Due diligence in M&A transactions involving DAOs

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M&A transactions are usually preceded by due diligence procedures, including legal due diligence, in order to identify the risks of the intended deal, evaluate the situation of the target company, confirm its assets and verify the existence and the amount of contingencies/liabilities. The result of the due diligence procedure serves as a basis for informed decision-making, and the structuring and negotiation of the terms and conditions of the deal.

In this context, the scope of the legal due diligence encompasses not only the target company but also its subsidiaries, controlled or invested ones, taking into account the risks, contingencies, and liabilities that may impact the business as a whole.

In a scenario where the target company owns tokens granting it the right to be a DAO member, observing the rules provided for in its governing documents as well as its smart contracts, how to evaluate this ownership and potential risks deriving from this asset still not regulated?

Assuming that smart contracts are protocols stored on a blockchain, which contain the rules for the conclusion of financial transactions and other even more complex transactions automatically, and without the necessity of intermediaries to guarantee their execution, smart contracts and other documents of DAOs must be analyzed during the due diligence, in order to understand what are the rights and duties of the target company owning the governance token of a DAO, its purposes, the investments or actions conducted by the DAO, the quorums to modify its rules and characteristics, the exit possibilities, among others.

As for the rights, we emphasize the possibility to receive profits from investments in companies or proceeds from the sale of assets, whether they are shares in companies, intangible virtual assets, or real-world ones.

The assessment of potential liability risks for the owner of DAO tokens may be challenging during a due diligence, to the extent that, as DAOs are mostly deprived of legal personhood, they may be considered as a "*sociedade em comum*" (similar to a general partnership), so that all members are jointly subject to unlimited liability for the obligations of the DAO. In some cases, it can already be seen the development of DAOs wrapped by types of companies whose liability regimes are limited.

With regard to its purposes, DAOs may be, for instance, investment, social or philanthropic ones, and the due diligence shall verify if the DAO's documents are in accordance with the intended purpose, as well as the investments and businesses that are being carried out.

Bearing in mind DAOs' decentralized nature, the decision power of a member is limited to the number of votes that its tokens denote, thus being bound to the decision power of a majority of token owners stipulated under its rules. Nonetheless, some cases may have rules allowing any member, if desired, not to participate in certain businesses the member is in discordance with.

As the owner of tokens only has access to its own transactions via its e-wallet and, in the case of a DAO without legal personhood, the owner is unable to know the identity of the other members and, consequently, from making voting or veto agreements, realizing a due diligence procedure on the other members of the DAO, including background checks, as may occur in traditional companies.

It is also necessary to understand the exit possibilities from the DAO, the rules for the restitution of the amounts eventually contributed, the rights and limitations on the transfer of the tokens' ownership, as well as the hypothesis of extinction of the DAO.

Despite the numerous advantages brought by a system based entirely on technology and self-executing rules, which ensure trustfulness in the decision-making regardless of the members' involvement, the urge to understand the characteristics and rules applicable to a DAO is not exempted. This is because due diligence pursue not only understanding legal risks, but also the businesses and the rights and obligations deriving from the assets acquired.

In addition to the legal due diligence, whenever dealing with a digital asset, it is recommended to conduct a technical due diligence, as long as the constitutive terms of DAOs often provide that the code is the law, so that if any failure occurs, or a disagreement with the written documents of the DAO, the code will prevail.

In sum, due diligence shall evolve for the assessment of technical, legal, and operational risks of digital assets.

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