) at 49.

for which it has been established is one of a list of exempt purposes that qualify for 501(c)(3) treatment. For most DAOs, this means that they must usually show that they have been established for either charitable, educational, or scientific purpose.³¹ A nonprofit must also pass an operational test demonstrating that most of its activities are related to furthering the exempt purpose. If more than an insubstantial amount of its activities is not related to accomplishing the exempt purpose for which the organization was created, the DAO will fail the operational test.

After the organizational and operational hurdles are met, founders will then have to decide just what kind of nonprofit it will be: a 501(c)(3) public charity, or a 501(c)(3) private foundation.

A nonprofit seeking treatment from the IRS as a public charity must show that it is supported by the general public. Most do so by demonstrating that at least one third of the support they receive is from the public. For legal purposes, this can be shown by demonstrating that the total amount of public support received, divided by their total support—which could come from investment or other activities—is at least 33%, with no donor used to calculate this percentage giving 2% or more to the nonprofit's total income.³²

In contrast to public charities, private foundations are generally created by a single benefactor like an individual or business and thus are not subject to the public support test. However, they must distribute 5 percent of the value of their non-charitable assets, including stocks bonds, interest-bearing notes, endowment funds and leased real estate.³³

The Political Nonprofit

Nonprofit entities organized as 501(c)(3) organizations are highly constrained in their political activities, with public charities and private foundations subject to different limitations and rules.

³¹ The term charitable is a capacious one, and understood to include the advancement of education and science, along with other prosocial activities like caring for the underserved and the poor. As such, the 501(c)(3) requirements have an overlapping, albeit distinct quality, and DAOs in principle could cite more than one when both creating their nonprofit and petitioning the IRS.

³² A nonprofit has five years upon initially filing to collect data to pass this test, assuming that it has no such financial data when initially applying to the IRS for 501(c)(3) status. Erik Estrada, *Understanding Nonprofit Law and Finance: Forty-Eight Key Principles for Philanthropic Leaders*, Rowman & Littlefield Publishers, (2019) at 39.

³³ If they do not, they become subject to an excise tax on undistributed income. *Id* at 44.

The extent to which a public charity is permitted to lobby is determined by the “substantial part” test. According to the IRS Code, “no substantial part of the activities of the organization is carrying on propaganda, or otherwise attempting, to influence legislation.” Generally, the more spent on an exempt purpose (say education), the more a charity has to spend on lobbying. Still, the substantial factor test can be ambiguous, and applied differently depending on the metrics one uses. To provide clarity, there is a 501(h) election offering a safe harbor allowing entities to avoid the substantial part test and rely on an IRS formula to calculate permissive lobbying expenditures.

Private foundations are altogether barred from lobbying unless they are engaged in “self defense” lobbying. That is, they are permitted to lobby government officials if there is a piece of legislation or a regulatory matter that directly attacks one of the purposes for which the private foundation operates.

Not all nonprofits enjoying favorable tax treatment are, however, limited in their lobbying. Nonprofits that qualify for exemption under 501(c)(4) of the IRS code, called “social welfare organizations,” may engage in an unlimited amount of lobbying so long as such lobbying activities are related to its exempt purpose. To qualify as a 501(c)(4), the primary purpose of the nonprofit must be to further the common good and general welfare. This means that they must work for the benefit of more than just their members. Notably, in contrast to 501(c)(3) organizations, charitable donations to 501(c)(4) are not considered tax-deductible, even as the organizations are exempt from income taxes.

Social Clubs

Another nonprofit wrapper of potential utility for purely recreational DAOs is the social club exemption associated with Section 501(c)(7) of the IRS Code. This exemption from federal income tax allows people who have mutual interests to come together and socialize. Most social clubs are funded by dues paid by members, and no more than 35 percent of the club’s revenues can come from sources outside of its membership without risking its tax-exempt status.³⁴ In contrast to social welfare organizations, social clubs must primarily benefit their members and not the general public.

³⁴ Venable, *Requirements for Tax-Exempt Status under IRC § 501(c)(7): A Primer for Social Clubs*, (June 2008) <https://www.venable.com/insights/publications/2008/06/requirements-for-tax-exempt-status-under-irc-501c7> (last visited May 26, 2022).
Electronic copy available at: <https://ssrn.com/abstract=4123737>

As with other nonprofits, a social club must file organizational documents with the state in which it seeks to incorporate. To satisfy later IRS review, filed documents normally include a nondiscrimination clause, a stated prohibition against self-dealing and conflicts of interest, and a purpose clause indicating how the club is formed for an exempt purpose like networking, social opportunities. A social club's governing document cannot authorize the club to engage in activities beyond the scope of § 501(c)(7).³⁵

The social club exemption is based on the principle that when people band together for their mutual enjoyment, they should not be liable for income tax. It has thus been employed in a number of contexts where organizations run clubhouses, golf courses and swimming pools for members. Because, however, social clubs are not charitable, but are instead focused on members, donors and dues payers do not receive a tax deduction.³⁶

Unincorporated Nonprofit Association

An Unincorporated Nonprofit Association (“UNA”) is an organization that is, in some ways, the non-profit equivalent of an unincorporated general partnership but in certain states can provide limited liability for its members and other benefits.

