

DECENTRALISED
AUTONOMOUS
ORGANISATION
(DAO)

CONNECTING YOU TO A BETTER FUTURE



OVERVIEW

Australia is currently experiencing a technology revolution with significant growth in the digital economy. There is enormous opportunity for Australia to capitalise on this growth however, the importance of the legal system adapting to service this growth is vital.

One solution to meet this need, has been to recognise Decentralised Autonomous Organisations (DAOs) as a new legal entity. DAOs operate through a flat corporate structure whereby members vote on proposals which are executed through smart contracts.

DAOs are currently being used globally for purposes such as fundraising, charity, investment, borrowing and buying non-fungible tokens. According to data from DAO statistics platform DeepDAO, the total global assets under management for DAO treasuries listed on the platform increased from around US\$380 million in January 2021 to a peak of US\$16 billion in mid-September 2021.

DAOs are not currently recognised in Australia which means members are not provided the usual protections afforded to legal entities. However, the Australian Government has committed to preparing a draft proposal for legislative reform that may encompass recognising DAOs as a new legal entity.

WHAT ARE DAOs?

A DAO is an organisation that operates on decentralised blockchain infrastructure. This means that the organisation utilises the power of smart contracts and blockchain technology to attempt to bring about greater transparency, efficiency and decentralisation in the entity's decision making, ability to transact and obtain member consensus.

Unlike traditional organisations, a DAO's governance mechanisms are not enacted by human agents on behalf of shareholders, but through members engaging directly with computer-coded protocols.



HOW DO DAOs WORK?

DAOs take advantage of decentralised finance (DeFi). DeFi refers to any number of new financial applications and transactions powered by the blockchain. Most importantly, they can do it without having to go through a centralised institution, like a bank.

Each DAO's rules are inscribed on the blockchain in code form, in what is called a smart contract, agreed upon by the persons who started the DAO. Like a digital 'constitution' these contracts govern the operation of DAOs, as they ensure that a group's pooled money will go only toward financing its mission. Member decisions are made and recorded automatically using these self-executing smart contracts.

Since DAOs are built on self-executing contracts, before the DAO votes on a proposal, the party lodging the application must review and accept the smart contract terms to govern their proposal in advance. These contracts are generally pro forma and provided to the applicant by the DAO. If the applicant has any form of disagreement with the proposed smart contract, they must lodge a dispute, which the DAO will resolve before voting on the proposal.

Once the smart contract terms are approved, the proposal is put forward to the members of the DAO. A practical example of a proposal may be voting on hiring/employing a developer for the DAO and voting on their salary, which would be paid automatically by the DAO in cryptocurrency. Rules may differ from DAO to DAO, however, generally a majority of those voting on the matter at hand is required to reach quorum. This means that DAOs with relatively high levels of passive participation can remain active and pass high numbers of proposals with only a small number of participants engaged.

DAOs are similar to traditional corporations in that profits can be shared with the members, however the use of smart contracts makes this process much more autonomous and efficient. This, combined with the attached voting rights of a token makes holding DAO tokens much more valuable than many other cryptocurrencies.



ORGANISATIONAL HIERARCHIES OF DAOs

DAOs reimagine the traditional corporate structure by utilising flat hierarchies, with no central leader or figurehead. Instead, decisions are made by members belonging to the DAO. When someone becomes part of a DAO, the person buys into the group's specially made crypto tokens. The level of say in a decision is proportional to how many tokens that person holds.

Even without a recognised leader, DAOs function with an understanding that all of its members will follow a specific set of rules, etched online as code.

Supporters of DAOs claim the model is transparent and gives direct control of the entity to its shareholders, removing the need for a board or management. The decentralised nature of DAOs may also have great appeal to employees as the structure of a DAO creates a culture of strong communication as members lobby each other to promote their own ideas. This is very different from centralised organisations where strategies are usually created and decided by a small group of management or directors. This transparency is a critical component to members' empowerment. Every decision within the DAO is pitched, discussed, voted on and documented publicly.

One of the downsides of decentralising decision rights is that voting on code, creating rules and implementing projects can be time consuming. Expertise are needed to accurately consider proposals and vote effectively. Making a code available for inspection doesn't necessarily guarantee that every investor will have the time, skill or energy to review it.

DAOs AS A LEGAL STRUCTURE

At present, Australian law (such as the Corporations Act 2001 (Cth)) does not recognise DAOs with legal personality.

Without legal recognition, the legal ownership of assets controlled by a DAO is unclear, and it is possible a DAO may be classified as a partnership or unincorporated association, exposing its stakeholders to personal liability for any debts or legal actions against another member of the DAO. Since the DAO has no legal personality, it is at risk of having insufficient standing to enforce the entity's rights. Similarly, other entities (i.e., individual or corporate investors) may be unable to bring proceedings against DAOs given their unrecognised legal status.

