

Using a **DAO** for Corporate Governance

News coverage in recent weeks has shed the spotlight on an increasingly important aspect of the crypto space, Decentralized Autonomous Organizations, or DAOs.



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Recently, Constitution DAO, a community of individuals that sought to purchase a copy of the United States Constitution being auctioned at Sotheby's, raised over \$40 million dollars to try and do so. Ultimately, they were unsuccessful. But the fact that the DAO was able to raise so much money in such a short period of time shows how significant DAOs are—and the potential they have. So, if a DAO has the ability to develop communities this quickly, does it have other uses, such as being used in a corporate context?

Below I explain a basic overview of what a DAO is, how it can be used for corporate governance, and the pros and cons of doing so. You need only to have a basic understanding of cryptocurrencies, smart contracts, Non-Fungible Tokens and how blockchain technology works.



> What is a DAO?

Like a traditional company, a Decentralized Autonomous Organization is governed by a contract or series of contracts. But unlike a traditional company, which is run by individuals that interpret those contracts and govern themselves according to those contracts, a DAO generally has little to no human input but operates automatically based on the written code within the smart contract(s) that govern(s) the organization.

Briefly, smart contracts are like legal contracts except that they are self-executing. For example, let's say Bob has a contract with Sally for Sally to buy paint from Bob for \$100.00. With a regular contract, Bob would have to deliver the paint and Sally would have to transfer the money. With a smart contract, code would be written in the contract that on a given date or on the occurrence of a particular event, the money is transferred and paint is delivered simultaneously—without any human effort.

Although human input is required to draft the code that dictates how the smart contracts will operate and how the DAO will be structured, once that code is deployed on the blockchain, the DAO generally no longer requires human supervision to operate. But as with any general rule, exceptions exist.

A more sophisticated DAO could be governed by one or more layers of smart contracts that require human input to execute those more sophisticated functions. Examples include those who are part of a particular DAO take a vote on the purpose of the DAO, how the DAO will use and distribute its funds, or even how votes are allocated amongst the members of the DAO. But overall, every DAO operates based on the code that was written for it and according to the smart contracts that govern it. And as the DAO evolves over time, the artificial

intelligence (yep, robots) built in to the code and smart contracts governing the DAO evolves over time and becomes more adept at managing itself and its interactions with the required human input.

So, like a company, a DAO is a governance model. But it operates on the blockchain and is subject to a set of rules that are outlined in the code that created the DAO.

> How does a DAO Sustain Itself?

Like a company, a DAO has to rely on funding to maintain its operations. You might ask, "If the DAO operates automatically without human input, why does it need money to continue existing?" Good question.

Transacting on the blockchain isn't free. For example, Ethereum operates on its own network and to transact on that network, you have to pay gas fees for each transaction. Gas fees are just like tolls. If you're traveling on the highway and it's congested, you'll pay a higher toll. If it isn't as congested, you pay less. Gas fees operate the same way.

Each time a DAO performs an operation on the blockchain, it is required to pay a fee for doing so. That said, a DAO needs funding to operate. But how does it fund itself? One way a DAO can raise funds is by issuing tokens—similar to a company that raises money by issuing stock or bonds. So, when a DAO is formed, it offers its tokens for sale to its members and the public that wish to become a part of it. Purchasing tokens for a DAO is like purchasing stock with voting rights. How many tokens you own determines the weight of your voting rights.

Publicly Traded Companies Are Similar to DAOs, but with Less Flexibility

To help understand how a DAO functions, think of a publicly traded company—let's call it XYZ. Like any other company, XYZ's operations are subject to, and governed by, its bylaws and articles of incorporation. A DAO is governed by the blockchain that it operates on, and the written code built into the smart contracts of the DAO. The code and the blockchain, just like the bylaws and articles of incorporation of XYZ, govern how the DAO operates.

XYZ is required to appoint a board of directors to govern how the company operates. These directors analyze XYZ's business objectives, and they vote on how XYZ will achieve those objectives (e.g., which CEO to appoint, how to spend money toward a new venture, whether to exit a particular market, etc.). Conversely, a DAO can be structured in several ways.

First, it can be structured so that its members elect a committee similar to a board of directors that can decide on the DAO's objectives and future direction. Second, a DAO can bypass having a board and have its members vote on how its directives are achieved, which directives should be pursued, which should be retired, so forth. With this structure, members could vote on whether the DAO's current board of directors are fit to continue leading the DAO. This is similar to an annual shareholder meeting where if XYZ was presented with an offer to be bought by another company, the shareholders could vote on whether to accept the offer.

And if neither of these two structures are agreed upon by the members of the DAO, the community can come together to formulate their own unique structure that best serves their objectives. In short, DAOs can be structured in various other ways other than publicly traded companies. As DAOs evolve, the complexity of their code, the smart contracts governing them, and the creativity of their community members will determine their governance structure.

Pros of Using a DAO for Corporate Governance

It may appear that except for operating digitally, a DAO is nearly identical to existing corporate governance structures. While that might be right, there are a few nuances that separate DAOs from traditional corporate governance models.

First, and perhaps most importantly, because a DAO operates on a decentralized model, it is not located nor subject to attack in a single location. So, a strong positive aspect of using a DAO for corporate governance is security: DAOs cannot be pressured nor coerced to forcibly act in a given way. That said, unless the underlying blockchain on which the DAO operates is compromised, individual actors cannot intervene to overturn the decisions made by a DAO. Put simply, a DAO cannot be hacked. And when strong underlying principles govern a DAO, so long as its mission is morally and ethically sound, a DAO can be unassailable.

By contrast, a traditional company can be hacked in several ways: Digitally, financially, and most intriguing of all, via humans. Any individual, whether an internal or external influence, can persuade a key stakeholder or decision maker in a company and shift the company's directives, positions, or morals with one fell swoop. Granted, companies have safeguards in place that prevent such malfeasance. But the

possibility remains nonetheless.

Because a DAO operates strictly based on its written code and the artificial intelligence that interprets same, and because it lives on the blockchain, a DAO cannot be hacked. This is a huge advantage over traditional corporate governance models because it helps assure investors, stakeholders, and third parties that a company governed by a DAO will remain true to its objectives and will not be swayed by external influence nor interrupted by black hat hackers.

Cons of Using a DAO for Corporate Governance

Although a DAO decentralizes the governance process and "gives the power back to the people," that is not without its flaws and potential pitfalls. First, removing the decision-making process from the board room to the chat room convolutes and extends the same. For example, if XYZ's board of directors that were elected by the shareholders to represent their interests is limited to nine people, a decision could be made on a major company directive at one board meeting. But when that same decision is presented to thousands of people with varying shares of voting rights in a DAO, it is likely that the decision-making process will stall and be delayed.

Second, as of this writing, DAOs are self-regulated and are not subject to outside regulation. This can be a double-edged sword. For example, if the DAO is filled with good actors, then presumably, the DAO will pursue its objectives in good faith and not cause harm to others. But if the DAO consists of primarily bad actors that have ulterior motives, then it would be similar to an organized crime operation—with protective mechanisms in place to prevent them from being dismantled. Because DAOs are in their infancy and many regulatory officials do not understand them, it is unlikely that we will see regulations implemented against them in the near future.



> Why Bother with DAOs?

Overall, the use case for DAOs is still being developed. As the cryptocurrency and NFT community continues to evolve over time, and the rest of the world begins to take notice, DAOs will evolve in both form and function and will see greater adoption across various sectors. For now, DAOs have ample ability to create and foster communities and facilitate the achievement of objectives. As for the future, we'll have to wait and see.