Like unincorporated general partnerships, UNAs are typically not required to make any state filing in order to form, and can arise from an oral agreement between participants. While rules vary across states, an UNA is instead usually formed when two or more persons agree orally or in writing to work together for a nonprofit goal.³⁷ And even if only arising orally, UNAs still, at least in certain states, provide a separate legal identity and limited liability for their members. UNAs thus potentially offer a more flexible framework to accommodate a DAO’s

³⁵ *Id.*

³⁶ Heather Karellas, *Ultimate Guide to Start a 501(c)7 Social Club Organization*, Donorbox Blog (May 18, 2022), <https://donorbox.org/nonprofit-blog/start-a-501c7>.

³⁷ See National Conference of Commissioners on Uniform State Laws, Uniform Unincorporated Nonprofit Association Act (2008/2011), available at <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=4e8cc4f9-7441-4fa8-9f24-ecfe883b64d8&forceDialog=0> (“RUUNA”) (defining UNA as “an unincorporated organization, consisting of [two] or more members joined by mutual consent pursuant to an agreement written, oral, or inferred from conduct, for one or more common, nonprofit purposes that is not a trust, a marriage, domestic partnership, common law relationship or other domestic living arrangement, or that is formed under any other statute that governs the organization and operation of unincorporated associations.”) Much of the question as to the applicability of UNA for a DAO will rest on whether the activity of that DAO is considered “not-for-profit” under something called the Uniform Unincorporated Nonprofit Association Act (UUNAA) that has been adopted by many states. While many DAO generate profits, in general that is allowed under the UUNAA if the profits are not being distributed to members.

fluid membership than other traditional entity types.³⁸

If operating in a state that has fully adopted the Uniform Unincorporated Nonprofit Association Act (UUNAA), the model framework for UNA statutes, UNAs are also permitted to participate in for-profit activities if they are in furtherance of the purpose of the organization, though significant for-profit activities would jeopardize tax-exempt status under Section 501(c)(3) of the tax code.³⁹ UNAs have additionally been able to make distributions in some states that have adopted the UUNAA, introducing the possibility of such a distribution being acceptable for a DAO that is registered as a UNA so long as such distributions are in the furtherance of the DAO's nonprofit purpose.⁴⁰

Still, UNAs face considerable drawbacks. For all their advantages, the UNA framework leaves the definition of “nonprofit” undefined, and a matter of state interpretation. Moreover, their governing statutes vary across jurisdictions and are untested by courts, therefore offering much less certainty about their application than common entities with longer histories such as a C Corp or LLC.

Limited Cooperative Associations

Cooperatives are another entity type that some commentators have advanced as potential legal wrappers for DAOs.⁴¹ Cooperatives are structures that embrace a very different philosophy than most corporate models; they are formed by members and for members.⁴² Cooperatives thus embrace a coordinating logic where they are run by the people using them, distinguishing it from traditional business organizations.

In particular, states like Colorado have recently adopted laws that expand the cooperative options by recognizing Limited Cooperative Associations (“LCAs”).⁴³ LCAs combine the

³⁸ See *A Legal Framework for DAOs* *supra* note 9, (“the requirements for member participation in a registered UNA are significantly less cumbersome and present a viable path for an already operating DAO to utilize its governance protocols to form an agreement sufficient to establish the holders of the governance token as members of the entity through their continued membership in the DAO.”)

³⁹ RUUNA *supra* note 37, Comments to Section 2.

⁴⁰ Jacob Hirshman, *An Exploration of the Regulation and Governance of Decentralized Autonomous Organizations* (2022) at 43 available at <http://www.keepandshare.com/doc17/view.php?id=27147&da=y>.

⁴¹ Jacqueline Radebaugh and Yev Muchnik, *Solving the Riddle of the DAO with Colorado's Cooperative Laws*, The Defiant, (Dec. 16, 2021), <https://thedefiant.io/solving-the-riddle-of-the-dao-with-colorados-cooperative-laws/>.

⁴² See, e.g., International Cooperative Alliance, Cooperative identity, values & principles, available: <https://www.ica.coop/en/cooperatives/cooperative-identity>

⁴³ Colorado adopted the Uniform Limited Cooperative Association Act (“ULCAA”) in 2010. The ULCAA has since been adopted in a few Electronic copy available at: <https://ssrn.com/abstract=4123737>

traditional cooperative principles with a more flexible capital structure, allowing for two types of members: investors-members and patron-members, each with a right to vote and get a share of revenue. LCAs also provide a more permissive governance structure than traditional co-ops, allowing members' votes to be counted as "one member, one vote" (as is typical for co-ops) but also based on use or patronage or even on equity.⁴⁴ However, in the event that LCA's formation documents are silent, the statute prohibits the transfer of non-financial interests.⁴⁵ For these reasons, LCAs have been argued to be effective legal vehicles that are ideologically and structurally aligned with how DAOs operate,⁴⁶ but may not be an ideal entity for a DAO with a very fluid member base that wishes to remain pseudonymous.

To form a LCA, two or more organizers (who need to be "patron-members") must file the articles of organization with the secretary of state.⁴⁷ Most of the governance rules, however, will be in the separate bylaws, which are akin to the operating agreement of an LLC, and need not be publicly filed.⁴⁸ Once formed, the LCA will have separate legal personhood and provide limited liability to its members.⁴⁹

International Options

Ownerless Foundations

DAOs, along with some high profile projects including some layer one protocols, have employed various foreign wrappers in jurisdictions in order to help align operational structures with DAO attributes.

While Swiss foundations were employed by various early projects,⁵⁰ today one of the most

other jurisdictions, but is not yet prevalent across the US.

