

# DAOS IN FINANCIAL DISTRESS

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## ABSTRACT

Decentralized blockchain-based organizations with automated governance and operation systems (more often called decentralized autonomous organizations or “DAOs”) come in varying forms, ranging from loosely-structured distributed collaborations to sophisticated structures resembling traditional businesses. Yet, their novel attributes have raised a plethora of novel and as yet unsettled legal conundrums. While, to date, much attention has been paid to issues of governance and liability involving these entities, a related question has been largely unexplored: what happens if a DAO can’t pay its debts?

This issue is easy to overlook in bull markets, but the crypto winter of 2022 has shown us how quickly tides can turn. If the market falters again, we can expect some DAOs to follow the lead of crypto giants like FTX and Voyager Financial by resolving their distress in U.S. bankruptcy courts. But even in the absence of a cataclysmic market shift, DAOs might find bankruptcy an attractive forum to achieve other ends, such as addressing legal liability. Not only that, but a DAO’s creditors, which might include its tokenholders, could find the threat of involuntary bankruptcy to be a powerful lever to drive governance decisions.

This Article explores the intersection of DAOs and the U.S. bankruptcy system. We begin by examining the intellectual foundations of DAOs, exploring how they shaped the development of these novel entities and continue to influence their community. We then survey the current landscape of DAOs, documenting the broad range of economic activities they pursue as well as the vast array of governance models they implement by leveraging blockchain networks, smart contracts, and digital assets. To navigate this remarkable heterogeneity and lay the groundwork for our subsequent bankruptcy analysis, we distill our focus to four key aspects of DAOs critical to

insolvency proceedings: corporate form, ownership structure, management, and creditor relationships.

With that framing, we then examine arguments on the applicability of bankruptcy law, which offers distressed businesses orderly rehabilitation or liquidation options, but assumes conventional management and debtor-creditor frameworks. The enormous diversity in DAO ownership structures, governance models, and operational processes yields a spectrum of potential outcomes when DAOs meet bankruptcy law. At one end, DAOs that embrace automation and distributed governance technology while remaining open to more traditional corporate-esque operating structures may be able to access the bankruptcy system with some creativity and compromise. At the other end of the spectrum, DAOs that choose not to engage with the law for their corporate form, while implementing highly decentralized and automated governance models, are simply incompatible with numerous core standards and rules of the centralized, court-supervised insolvency process.

We conclude by proposing a framework for evaluating DAO bankruptcy. Our aim is to offer guidance to policymakers, courts, and founders to navigate the uncharted waters where DAOs meet bankruptcy.