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Industry Information

Bridging the Gap – How Trusts Can Give DAOs a Foothold in the Traditional Economy

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What started out late last year as an internet meme, ended with a pool of \$47 Million worth of crypto currency raised by a virtual community who came together to buy one of the original copies of the United States Constitution at an auction at Sotheby's. Although unsuccessful in their bid, the community – Constitution DAO - was able to raise a record amount in just a few days.

More followed. PleasrDAO pooled their funds to buy the sole existing copy of the album "Once Upon a Time in Shaolin" by the Wu-Tang Clan for a sum of \$4 million. PleasrDAO is also the owner of the original "Doge" meme non-fungible token (also worth about \$4 million) together with a sizeable portfolio of other rare collectables. And in the world of professional sports, The Krause House (named after the architect of the Chicago Bulls' golden era in the 1990s) formed with the intention of seeking majority ownership of an NBA franchise with rights to both equity and influence in governance.

At the time of writing, the top 20 DAOs hold a combined value of about US\$14 billion worth of digital assets, with many predicting that DAOs will become the "next big trend" and will soon be able to compete with more traditional forms of fund-raising models and business structures.

What is a DAO?

A DAO is a Decentralised Autonomous Organisation formed using blockchain technology combining coins or tokens to raise funds and equity, and smart contracts to carry out its aims. Coin or token holders are effectively shareholders, smart contracts set out the rules (similar to a company's memorandum and articles of association) and the purpose of the DAO.

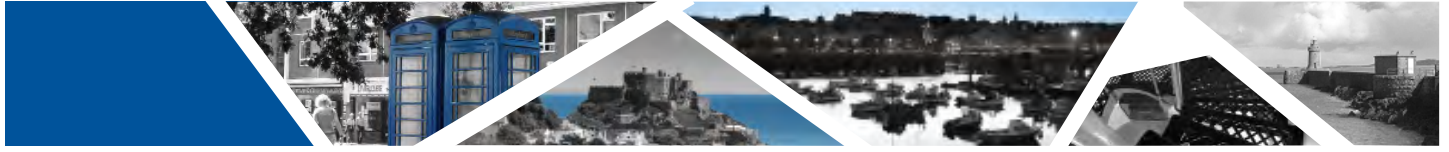
The Blockchain serves as the underlying foundation upon which these organisations are built with the novel technology acting as the main point of coordination to facilitate economic transactions and social interaction. The technology and use of DAOs are still evolving, and so far DAOs are being used for a variety of purposes, including investment, licencing of intellectual property rights, philanthropy and collection of valuable assets.

How do DAOs work?

A DAO relies on smart contracts that automatically execute transactions on Blockchain when certain conditions are fulfilled. The smart contract contains the organisation's rules and protocols as well as provide for the creation and distribution of native tokens. Smart contracts can also send and receive funds without relying on a human-driven intermediary.

Membership to the DAO is acquired upon the purchasing of tokens, typically with Ethereum (ETH). Voting rights are generally attached to the tokens and decisions regarding the DAO (including expenditure and allocation of funds) are typically made through proposals voted on by the token holders.

Taking The Krause House (mentioned above) as an example, the first round of funding was achieved by selling NFTs consisting of their Genesis Edition Tickets, giving members access to a members-only forum and an allocation of their ETH based tokens called \$KRAUSE.



Through the forum members discuss and vote on decisions, and if successful in their objective of ultimately buying an NBA franchise, have committed to using the same platform to make operational decisions including general management, ticketing, merchandising and partnerships. Although the Krause House may have some way to go before being able to realise their ultimate objective, they were able to reach their initial funding goal of 1,000 ETH (valued at around US\$4.3 million at the time) relatively quickly and at present they already have thousands of members.

Legal Status of DAOs

One of the practical obstacles for DAOs is that they exist entirely in digital form - they have no legal personality or existence. Whatever the value or objective, a DAO is essentially a collection of computer code and data on Blockchain. To date, the state of Wyoming in the US was the first jurisdiction that provided legal status to DAOs pursuant to the framework of a Limited Liability Company, commonly referred to as the DAO LLC.

The DAO LLC is not the ideal solution as it fails to meet the requirements of decentralisation. This potentially creates problems for DAOs, which require some form for legal personality to bridge the gap between the digital world and the traditional economy, particularly on the regulatory front.