⁴⁴ Compare CO Rev. Stat. § 7-58-603 (2016) (Colorado's traditional Co-Op statute which requires each member to have no less than one vote, but no more than 2.5% of the total votes) with ULCAA §412 available at <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=bcf08f79-9191-c615-1388-00e1007a9294&forceDialog=0>.

⁴⁵ See CO Rev. Stat. § 7-58-603 (2016) (Stating that unless the articles or bylaws otherwise provide, a member's interest other than financial rights is not transferable.)

⁴⁶ Colorado, Co-opLaw.org, <https://www.co-oplaw.org/knowledge-base/colorado/> (last visited May 26, 2022).

⁴⁷ ULCAA §302 available at <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=bcf08f79-9191-c615-1388-00e1007a9294&forceDialog=0>.

⁴⁸ See, e.g., Bylaws of SongDAO, a Colorado LCA, <https://songaday.world/assets/nitty-gritty/SongDAO%20LCA%20bylaws.pdf> (last visited May 26, 2022).

⁴⁹ ULCAA §404.

⁵⁰ See, e.g., Ethereum Foundation and Tezos Foundation. Swiss foundations are less popular in part due to perceived administrative Electronic copy available at: <https://ssrn.com/abstract=4123737>

often used, and internationally recognized structures is the Cayman Foundation Company, which offers the advantages of separate personhood and limited liability associated with a typical corporation.⁵¹ Once know-your-customer checks are finished, Foundation Companies can be created in just a day. While managed by a board of directors, the Foundation Company does not have any owners or shareholders; it can be “ownerless.”⁵² Instead of being directed by fiduciary duties towards shareholders, Directors and managers have a duty to act pursuant to the foundation company's governing documents. In this sense, the Foundation Company functions similar to a mix of a corporation and a trust. Even without shareholders, Foundation Companies can undertake critical functions for DAOs, including hiring developers, offering a vehicle for early stage funding, marketing DAO projects, holding treasury assets and more.

Ownerless foundations like the Foundation Company provide a flexible governance structure that allows for persons other than directors to exercise control. Therefore, the board can be directed by the vote of the DAO token holders to a greater extent than under other regimes. Meanwhile, one or more “supervisors” can be tasked with ensuring that the directors of the foundation company observe their obligations to the DAO pursuant to the foundation company's governing documents. They also have standing to bring suit against the directors if needed.

The Foundation Company can, given the favorable tax treatment in the Cayman Islands, also provide potential tax advantages. However, tax benefits will not be the primary appeal for DAOs. DAOs with US operations or with US actors that exercise control over foundations even if located offshore may still be subject to US taxes. Furthermore, offshore foundations can be relatively complex and expensive to set up, as they will typically require advice from lawyers across multiple jurisdictions and often employ independent directors.

It is also important to highlight that the offshore foundations do not typically “wrap” the DAO, but rather act as an affiliate of the DAO, or even an independent entity, that is directed by the DAO’s token holders for a specific purpose. This relationship has important implications for

challenges. They are overseen by the Supervisory Authority of Foundations which needs to approve the foundation’s charter, as well as adoption of bylaws, and any amendments thereof, as well as merger or dissolutions..

⁵¹ See, generally, Bradley Kruger and Michael Robinson, *The Foundation Company as a Decentralised Autonomous Organisation (DAO) in the Cayman Islands*, Ogier (March 31, 2020) <https://www.ogier.com/publications/the-foundation-company-as-a-decentralised-autonomous-organisation-dao-in-the-cayman-islands#>; Bernadette Carey and Chris Duncan, *Cayman Islands Foundation Companies for DAOs, Defi, and NFTs*, Carey Olsen (Apr. 5, 2022) <https://www.careyolsen.com/briefings/cayman-islands-foundation-companies-daos-defi-and-nfts>.

⁵² *Id.*, Kruger and Robinson.

the potential liability of DAO members (who may not themselves be shielded from liability by a legal entity) and for the directors or managers of the offshore foundation, who may be directed to act by a third party (within the confines of their fiduciary duties).

Guernsey Special Purpose Trust

Several DAOs have recently employed special purpose trusts formed in the island of Guernsey as part of their legal structure.⁵³ These trust structures are not limited to charitable purposes but can be formed for any purpose.

A Guernsey trust separates a person's ownership of property from the right to benefit from that property. It involves a person or entity (settlor) transferring property to another (trustee) who is then charged with holding it for the benefit of a specific purpose.⁵⁴ As such, they can be useful for DAO community treasuries earmarked for a given DAO's growth and development (like grants)—and clarify the existence, or lack thereof, of any US tax payment and reporting obligations.⁵⁵

Guernsey trusts are governed by trustees, who have general fiduciary duties to act in the best interest of the trust and are subject to removal by other trustees, which can in turn be directed by vote of DAO token holders. Special purpose trusts also have an “enforcer” with broad rights to monitor the trustees and standing to bring suit. DAO token holders can exercise a range of control over actions of Trustees, including to require them to terminate the trust and transfer the assets to a different entity.

One possible advantage this wrapper may have over some other structures is that the Guernsey special purpose trust wrapper does not require any governmental filing to be formed. Instead, as a special purpose trust subject to Guernsey law, it is formed by contract between the grantor and the trustees. It thus may be more resilient to post-hoc charter revocations, and offer the prospect of more clarity and legal finality.

