

# Navigating Section 363 As A Decentralized Autonomous Org

By **William K. Pao, Laura Smith and Emma Persson** (June 16, 2022)

They are all the rage: People are forming decentralized autonomous organizations, or DAOs, as vehicles to purchase or bid on a wide range of assets — from NFL teams and golf courses to fossil-fuel companies and a copy of the U.S. Constitution.

Yes, following the announcement in November 2021 that Sotheby's was auctioning off an original copy of the U.S. Constitution, ConstitutionDAO was quickly formed and pulled in \$47 million from more than 17,000 people in less than a week to bid for the historic document.

Although the group ultimately lost out to hedge fund billionaire Kenneth Griffin, the short time it took ConstitutionDAO to raise capital, present a bid and participate in the process exemplifies some of the primary benefits of DAOs in competing in asset sales.

Then there was PleasrDAO — a "collective of DeFi leaders, early NFT collectors, and digital artists" — which purchased the only existing copy of the Wu-Tang Clan's "Once Upon a Time in Shaolin" album for \$4 million.[1]

DAOs do raise a number of questions about their appropriate legal status and tax responsibilities, and there are regulatory considerations too, but their fundraising capability is unquestionable.

So, what opportunities might they have to purchase assets from a distressed or defunct entity in bankruptcy? Can the benefits of a DAO be coupled with the Section 363 sale process to acquire assets free and clear under the supervision of a bankruptcy court? What are the advantages and disadvantages of using a DAO?

## What Is a DAO?

A DAO is a decentralized, autonomous investment or financial organization that is controlled by the organization's members rather than by a central corporate entity.

DAOs typically share several features:

- A bottom-up governance model built on computer code, with each member having a voice in the project's future and how funds are spent;
- The issuing of tokens to raise money for the DAO or to establish a governance protocol for the DAO — e.g., a token entitles a member to a vote; and
- Smart contracts that make decisions for the DAO automatically based on a computer code or consensus mechanism.

DAOs are rarely formal legal entities, unlike a corporation or limited liability company, and there is typically no CEO, board of directors or other management.



William K. Pao



Laura Smith



Emma Persson

## **What Is a Section 363 Sale?**

Section 363 of the Bankruptcy Code is the primary mechanism by which a debtor-in-possession or a trustee of a bankrupt entity may sell estate assets to a prospective purchaser.[2] A Section 363 sale is a court-supervised process, which affords a purchaser certain rights and protections that may not be afforded to a buyer in an out-of-court sale.

Under Section 363(f), sales of assets are free and clear of claims, liens, encumbrances, and other interests.[3] Purchasers who are found by a court to have acted in good faith may also be protected against the purchase being unwound on appeal.[4]

A Section 363 sale is typically quicker and more transparent than sales outside of bankruptcy. The debtor-in-possession or the trustee often proposes a condensed timeline for a Section 363 sale as outlined by specific bid procedures and a corresponding asset purchase agreement which has to be approved by the bankruptcy court.

The bid procedures provide the road map for conducting the sale, and they give the debtor-in-possession the flexibility to get the highest or best bid for the creditors' benefit.

Such procedures may also protect a stalking horse bidder — an initial, committed bidder, if one has been designated by the debtor-in-possession — and establish a floor for subsequent bidding. Such protections may include a break-up fee, typically from 1% to 4% of the purchase price, and an expense reimbursement provision, which is usually capped.

The stalking horse bidder also has the benefit of being first — able to negotiate the terms of the asset purchase agreement, which will serve as the form for subsequent bidders. These protections compensate the stalking horse bidder for the upfront time and expense of vetting the transaction while other bidders could outbid the stalking horse down the road.

The Section 363 process presents drawbacks for some parties.

One is the as-is, where-is nature of the sale of assets, which means that a debtor-in-possession or a trustee is usually in no position to offer representations or warranties about the assets it purports to sell — nor will there typically be any surviving entity to stand behind any representations. But the quick and as-is nature of the process is often balanced by the benefits of the bankruptcy court's free and clear order approving the sale.

Another drawback of Section 363 sales is that their transparent nature creates a greater risk that a prospective purchaser may be outbid. While competition presumably benefits the debtor and the estate, it does not help a purchaser who hopes to buy on the cheap.

