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How Should the Law Classify Decentralized Businesses?



By Carla L. Reyes January 3, 2018

In July 2017, the Securities and Exchange Commission (SEC) issued a ruling on The DAO, a decentralized smart-contract based investment fund, determining that the tokens it sold were unregistered securities and warning that other initial coin offerings (ICO) may need to comply with securities laws.^[1] The DAO operated a decentralized venture capital firm on top of the Ethereum protocol. Investors contributed ether (a crypto-currency) to The DAO and received DAO tokens in exchange. The DAO held the ether in smart contracts, while the DAO tokens entitled investors to: (1) vote on which investment proposals to fund, and (2) a return on their investment proportional to the ether contributed.

Deep in the ruling, the SEC, in passing, called The DAO “an unincorporated association.”^[2] Although few paid much attention to the comment, it carries significant consequences for The DAO participants under business entity law. The DAO investors constituted a group of persons carrying on a joint association for the pursuit of profit. The SEC’s comment might be read to say The DAO was a partnership. As a partnership, The DAO’s participants would shoulder joint and several personal liability for any liabilities of the business, among other responsibilities. Such results, particularly when extrapolated to other business activity taking place on distributed ledgers, may lead to unexpected (and, at times, undesirable) outcomes.

Although decentralized autonomous organizations often come to mind as the vehicle for operating a business on top of a distributed ledger protocol, it is not the only vehicle. For instance, business activity can take place on distributed-ledger protocol smart contracts that do not rise to the level of a DAO (e.g., ICOs). Further, thinking broadly about the nature of a distributed ledger protocol itself, certain protocols might be considered a vehicle for business activity. Are all of these computer-coded business ventures partnerships? And as a policy matter, should they be?

Conceptually, an association of two or more persons in the pursuit of profit is a partnership, regardless of whether that association occurs through a DAO, a smart contract, or a distributed ledger protocol. The wrinkle in the decentralized ledger space is that many of the people participating in these activities are consumers with no intent to pursue profit or assume joint and several liability with other consumers. Further, many of the participants that did intentionally join the association for business purposes joined in the context of peer production, explicitly choosing (they thought) not to form a partnership. Thus, although the partnership form may fit well for some distributed ledger-based business entities (like, say, The DAO), others will struggle under that mold.

So why not form an LLC or corporation? For some distributed-ledger based businesses, an LLC or corporation may work if the businesses can satisfy the elements of one or both of those entities (e.g., natural persons must serve as directors, in the case of a corporation). Other distributed ledger-based businesses, however, will be fully autonomous and will not find a home, either technically or philosophically, in either of these statutory forms. Are such businesses doomed to the joint and several liability and other potential drawbacks of a general partnership?

In the past, when technologies allowed for business models that statutes did not contemplate, entrepreneurs turned to a business trust, which is created by a trust agreement that provides for the management of assets for a business purpose. Participants contribute the assets to the trust in exchange for trust certificates. Those certificates enable the participants to elect the trustee (or board of trustees) and receive a return on those assets. Trust certificates do not entitle their holders to manage the business. Rather, all management authority is vested in the trustee (or board of trustees) who must manage the trust assets on behalf of, and for the profit of, the trust certificate holders. The trust certificate holders enjoy limited liability, and many states attribute to business trusts the same rights and responsibilities of corporations, including legal personhood.

In the context of The DAO, if its tokens had enabled their holders only to elect a group of fund managers who determined which investment proposals to fund, The DAO could have been structured as a business trust. Other forms of ICOs might similarly adopt a business trust structure, where the smart contract acts as the trustee, automatically fulfilling its duties by operation of code. The ability to create and maintain such legally recognizable entities may help create more regulatory certainty and may enable new pathways to compliance. Exploring the ability to map the business trust structure at a more abstract level of distributed ledger protocols may offer insights for distributed ledger technology governance more generally.

To be sure, significant practical hurdles remain before we see a large-scale rise of decentralized business trusts, including questions of jurisdiction and the nature of fiduciary duties. Further, decentralized business trusts may create new negative externalities such as a continued shift in business culture toward heightened risk, heightened economic returns for the few at the expense of the average worker, and decreased diversity.

Ultimately, it is clear that a new wave of decentralized businesses is on the way and strong policy reasons exist to develop a robust menu of business entity structures for such businesses. Meanwhile, the legal regimes surrounding each type of entity should prepare to be challenged with key questions over fiduciary duties, legal personhood, the extent of limited liability, and investor protections in the context of decentralized business ventures.

ENDNOTES

[1] Securities & Exchange Commission, Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, S.E.C. Release No. 81207, 11-15 (July 25, 2017).

[2] *Id.*

This post comes to us from Carla L. Reyes, faculty associate, Berkman Klein Center for Internet and Society, and visiting assistant professor, Stetson University College of Law. It is based on her recent paper, “If Rockefeller Were a Coder,” available [here](#).

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