⁵³ See, e.g., *Non-US Trusts in Decentralized Autonomous Organizations*, dYdX Foundation (Mar. 15, 2022,) available at <https://dydx.foundation/blog/en/legal-framework-non-us-trusts-in-daos>.

⁵⁴ Nigel Le Quesne, *An Introduction to Guernsey Trusts*, JTC Group (Nov. 25, 2014), available at <https://www.jtcgroup.com/insights/an-introduction-to-guernsey-trusts/>.

⁵⁵ See *Non-US Trusts in Decentralized Autonomous Organizations*, *supra* note 54.

4 Examples and Explanations

Let's now take the opportunity to apply some of the legal considerations with more contextual precision. Although DAOs share some common features, they nonetheless differ dramatically from one another in terms of their purpose and operation, and as a result, particular legal wrappers may make sense in one situation, but not others.

1. Protocol DAOs

Example: Developers want to launch an automated market maker on a new blockchain offering unique privacy attributes and speed.⁵⁶ Building the protocol requires significant investments of capital and engineering. Ultimately the developers want to mint a token that will decentralize the protocol's governance by enabling holders to vote on certain of the protocol's parameters. All of the project's activities will be on chain.

Given the sophistication and resources necessary to develop the new AMM protocol, the founding teams for similar DAOs might create an entity to act as the "DevCo," through which it can onboard employees and fundraise capital for the initial development. Since Delaware C. Corps are very easy to set up and investors are familiar with the structure, many developers will default to this entity type, and sell investors preferred stock in the corporation, along with token rights (most commonly in the form of a warrant for future tokens or a token rights agreement). However, projects have also used public benefit corporations and other entity types to act as the DevCo. It is important to note that this DevCo will ultimately be distinct, and should be independent, from the DAO.

Once substantial development work has been completed and the protocol has been deployed, the founding team can begin to consider setting up separate legal entities, including one to act as the issuer of the tokens and one to incentivize and direct the future development of the protocol. Projects have often looked to international entities to play these roles. Among other options, projects have used an offshore corporation, formed in a jurisdiction such as BVI, to

⁵⁶ An AMM is a protocol that manages pools of token pairs which are used to effectuate a trade. When a trade is made, the AMM's algorithm determines the token's effective price based on the supply and demand dynamics between the involved tokens in these liquidity pools.

act as the direct token issuer, and then allocated a portion of the tokens to a Foundation Company (or potentially a Special Purpose Trust), which in turn distributes those tokens over time in a manner intended to promote future development of the protocol.

The power and locus of activity typically shifts between these entities over time as the protocol matures and decentralizes, starting with an initial focus on the DevCo which is later diffused as the foundation or trust take over more power. Projects should be mindful that in order for the offshore entities to be respectful of and in compliance with securities and tax laws, it is critical that the DevCo or other US-based persons do not exercise control over the offshore entities.

2. Social DAOs

Example: A digitally native community that is organized around a particular interest mints a membership token that allows holders to access a token-gated Discord server, as well as participate in snapshot votes about potential group activities. In addition to congregating online, the SocialDAO also hosts fun IRL parties and events.

Social DAOs can take wildly different shapes and forms. Two key distinctions among Social DAOs that will affect the potential liability of members and the need for a legal wrapper is the extent to which the DAO is pooling and dispersing assets, as well as the extent to which the DAO touches the “meatspace.” The need for a legal entity for a Social DAO that is limited to a simple token-gated Discord server is much less than that of one which controls a large treasury and hosts IRL events.

One potential legal entity for Social DAOs to explore is the UNA, given that it is likely to be ideologically aligned with the recreational focus of most Social DAOs, as well as potentially provides a legal structure that is more amenable to the fluid membership of DAOs. As noted above, forming a UNA could provide a liability and tax shield for members of the Social DAO. Social DAOs that are purely recreational should also consider whether they can elect for tax treatment as a 501(c)(7) social club.

However, some Social DAOs may look to host events in the real world, or even potentially fundraise to develop products that can be whitelabeled and monetized. If so, they could consider

setting up a siloed or affiliated entity to provide a fundraising vehicle, facilitate interactions with service providers (such as booking event spaces), to act as an additional layer of liability protection (e.g., slip and fall at a party) or to shield members from income stemming from events like token sales or revenue from the platform. The most common entity types for this role would be a Delaware C Corp or LLC. Importantly, these siloed entities do not “wrap” the entire DAO, but instead serve to isolate liability from specific activities conducted by that entity.

3. Investment and Venture DAOs

Example: A group of investors is interested in pooling funds together to invest in Web3 projects, including purchasing digital assets, but also funding projects pre-token launch by investing in equity and token rights. They intend to source investment opportunities from their members and make collective investment decisions by voting their DAO tokens on snapshot. Ultimately, they intend for the digital assets and any profits to be distributed to the members.

Although the overwhelming majority of traditional venture funds today are organized as limited partnerships, Venture DAOs have most often experimented with LLCs, with the most prominent examples being organized as Delaware LLCs.⁵⁷ As noted above, this entity type provides for separate legal personhood, limited liability of members and a relatively flexible governance framework. However, one of the main downsides to using an LLC for investment purposes is that, as stated below, it is likely to be heavily regulated. Further, membership to an LLC may not always be conducive to dynamic investing and fluid participation. As noted above, to join an LLC, each DAO member would have to enter into a binding legal agreement. Most structures will also require the members to be accredited investors. Issues can also arise with members taking distributions and exiting the LLC, as statutes typically prohibit members from taking “improper distribution” if there exist pending liabilities, but many investment DAOs have “ragequit” functions that could allow members to do so.⁵⁸

A critical consideration for Venture DAOs is whether they may constitute an investment company under the Investment Company Act. The SEC warned of this risk dating back to The

⁵⁷ See, e.g., Metacartel Ventures, <https://metacartel.xyz/> (last visited May 26, 2022); the LAO, <https://docs.thelao.io/> (last visited May 26, 2022); Flamingo DAO, <https://flamingodao.xyz/> (last visited May 26, 2022).

