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Emerging Issues in Decentralized Governance and the Lessons of Corporate Governance

While recent gyrations in cryptoasset markets have focused attention on the future contours of stablecoins, market-making, and impending regulation, another feature of the blockchain landscape is also confronting noteworthy challenges. Specifically, a new breed of business organization has emerged that is defined by its rejection of the centralized, traditional governance structures at the heart of our modern corporations. These decentralized blockchain-based organizations are conducting a substantial, growing volume of business activity, and many are encountering a variety of governance challenges. Some of these challenges are novel, but many others strikingly resemble those that corporations have confronted for decades. We believe that governance design for these organizations should heed some of the hard-fought lessons that have helped to form the pillars of modern corporate governance.

Blockchain networks that allow the limitless programming of computer code (such as Ethereum) enable software developers to create business applications that run without the need for further human administration. A prominent example is Uniswap: a decentralized application that enables the trading of cryptocurrencies through an automated market-making function, with more than $1 trillion in trading volume to date. Decentralized trading exchanges like Uniswap are but one flavor of business activity using decentralized blockchain protocols. Among other examples, there are popular decentralized applications for collateralized lending and even more sophisticated financial applications.

Very often, these protocols are controlled not by a central managerial authority or corporate organizational documents, but rather by a diffuse group that governs the protocol by referendum, in accordance with parameters built into the computer code. Blockchain applications governed in this manner are known as Decentralized Autonomous Organizations ("DAOs"). Typically (as in the case of Uniswap), the right to vote in a DAO's governance is based on ownership of a cryptoasset known as a "governance token," akin to voting rights in a corporation. There are thousands of DAOs of varying design, from simple single-purpose organizations, to elaborate formats melding governance by DAO tokenholders with traditional corporate forms. DAOs collectively hold billions of dollars of assets and can conduct business at significant scale — for instance, by pooling participants' capital, by transacting or investing in both cryptoassets and other assets, and by interacting with other blockchain protocols and DAOs, all without centralized management or the involvement of traditional legal entities.

For all the intriguing potential of the DAO organizational form, it is worth remembering that traditional corporations benefit from a modern system of corporate governance that is the product of carefully honed statutes, sophisticated jurisprudence, and battle-tested practice, which together offer consistency and predictability that redound to overall social benefit. Conversely, nascent DAO governance models vary in the extreme and — although often very thoughtful in design — frequently pose practical challenges that already have been confronted in the domain of corporate governance. For example:

- DAOs' tokenholders and developers do not owe — or have the benefit of — fiduciary duties, and conflicts of interest may abound without adequate safeguards;

- Some DAOs require frequent technical decision-making by non-experts, with attendant inefficiency and risk of low voter participation;
- Although there are nascent efforts to recognize DAOs as legal persons (*e.g.*, Wyoming has enacted a DAO statute), there is a risk that some DAOs could be found to have the legal status of general partnerships, exposing founders and tokenholders to unlimited liability;
- Some DAOs form traditional business entities to conduct important operations (*e.g.*, banking, hiring employees, retaining service providers, etc.), but this practice poses many legal and regulatory questions;
- Many DAOs enable unchecked voting-related activity, wolfpack-like activity, solicitation activity, and undisclosed voting arrangements;
- DAOs often have unclear or suboptimal dispute resolution mechanisms; and
- Computer code may be susceptible to design flaws, cyberattacks, and exploitation, and the inherently decentralized governance in DAOs may impede adequately nimble responses to a security crisis.

If DAOs are to be deployed on a large scale as blockchain technology expands to important areas of the economy, it will be critical to reckon with challenges like these through the development of appropriately tailored code-based rules, best practices, and, where applicable, laws.

Select design elements from the carefully constructed edifice of modern corporate governance may provide at least a partial blueprint for DAO governance. For example, consider the concept of a proxy season: Although public corporations occasionally hold special meetings, they have a single proxy season and rules prescribing reasonable notice procedures and ownership thresholds for proposing business at a meeting. A corresponding best practice for a DAO — in lieu of a relentless dribble of referenda — could be to hold non-emergency referenda only at reasonable periodic intervals following adequate notice and based on reasonable ownership thresholds. More broadly, aspects of the New Paradigm for Corporate Governance, designed to foster long-term value creation for all stakeholders, may also provide valuable guidance to DAOs to address the interests of tokenholders and broader stakeholders as well. (Reciprocally, blockchain technology may eventually yield innovations that could benefit traditional corporations' governance, such as by streamlining some of the mechanisms of the U.S. proxy system.)

We do not contend that all features of modern corporate governance bear precise applications in the DAO context. But good governance over business organizations is a vital social good, and the dynamics that produced these features have analogues that merit serious consideration in seeking to optimize DAO governance. Much like our modern corporate governance best practices, DAO governance practices warrant ongoing examination and fine-tuning in pursuit of sustainable long-term value for tokenholders and other stakeholders alike.

A final thought is worth underscoring. Today, DAOs look innovative and novel. But from the perspective of business history, they are just the latest example of dynamic market activity. The fundamental purpose of enabling corporate law statutes like Delaware's and of the business judgment rule is to ensure that business leaders can innovate and can take risks without fear of undue liability or inhibition. The American corporate law model has facilitated creative business development in cutting-edge industries for generations, while providing credible and important protection to investors, creditors, and other stakeholders. That model can be adapted by DAOs in a manner that allows their economic potential to flourish but that answers important questions about their value to their investors, stakeholders, and society.

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