The DAO structure may prove useful for the future in implementing appropriate corporate oversight for emerging types of blockchain-based organisations operating in Australia. Legal recognition of DAOs will also provide these organisations with legal capacity to employ people, enter contracts, hold property, and obtain licences and insurance with confidence.

A major stumbling block for the legal recognition of DAOs may be the acknowledgement of ASIC as to the difficulty in identifying who the regulator can hold accountable if something goes wrong. The same accountability question applies for the law courts. This issue is compounded by the anonymity in which blockchain operates.

BENEFITS OF A DAO

Courtesy of the advanced technology they utilise, DAOs provide numerous unique benefits that are not available to traditional recognised entities including:

- Being trustless – members do not need to trust any CEO, manager etc with decision-making. The DAO will also keep running if an important developer leaves the organisation or if funding ceases;
- Cannot be shut down – the only way a DAO could be shut down was if an authority or person had a very large number of tokens and fairly voted to shut down the DAO;
- Open source – a DAOs code and rules are out there for everyone to see, which promotes reliability and continuous improvement.

Despite the benefits, the uncertainty surrounding the legal status of DAOs poses a multitude of legal risks for both DAO leadership teams and its investors/members. For instance:

- is a DAOs leadership team offered protection in the form of limited liability or are they to be held liable for the debts of the DAO?
- if the pre-determined smart contracts which govern how certain decisions of the DAO are made are flawed, what recourse or protections are available to members of the DAO that are negatively affected by such decisions?
- because DAOs may offer a variety of different types of incentives to investors, how are such incentives to be treated for taxation purposes (i.e., if a DAO incentivises early investors by providing those investors with additional tokens which have some ascribed value based on market sentiment (among other things), how is the provision of those additional tokens taxed in the hands of the investor)?
- what sanctions can be imposed on nefarious DAO leadership teams, which may reside in Australia and/or overseas who run off with investor funds or DAO treasuries (colloquially referred to in the crypto industry as a "rug pull")?

Aside from the many legal risks, DAOs are also vulnerable to attacks with hackers potentially being able to 'reverse engineer' its code for their own financial benefit.

WHAT RISKS DO
DAOs PRESENT?



WRAPPED VS UNWRAPPED
DAOS

DAOs can be structured as either 'wrapped' or 'unwrapped'. 'Unwrapped' DAOs have no legal registration in any domicile and rely on their internal digital mechanisms for dispute resolution to govern the group. In contrast, wrapped DAOs use existing legal structures to register the DAO as a company or other non-profit entity, giving it legal personality.

Australian law appears to be incongruent with the core characteristics of anonymity, pseudonymity and decentralised governance intrinsic to the form and function of a DAO. No arrangements presently exist for the registration or regulation of DAOs in Australia as unique entities. As discussed, if an unwrapped DAO was to emerge, courts would likely consider it an unregistered general partnership by default, an arrangement that would likely create joint and several liability for all DAO participants involved.

Registering wrapped DAOs in Australia could be attempted in several ways. Firstly, they could be wrapped as a proprietary limited company; they could also be registered as a cooperative, a partnership or a non-profit. Each avenue would provide its own myriad of legal challenges for the DAO to operate according to its intended design.

When comparing options for wrapping DAOs under Australian law, it should be noted that most company structures, including those listed above, require the formal registration of participants as either directors, officers or shareholders. The anonymity associated with blockchain technology means a requirement for DAO leadership to register the names of participants as directors, officers or shareholders may be impracticable, given that obtaining details of these participants may be impossible due to the DAO's code.



REGISTRATION ISSUES FOR
DAOS

Relevant to registering DAOs under Australian law is the question of whether or not allocating financial capital to an investment-purpose DAO would constitute the issuing of 'securities' to the public.

Pursuant to Chapter 6D of the Corporations Act 2001 (Cth), only public companies can raise funds from the general public and to do so, they must first submit a prospectus for approval with ASIC. Whereas, private companies can raise capital without such a prospectus provided they satisfy certain conditions. The scenario of a DAO wrapped as a public company is problematic because prospectuses generally require detailed information about the investment's strategies, risks, management and disbursement policies. DAOs are democratically governed by its members and may have constantly changing strategies or even no strategies at all. Also, the disbursement policies from the DAO may be altered at any time via a proposal, meaning that reliable information about the 'investment' could not be lodged with ASIC. DAOs wrapped as private proprietary limited companies would also face severe limitations on the scale, given that raising money without a prospectus would limit the pool of investors to the creator's existing network or professional and sophisticated investors.



In April 2021, the US state of Wyoming introduced legislation that provided individuals and organisations in the blockchain industry to create a legally recognised DAO in Wyoming.