⁵⁸ See Shapiro, *supra* note 2.

DAO Report,⁵⁹ and recently entered into a major settlement that included related claims⁶⁰, leading lawyers in the space to expect increased focus on this point. To date, most Venture DAOs have avoided becoming registered investment companies by qualifying as an investment club under current SEC guidance.⁶¹ While investment clubs offer a potential alternative, they also include limitations such as a cap on number of members and requirement that all members actively participate in decision making.

4. Collector DAOs

Example: NFT collectors seek to establish a DAO for the purchase of rare NFTs and digital art. The collectors plan to display the NFTs in galleries open to the public. Collectors contributing to the DAO treasury receive a governance token that gives holders a vote to decide which NFTs to purchase, where the NFTs are displayed, as well as to when and to whom the NFTs are potentially sold.

Collector DAOs share many of the same features as Social DAOs insofar as one important purpose may be for people to engage in a kind of recreational activity– working together as a group to purchase certain items for the collective enjoyment and sense of community. In another way, they also share some of the features of investment or venture DAOs, since they pool capital in order to buy assets, with one significant difference being Collector DAOs aren’t typically so focused on distributing profits back to the DAO members as are Venture DAOs.

The most famous example of a Collector DAO to date is the ConstitutionDAO which raised \$47 million with the goal of purchasing a copy of the United States Constitution and displaying it in public spaces. Arguably due to the DAO’s inability to shield its maximum bid from competitors, the DAO lost its bid. Weeks after the event around \$23 million had yet to be refunded, partly due to fees that had been incurred in making the bid and the high gas costs

⁵⁹ SEC Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) at Footnote 1, <https://www.sec.gov/litigation/investreport/34-81207.pdf> (“This Report does not analyze the question whether The DAO was an “investment company,” as defined under Section 3(a) of the Investment Company Act of 1940 (“Investment Company Act”), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.”).

⁶⁰ See SEC Release No. 11029, Order Instituting Cease-and-Desist Proceedings, In the Matter of BlockFi Lending LLC (Feb. 14, 2022), <https://www.sec.gov/litigation/admin/2022/33-11029.pdf> (including charge that BlockFi operated as an unregistered investment company and violated Section 7(a) of the Investment Company Act).

⁶¹ See *Investment Clubs and the SEC*, SEC.Gov, (Mar. 20, 2018), <https://www.sec.gov/reportspubs/investor-publications/investorpubsinclub.htm> (last visited May 26, 2022).

associated with returning small contributions.⁶² (The novelty of the project nonetheless led to the tokens connected to the DAO, the People's token, to fluctuate dramatically in value).

With more advanced planning, a 501(c)(7) nonprofit wrapper could offer important liability protections to members of future Collector DAOs. Additionally, members' contributions could be deducted from their personal tax liability if the DAO elected treatment as a private foundation.

Still, many Collector DAOs have for profit purposes, as the hypothetical above illustrates. Many of the first have focused on the prospect of raising funds to support the purchase of rare or high value NFTs. In these kinds of DAOs, DAO members contribute capital, and can in return receive both governance rights as well as pro rata ownership of digital assets purchased by the DAO. NFTs in particular offer the prospect of fractionalization and offering each member direct partial ownership of the digital assets acquired by the DAO.

Collector DAOs such as these can involve sophisticated legal wrappers. Founders could, for example, collectively set up a co-op that buys NFTs where they would be members of the co-op under a Colorado LCA. [By establishing a co-op, they could purchase NFTs directly from the DAO once the DAO acquires them.] In the event that the membership to the Collector DAO is intended to be a closed set, they could consider in the alternative a corporation or LLC (including potentially a DAO LLC). In addition, certain Collector DAOs have also formed non-U.S. structures (such Ownerless Foundations) to hold assets and act as a potential liability shield for the members.

As with Investment and Venture DAOs, to the extent a Collector DAO is pooling funds and investing them in assets, close attention should be paid to ensure the DAO does not qualify as an investment company.

5. Media DAOs

Example: A DAO is formed to produce content intended to educate and help onboard more

⁶² See Jacob Kastrenakes, *Almost buying a copy of the Constitution is easy, but giving the money back is hard*, The Verge (Nov. 24, 2021) <https://www.theverge.com/2021/11/24/22800995/constitutiondao-refund-progress-steep-gas-fees-cryptocurrency>. Another prominent example of a collector DAO is pleasrDAO, which has collected several high profile NFTs (see, <https://pleasr.org/>)

users to Web3. Instead of having a central entity making editorial decisions and relying on advertising for revenue, a Media DAO intends to leverage tokens to incentivize content producers and consumers.