Bridging the Gap

Another way of establishing legal personality for the DAO and to bridge that gap between the digital and traditional economy is by using a Guernsey purpose trust as an executory solution, into which traditional assets such as shares can be settled. Certain DAO communities, for example, can use a purpose trust in which no individual members have a beneficial interest, but the trust instruments can articulate the DAO community's purposes and set out its objectives, regulations, and voting mechanisms.

Jersey and Guernsey laws allow a trust to be established to further either charitable or non-charitable purposes. Both Jersey and Guernsey laws also permit the establishment of hybrid trusts which mix charitable and or non-charitable purposes and or beneficial trusts. With hybrid trusts it is possible to have both purposes and beneficiaries or, if desired, the option to add beneficiaries at a later date if needed.

Creation of a Purpose Trust

A trust is a legally binding arrangement whereby, typically, one person (known as a settlor) transfers assets to another person (known as a trustee) to hold for the benefit of certain other persons (known as beneficiaries) or for a specified purpose. Trusts are highly flexible and can be adapted to the settlor's needs depending on the circumstances of the case. The settlor can either be one of the beneficiaries or even one of the trustees. Neither Guernsey nor Jersey trusts require the registration of trusts at either the Guernsey Financial Services Commission or at the Jersey Financial Services Commission respectively, thereby maintaining the DAOs integrity of decentralisation.

A purpose trust is created when assets are vested in trustees for specific purposes. "Purpose" is very broadly defined under both jurisdictions trusts legislation with slight differences between the two laws.

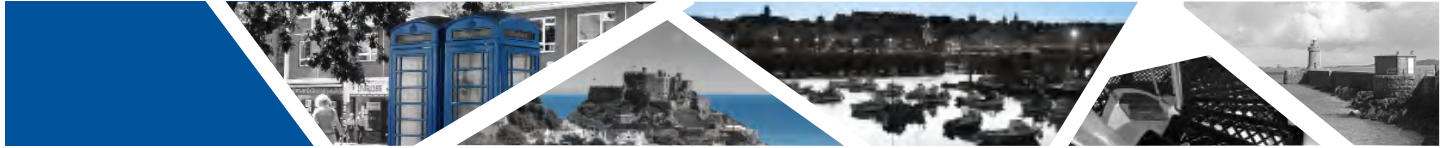
Under the Trusts (Guernsey) Law, 2007, "purpose" means any purpose whatsoever, whether or not involving the conferral of any benefit on any person, and includes, without limitation, the holding or ownership of property and the exercise of functions.

Under the Trusts (Jersey) Law 1984, "purpose" means any purpose whatsoever whether or not (a) involving the conferral of any benefit on any person; or (b) consuming or capable of consuming the income or capital of the trust, including without limitation the acquisition, holding, ownership, management or disposal of property and the exercise of functions.

Under Jersey and Guernsey laws purpose trusts must have the same legal certainties as are required in relation to any Guernsey law trust. Accordingly, with reference to the DAO community there must be absolute certainty as to the:

- DAO community's intention to establish the purpose trust;
- property to be held on trust; and
- purposes for which the purpose trust is being established (see further below).

A purpose trust must not be so uncertain that its performance is rendered impossible, contrary to public policy, or immoral.



The settlor

As mentioned, the settlor is the person who creates the trust by transferring certain assets to the trustees for a specified purpose. One of the issues posed when a DAO community creates a trust is the identification of the settlor(s). With DAO communities generally comprised of thousands of members scattered across the globe; the majority of whom go under pseudo names; and having the ability to freely join and leave the communities, creates certain regulatory problems when it comes to identifying source of wealth and source of funds. One of the ways in dealing with this is to have a more traditional form of business, generally the technology development company, create the trust with the aim of furthering the purposes of the DAO community. There is no requirement on the type of traditional entity to be used or where this entity should be based, however depending on the purposes and assets to be settled onto trust it is advisable to procure the necessary expert advice.

The trustees

A purpose trust, like any other type of trust under Guernsey and Jersey laws, must have trustees who will hold the settled property on trust subject to the powers and duties set out in the trust instrument and the law. The benefits afforded by both Guernsey and Jersey trust laws are that there are no requirements that the trustees should be based in the Channel Islands and DAOs are free to select their preferred trustees whoever they think are most suitable irrespective of where they are resident.