Last, an out-of-court sale, as opposed to the Section 363 process, may avoid any negative effects of a bankruptcy filing on the debtor's business operations.

## **Can DAOs Bid in a Section 363 Sale?**

The Section 363 sale process presents some interesting issues for DAOs.

Since they can raise funds so fast, are they particularly well-suited to the Section 363 sale process? How should a DAO be structured to participate in a live auction? Who, ultimately, will be the decision maker for the DAO? How would a DAO consummate a Section 363 sale — who would have authority to execute the asset purchase agreement?

On the one hand, a DAO might be an efficient and rational player in a Section 363 process. The smart contracts implementing the DAO's purpose can quickly — autonomously and automatically — respond at decision-making points. That certainly could be an advantage in an auction, where the consideration is simply cash, like bidding for a copy of the Constitution.

But bids for a business are not always simple and predictable — they are not always apples-to-apples. Can smart contracts be written to contemplate oranges too? Can they account for assumption of certain contracts, treatment of employees and specific performance as a remedy?

If the coding cannot contemplate the twists and turns of a sale, it remains to be seen whether the voting rights that DAO members receive upon purchasing tokens will be sufficient to guide a DAO through a quickly moving Section 363 sale. This complication has been addressed in nonbankruptcy circumstances by DAOs designating limited decision-making authority to certain individuals.

The decentralized nature of a DAO may jibe with the disclosure and transparency of a Section 363 sale. A DAO could work well for buyers seeking anonymity, and, with a DAO, financial wherewithal can be easily established, as was the case for ConstitutionDAO. Also, a DAO's smart contracts are visible, verifiable and publicly auditable.

So, can a DAO become a successful purchaser with all the protections and benefits in a court-supervised process under Section 363?

The Bankruptcy Code protects from reversal or modification on appeal a sale or lease of property "to an entity that purchased or leased such property in good faith." But, a DAO is not an entity — though this hiccup may be addressed if a DAO uses, among other options, a Cayman Foundation, which is a popular structure that operates as a hybrid between a company and a trust.[5]

Also, the good faith finding looks at the integrity of the buyer's conduct and the anonymity of a DAO's members may present a hurdle to establishing the record necessary for such a finding. And anonymity may mean that the DAO cannot attest that the sale is not being made to an insider, which could subject the sale to greater scrutiny.[6]

The ability to enter the DAO's smart contract into evidence and the decentralized nature of the DAO's decision making may be helpful factors in these analyses.

If a DAO is the successful bidder in a Section 363 sale, the DAO's token holders should — because the DAO is typically not a separate legal entity — consider the implications of having partial direct ownership of the purchased assets. It may also be possible for the DAO's smart contracts to address these post-sale closing ownership rights.

## **Conclusion**

DAOs present unique challenges in navigating the Section 363 sale process.

Understanding the underlying legal nature of DAOs is critical to any analysis, and practitioners would be wise to closely monitor the legal issues surrounding DAOs, including their role in federal bankruptcy cases going forward.

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*William K. Pao is a partner at O'Melveny & Myers LLP and chair of the firm's fintech group.*

*Laura Smith is counsel at the firm.*

*Emma Persson is an associate at the firm.*

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[1] See PleasrDAO, <http://pleasr.org> (last visited June 13, 2022).

[2] See 11 U.S.C. § 363(b), (c).

[3] See 11 U.S.C. § 363(f).

[4] See 11 U.S.C. § 363(m).

[5] See, e.g., 11 U.S.C. § 363(m) (good faith purchaser must be an "entity"); see also *Barnes v. 309 Rte 100 Dover LLC*, 2020 U.S. Dist. LEXIS 209188, at \*21 (D. Vt. Nov. 6, 2020) (affirming, in relevant part, that a Member Group comprised of individuals and entities were good-faith purchasers under Section 363(m) of the Bankruptcy Code).

[6] See, e.g., *C & J Clark Am. Inc. v. Carol Ruth Inc. (In re Wingspread Corp.)*, 92 B.R. 87 (Bankr. S.D.N.Y. 1988) (sales to fiduciaries in Chapter 11 cases are not per se prohibited but are subject to heightened scrutiny because they are rife with possibility of abuse).