DAOs offer particularly interesting applications for the entertainment industry, and several DAOs have been launched with the purpose of reinventing how both content producers and consumers engage with media.⁶³ Instead of centralized models where content is paid for by advertisers, Media DAOs operate with the aspiration of community-driven media production and consumption.⁶⁴ We have seen examples of Media DAOs that produce newsletters and podcasts,⁶⁵ are financing and producing a feature-length film on the development of Ethereum,⁶⁶ and even Protocol DAOs that have segregated their IP assets in separate legal structures.⁶⁷

Media DAOs can involve sophisticated legal wrappers, both for potential monetization and to insulate actors from liabilities, which in the case of Media DAOs can include libel, copyright and other IP infringement claims. In addition, from a practical perspective, legal entities are often a prerequisite to a Media DAO's ability to register IP and defend from infringement from third parties.

For Media DAOs that are focused on producing publicly-available information and may qualify as non-profit, an UNA structure could be appropriate and helpful insofar as UNAs offer separate personhood, limited liability, and a flexible structure for adding members.⁶⁸ However, Media DAOs that are strictly for profit and have a limited membership base (e.g., a Media DAO composed of a limited group that is financing a film) may find UNAs unavailable given their nonprofit orientation, and should instead consider an LLC or C. Corp as a legal wrapper.

⁶³ Justin Mart and Connor Dempsey, *DAOs: Social networks that can require the world*, The Coinbase Blog (Dec. 22, 2021) <https://blog.coinbase.com/daos-social-networks-that-can-rewire-the-world-128b73732547>.

⁶⁴ Bud Hennekes, *The 8 Most Important Types of DAOs You Need to Know*, Alchemy Blog (Apr. 6, 2022), <https://alchemy.com/blog/types-of-daos>.

⁶⁵ For example, Bankless DAO is an online community using digital tokens (BANK, 0x2d94/a198) to coordinate and support Bankless media properties (newsletter, podcast, youtube channel) with a vision of "drive[] adoption of bankless money systems like Ethereum, Bitcoin and DeFi...."

⁶⁶ *The Infinite Machine Movie NFT Holders Will Sit at The Producers' Table Via a DAO*, The Defiant (January 12, 2022), <https://thedefiant.io/infinite-machine-dao/>.

⁶⁷ dYdX Foundation, *A Legal Framework for Non-US Trusts in Decentralized Autonomous Organizations* (Mar. 15, 2022), <https://dydx.foundation/blog/legal-framework-non-us-trusts-in-daos>.

⁶⁸ See, e.g., *A legal entity for the Bankless DAO in the off-chain world* (June 13, 2021), available at <https://forum.bankless.community/t/a-legal-entity-for-the-bankless-dao-in-the-off-chain-world/997>; LexDAO Memo, Bankless DAO, available at <https://gateway.pinata.cloud/ipfs/QmcDRCGqbTXHXUZcB1szvjUh4NmaxR3G7sPhPMNuYnFQPF/bank.txt>.

Finally, Special Purpose Trusts may be appropriate for some Protocol DAOs, especially those that have segregated their IP assets. In such cases, Special Purpose Trusts offer the kind of flexible governance that enables token holders to direct the use of assets in ways reflecting the decentralized governance that takes place in DAOs. Additionally, non-U.S. iterations, such as the Guernsey Special Purpose Trust, can be created without lengthy approval processes and often with favorable tax treatment.

6. Philanthropic DAOs

Example: Developers, wishing to promote both financial inclusion and literacy, decide to create a DAO to pool donations, and provide grants and scholarships for students studying engineering and projects focused on assisting unbanked persons. They want to mint a governance token for deciding to whom the grants are given, and for which projects.

Philanthropic DAOs facilitate and manage donations and charitable giving in ways to support various causes, activities, or projects. Often, philanthropy supports work in the web3 ecosystem, but DAOs can also help organize off-chain giving as well.

Where DAOs facilitate altruistic activities of members, or are designed to support the altruistic activities of others, nonprofit wrappers are intuitively natural fits.⁶⁹ Here, the developers could file for nonprofit incorporation in any state, and then elect 501(c)(3) status as either a private foundation or public charity.

As with corporate wrappers, nonprofit incorporation requires structural features, like a board of directors and officers, that could be hard to square with the fluid and decentralized aspirations of DAOs. Furthermore, the DAO's activities would have to be centered around the expressed purpose of the nonprofit in order to meet the operational requirements of a 501(c)(3). The challenge becomes all the more formidable where DAOs go beyond just attracting funds for any one cause or purpose and instead offer a platform for managing charitable donations, or enable others to set up their own operations for similar ends.

⁶⁹ See, e.g., Big Green DAO, <https://dao.biggreen.org> (last visited May 26, 2022) (a 501(c)(3), which launched a DAO to support efforts for gardening and growing local food.)

For some of the most ambitious charitable ventures, certain projects have consequently leveraged tri-party structures to tackle financing and governance challenges. In such circumstances a nonprofit entity that qualifies as a 501(c)(3) carries out mission driven work, and a Delaware C Corp. is incorporated to finance the development of bespoke smart contracts. To ensure that the will of the DAO token holders is observed by the nonprofit, a Delaware C Corp. could additionally create subsidiary LLCs to serve as a conduit between the will of the DAO token holders and the directors that control the non-profit entity.⁷⁰

Under this model, tokens issued by the protocol serve the sole purpose of electing directors in the nonprofit on a regular basis. Token holders from time-to-time can also vote on changes to the token issuance schedule or governing rules of the LLC, within the allowances of the LLC's bylaws.