Wyoming's law attempts to resolve the legal uncertainty regarding DAOs. At a high-level, the Wyoming law prohibits lawsuits against DAOs as general partnerships and enforces the rights of DAOs as legal persons to protect individual DAO members. As a result, the law extends traditional legal protections to DAO members to minimise the risk of DAO members being held personally liable by a DAO.

Under Wyoming's scheme, DAOs must file articles of organisation identifying the smart contracts that manage the system. DAOs can also designate whether or not the DAO is managed by members, as in people, or whether or not it is algorithmically managed autonomously. Through these arrangements, states cannot alter or facilitate the internal governance of the organisation. However, ultimately, the state courts would be able to intervene in the instance that one member sought to initiate legal proceedings against another. The Wyoming legislation also includes specific guidance on the quorum required for the approval of a proposal, mandating that 50% of DAO members must approve a decision

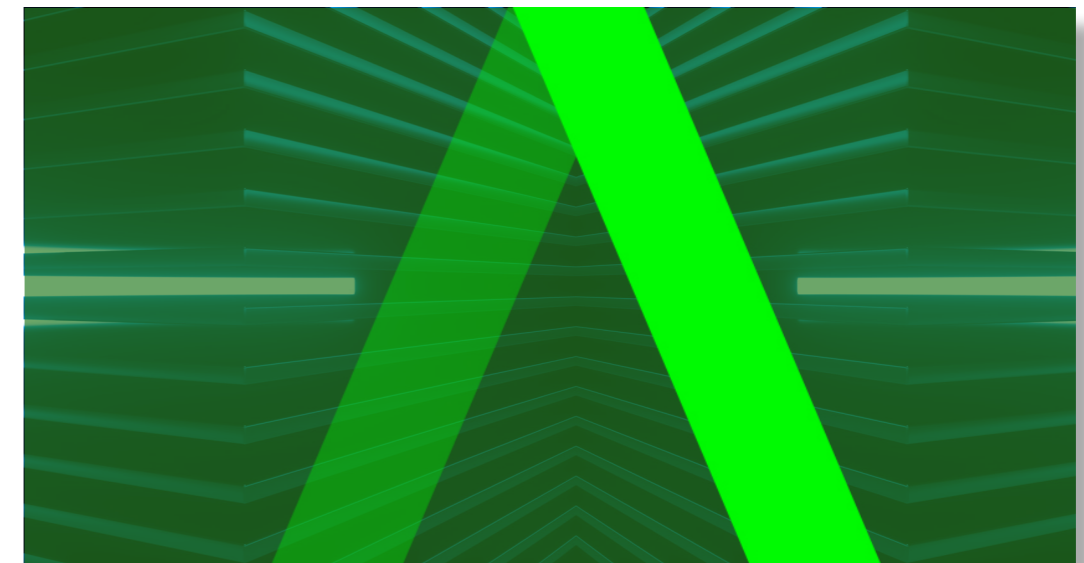
Wyoming's DAO legislation intends to give maximum effect to the freedom of contract principle, namely by waiving the fiduciary duties of DAO members by default. Under the new law, while members of traditional Wyoming companies still owe fiduciary duties of loyalty and care to the company and other members, DAO members participating in a DAO company are only subject to an implied contractual covenant of good faith and fair dealing.

Relevant to Australian legislators are the criticisms of Wyoming's DAO legislation in that it creates additional and allegedly unnecessary burdens for DAOs and the law's lack of significant guidance for the ways in which a DAO company in Wyoming practically differs from a traditional company in Wyoming.

WHAT IS NEXT FOR AUSTRALIA?

As it stands, no arrangements presently exist for the registration or regulation of DAOs in Australia as unique entities. However, in October 2021, the Select Committee on Australia as a Technology and Financial Centre, chaired by Senator Andrew Bragg, handed down a report ('Bragg Report') recommending that "the government establish a new decentralised autonomous organisation company structure".

Following the Committee's Report, the Treasurer Josh Frydenberg announced that the Government would examine the potential of DAOs and how they can be incorporated into Australia's legal and financial regulatory frameworks. Work is currently underway to prepare a draft proposal for what this legislative reform should be.



GET IN TOUCH



PAUL GRAY
PRINCIPAL
T 03 5225 5231 | M 0414 195 886
E pgray@ha.legal



RYAN POPOVSKI
LAWYER
T 03 5226 8572
E rpopovski@ha.legal



Geelong

70 Gheringhap Street
Geelong
VIC 3220

T 03 5225 5225
E geelong@ha.legal

Melbourne

Tower Two | Collins Square
Level 22, 727 Collins Street
Melbourne, VIC, 3008

T 03 9611 0190
E melbourne@ha.legal