The DAO community will typically elect members of the community to act as trustees, (generally between three and five). The DAO community can then direct the trustees by majority vote (in accordance with the community's governance protocols) to exercise certain powers (generally the giving of grants, execution of a specific transaction, or the acquisition of certain assets) to further the purposes of the trust and ultimately the community. The DAO community's communication with and direction of the trustees can remain digital (using snapshot or any other community approved digital communications platform) as well as the trustees' communications inter se and the exercise of their powers.

The trust is flexible enough to allow for the DAO community to draft bespoke terms, including (a) determining exactly how much discretionary powers are given to the trustees; (b) powers to amend the terms of the trust deed or its purposes; (c) establishing trustees' voting procedures where more than one trustee is appointed; (d) powers of appointment and removal of trustees from office; and (e) rights to disclosure of information relevant to the trust to ensure full transparency.

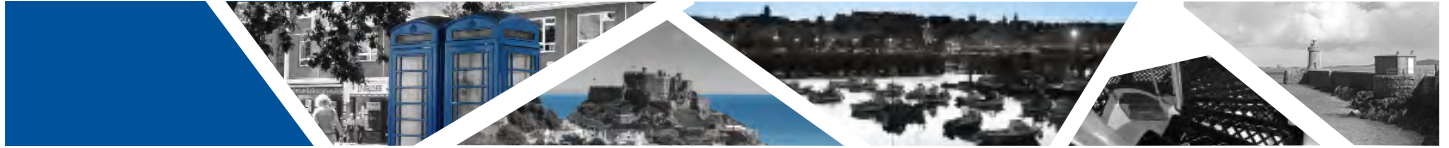
Notwithstanding their contractual obligation under the trust deed, the trustees are also legally bound by their fiduciary duties to advance the purposes of the trust providing further comfort to the DAO community that their ultimate objectives will be fulfilled.

The enforcer

One of the distinguishing features of a purpose trust is that an enforcer must be appointed to ensure that the trust assets are used in accordance with the objectives and rules articulated in the trust documents. The enforcer – who cannot be one of the trustees - acts as an additional check and balance on the trustees' powers. Not only does the enforcer enforce the terms of the trust, but they also have power to appoint and remove trustees subject to the consent of the DAO community. This effectively means that under certain circumstances the DAO community may appoint and remove trustees through the enforcer appointed by the DAO. Again, there are no rules under Guernsey or Jersey laws that require the enforcer to be resident in the Channel Islands and the DAO community is free to select any person who they think are most suitable for this role irrespective of where that person is resident.

The enforcer must not profit, directly or indirectly, from his office unless the terms of the trust permit such profit or unless such profit is sanctioned by the relevant Courts in either Guernsey or Jersey. As is the case in relation to professional trustees, express provision is usually made in the terms of the trust instrument for payment of a professional enforcer's fees and expenses.

The enforcer has the same rights as a beneficiary to see documents which relate to or form part of the trust accounts. It is possible to include more extensive rights in the trust documentation however from our experience, DAO communities limit the enforcer's rights to powers of removal and appointment of trustees and rights to disclosure of information for the benefit of the DAO.



Purposes

The non-charitable purposes must be clearly drafted so that they are legally valid and administratively workable. In respect of purpose trusts set up in the context of a DAO, the purposes must fulfil the intentions of the DAO community and must be drafted so that the trustees and the enforcer each understand and are able to fulfil their duties/functions under the terms of the purpose trust. Any ambiguity as to what is intended or whether a particular action is within a particular purpose may render a purpose uncertain and possibly the whole trust invalid. It is therefore suggested that expert advice is procured to ensure the trust is administratively workable and does not fall foul of relevant laws and regulations.

Conclusion

The use of purpose trusts - and specifically Guernsey or Jersey purpose trusts - solves an issue that confronts DAOs about bridging the gap between the digital world of smart contracts and crypto-currency, and the traditional economy. Our Guernsey team has experience of using these structures in practice, having worked with onshore counsel in respect of a trust established for Terra, a DAO which has agreed a five-year, \$38.15 million partnership with MLB team the Washington Nationals. Please get in touch with any of the authors or contacts listed below to discuss any questions about the use of trusts by DAOs.

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