Suppose that the developers also plan to fund grants through staking and mining activities, alongside contributions. Are limited-for-profit activities compatible with a nonprofit wrapper?

Possibly. An organization seeking IRS treatment as a 501(c)(3) organization cannot be operated for the benefit of private interests.⁷¹ But nonprofits *can* create for-profit subsidiaries. Thus a DAO could wrap an LLC or other corporate form around its staking and liquidity operations. It is worth keeping in mind, however, that the parent nonprofit would be required to demonstrate that it enjoys “public support.” Thus, for example, if the developers wrapped a 501(c)(3) charity around the philanthropic DAO, that DAO would still be subject to IRS requirements that donations comprise at least one third of its financial support. If the for-profit subsidiary grew so large that the total support enjoyed is so large that donations are less than 33%, the nonprofit could lose its status as a charity since it would no longer be able to demonstrate that it in fact enjoys “public support.”⁷²

The availability of a for-profit subsidiary to a charity naturally raises the question as to whether or not the opposite is true: can, in short, a for-profit entity have a public charity or private foundation as a subsidiary? The simple answer is no. Under the private inurement doctrine,

⁷⁰ See *Endaoment V2: System Administration & Entity Architecture*, NDAO (May 11, 2022) <https://endaoment.gitbook.io/contracts-v2-documentation/> (LLC serves as the sole member of the nonprofit (therefore having the right appoint its directors), and the LLC members are bound by the LLC operating agreement to enact the votes of the token holders)

⁷¹ See Estrada, *supra* note 32 at 53.

⁷² *Id.* at 67.

the resources of a nonprofit corporation cannot personally benefit any private shareholder or individual. If a nonprofit corporation was owned by a for profit entity, this doctrine would be violated.⁷³ Instead, for-profit entities tend to only affiliate with an incorporated nonprofit, in which case their relationship is much more of a peer to peer relationship than a hierarchical one.⁷⁴

These limitations have consequently led commentators to consider the possibility of UNAs as a possible hybrid wrapper given the flexibility potentially afforded them to engage in commercial activities.⁷⁵ Notably, the Uniform Unincorporated Nonprofit Association Act ("UUNAA"), the model statute for states adopting UNAs, defines UNAs as "consisting of [two] or more members joined under an agreement [...] for one or more common, nonprofit purposes"⁷⁶--but it does not specifically define the term "nonprofit." Instead, the statute leaves it up to the enacting jurisdiction to fill in the details.⁷⁷ Assuming a DAO's activities fell into the state's definition, perhaps because of the overall purpose or objectives of the DAO, it could then, as an UNA, conceivably engage in mining or staking activities and reinvest profits into the costs of running the DAO and the attendant philanthropy.⁷⁸

7. Lobby DAOs

Example: Cryptocurrency enthusiasts dissatisfied with the local state incorporation options for DAOs establish a DAO to convince legislators in all 50 states to improve legal wrappers or offer new legal wrappers for decentralized finance. Money is pooled to pay lobbyists throughout the country. Contributors receive a governance token enabling them to vote on policies for which to lobby.

DAOs, like crypto, are also moving into the policy arena as influencers. Lobby DAOs in particular are one expression of this development, and draw on large swaths of diverse individuals to craft and vote on public policy proposals for specific issue areas—and to advocate for chosen proposals with policymakers.

⁷³ *Id.* at, 48.

⁷⁴ *Id.* at, 66.

⁷⁵ Kerr and Jennings *supra* note 9 at 21.

⁷⁶ See National Conference of Commissioners on Uniform State Laws, *supra* note 37.

⁷⁷ Jacob Hirshman, *An Exploration of the Regulation and Governance of Decentralized Autonomous Organizations* (2022) at 43 available at <http://www.keepandshare.com/doc17/view.php?id=27147&da=y>.

⁷⁸ *Id.*

Lobby DAOs engage in activities where existing legal wrappers offer immediate options. The most obvious would be incorporating as a nonprofit that elects 501(c)(4) treatment. Notably, however, activities such as lobbying are of such a nature that they necessarily occur off-chain. No smart contract can meet with elected officials and discuss policy over lunch with regulators. As a result, varying levels of centralization and decentralization within the DAO infrastructure are generally required in order to accomplish the purpose of the DAO. Additionally, and closely related, a DAO might have to register under the Lobbying Disclosure Act if its spending on lobbying activities, or income from them, exceeds various thresholds.

An interesting and high profile example of layered and varied levels of (de)centralization is “Lobby3,” a DAO launched by former Presidential candidate Andrew Yang to advocate for sustainable crypto policy off-chain.⁷⁹ To mediate off-chain and on-chain activities, as well as crowdsourced policymaking and fundraising, the DAO has issued governance tokens in accordance with varying membership benefits tied to token purchases. All community members are able to draft policy proposals. Token holders who contribute a specific quantum (1 Eth) are meanwhile responsible for determining which proposals move to a community vote. Policy proposals approved by the DAO are then used as priority guidance for lobbying on issues concerning DAO policy.

5 Concluding Thoughts

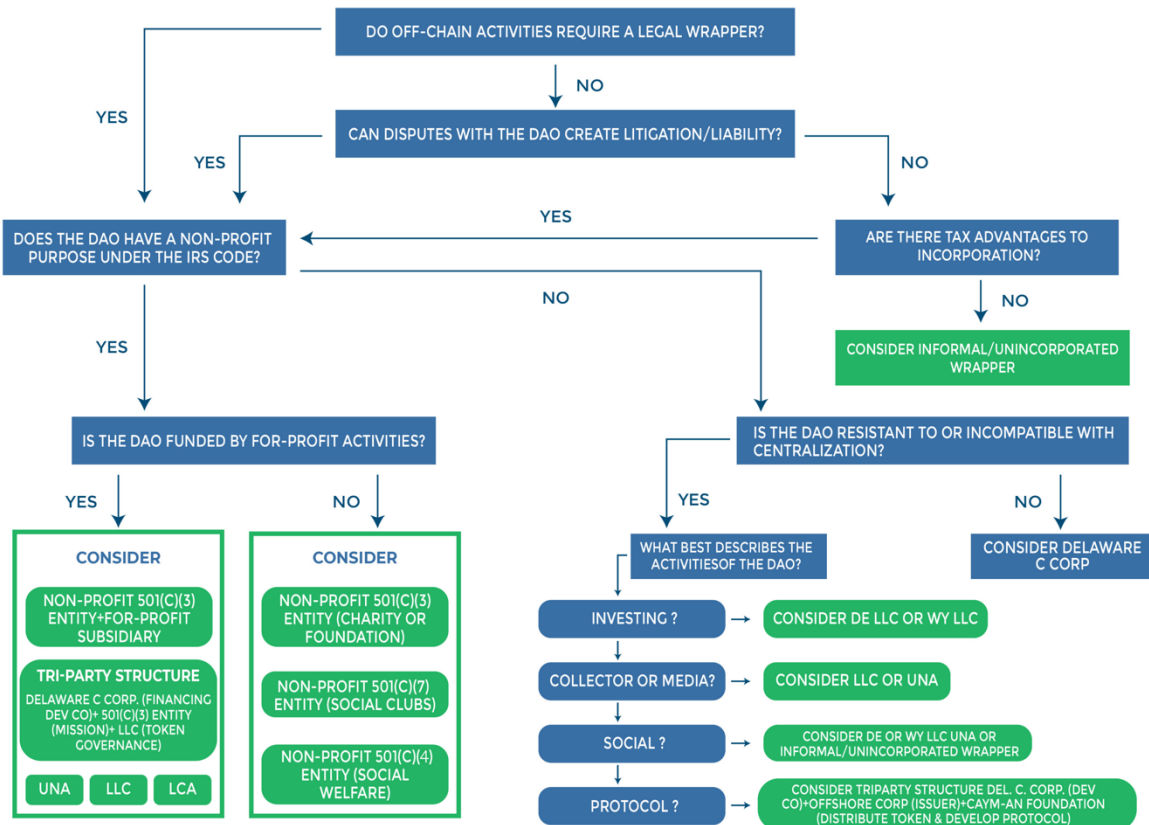
The spectrum of potential DAO wrappers is considerable, and broader than most founders might initially assume. It spans legal entities and forms commonly associated with business associations to both incorporated and unincorporated nonprofits.

Yet even in this variety, we anticipate that most founders will have to engage in a similar process of thinking when it comes to choosing legal wrappers. Early on, at a most basic level, some evaluation of the risks of not incorporating will have to be performed. As this white paper documents, founders will have to consider whether or not the activities of their DAO, or proposed DAO, create potential scenarios for disputes or litigation. And for larger, more

⁷⁹ Welcome to Lobby3, Lobby3, <https://www.lobby3.io> (last visited May 26, 2022).

ambitious projects, additional consideration will have to be made concerning whether the DAO's activities create any tax liabilities that if left unaddressed could undermine or even threaten the financial health of the enterprise.

WHICH LEGAL WRAPPER?



Next, assuming informality is untenable, founders will have to consider the salient qualitative features of their DAOs and to assess them against available wrappers. DAOs with large and fluid memberships might not be best for LLC structures that anticipate a relatively finite and stable body of members. DAOs with highly decentralized structures will be harder to square with the most traditional wrappers demanding centralized governance.

Finally, founders may have to take into account practical constraints. DAOs are attractive in part due to the speed with which people can organize around a specific goal and operationalize on and off-chain activities towards pursuing that goal. Some wrappers, like Delaware C. Corps, can accommodate these pressures, and can be launched quickly, even in a matter of hours; others, especially those that require multiple administrative steps like tax exempt

nonprofits, will take longer to both plan and execute. As processes lengthen, and potentially become costly, the resources of the DAO will become more important in considering whether to incorporate, as well as which wrapper to adopt. Ultimately, similarly situated founders may reach entirely different choices. A founder of a philanthropic DAO could choose a nonprofit private foundation as well as an LLC to conduct certain charitable activities; the founder of a Collector DAO could conceivably just as well deploy an LCA or LLC.

This “utility spread”—and diversity in outcomes—itself underscores that *no* legal wrapper is a perfect fit for the unique and novel characteristics presented by a Web 3 DAO. And as we noted at the outset of this white paper, this should not be surprising. The vast majority of legal wrappers available to DAOs were developed with traditional companies in mind, and based on 20th century presumptions about the very ability of individuals to collectively associate themselves. And they are themselves backed by in some instances decades of court decisions, statutes and legal opinions built on these assumptions—and the challenges that centralized managerial control posed to highly dispersed and passive stockholders. The coming work for researchers, regulators and venture professionals will be to think through how the existing universe of wrappers, and new legal tools, can better fit the features of DAOs in ways that serve the people that use and depend on them, and the broader public.