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Governance and structuring considerations in blockchain consortia

Blockchain consortia are helping many businesses make the most of their strategies and investments.

In this article, we discuss some of the high-level governance and structuring considerations that organizations should address at the outset to prepare for, join, and hopefully benefit from consortium membership. There are early decisions to be made, as well as financial, business, and technical areas that consortia members must consider—and agree upon—to become successful.

In the early stages of consortium development, there are four key considerations worth examining:

- Decision-making authority
- Funding and revenue-sharing
- Legal entity structures and risk
- Identification and ownership of intellectual property

In this, the third installment in our series on blockchain consortia, we discuss and provide insight into each of these areas.

Decision-making authority

The ability to agree, align, and execute on key operating decisions is typically a fundamental factor for the success of any consortium. Therefore, the mechanism for how these decisions will be made, how participants will vote, and the types of decisions participants are responsible for should be carefully considered and forcefully implemented.

Before the group can outline the rules of the road, two basic questions should be agreed upon: Why are we forming this consortium, and what are the overarching goals and value drivers for each member?

The consortium should have a clear mission statement—that the participant agrees to—which specifies that all decisions are being made for the good of the consortium as a whole, and not to further individual participant agendas. This holds true no matter how large or small the consortium may be and underlies the importance of creating a decision-making process that gives everyone a voice.

Keep in mind that you're setting up your consortium for sustainability and future growth, even if there are only a small number of participants coming together early on to test the value of the initiative. In this early stage, the goal should be to ensure that decisions are made in a manner that yields progression and momentum. For this reason, a simple approach such as "one plan, one vote" may make the most sense.

As the consortium grows, the decision-making approach will likely need to be reevaluated, as it may no longer reflect the needs of the participants or, indeed, be sustainable as a decision-making mechanism. Some participants may develop more influence than others, and this purely democratic approach may not accurately reflect the input that each member has on the group, whether that's through the amount of money, technological skill, or human resources they are providing.

In other cases, "one plan, one vote" may cause bottlenecks and slow momentum if decisions require validation from many participants. As such, we recommend designing a decision-making process that has strong foundations, clearly documented processes, and is "future-flexible" to adapt for growth and scale.

Closely related, and no less important, is to determine how the consortium will handle dispute resolution within the group. Because most consortium members are often, to some degree, competitors that are trying to work together to achieve a common goal, it will likely be uncommon for them to set their own agendas outside of the group that align perfectly with the goals of other consortium members.

As such, it can be critical to develop a process that can help the group avoid having each member's individual goals take precedence over the group's collective goals and to address disputes within the group in a manner that doesn't stop or bottleneck the consortium's overall progress.

In the end, the mantra for consortium members should be centered on creating a new "business as usual" atmosphere in which they establish processes for making decisions and handling disputes. Most importantly, however, is generally that each member of the group clearly understand these processes and agree to abide by them throughout their participation. This emphasizes other important responsibilities that each consortium participant has early in the process: Obtain a clear understanding of your individual company's long-term goals, align those goals with those of the consortium, and clearly communicate to internal leadership how these goals will coincide, or possibly conflict, with the company's goals.

Some key decision-making considerations

- How do we accurately classify decisions?
- Who can make decisions/has decision-making rights?
- How do participants vote on decisions and reach consensus as a consortium?
- How are decisions implemented and actioned?
- How are decision disputes, tiebreakers, or conflicts resolved?

Funding

Much of the success or failure of a blockchain consortium is tied to the complexities surrounding its initial and ongoing funding and to determining the commitments each participant will be expected to make.

Early on, it's fairly important to determine how funding of the consortium will be handled across the membership, particularly as members come and go. For example, say your business agrees to spend $2 million up front as part of a new consortium. If additional resources are needed or near-term goals are not met, do you have a clear decision path among members to acquire additional funding from new or existing members?

Similarly, funding situations may arise where the consortium develops new, innovative solutions requiring additional funds to develop. Inequitable investments among members could influence complicated models to control the prospective return and sharing once the new solution starts producing value. This same dynamic should be considered for new members joining because they have not contributed to historical development and may not have the same views of the value in the iterations to current state.

Conversely, however, businesses shouldn't consider giving a blank check to a consortium without first having a solid idea of what their ROI could—and should—be. There's no shame in consortium members looking out for their own financial interests when joining and funding a new initiative or wanting to develop a solid understanding of how quickly they should expect to see a return on their investments.

Building and running a consortium is a long-term commitment that requires constant maintenance as the organization and its intellectual property (IP) evolves. And, as in any other long-term endeavor, "ownership" of the consortium may change over time as new members are added and older members drop out.

Because of this, astute businesses should also develop an understanding of how their "shares" in the consortium may be diluted if other entities join the group and how expanding the consortium may affect both their financial commitments to the group and the potential for profit.

Should everyone receive equal shares of profits, or should only those consortium members that were active at the time the IP was created share in the profits of that technology? Aligning on a methodology can be critical during the development stage of the consortium. And beyond alignment, members should test the construct to help ensure it can be applied in a practical manner.

Some key funding-related questions

- Who is funding the consortium?
- Is there equal financial commitment from each participant and, if not, does financial contribution affect participant decision or voting rights?
- How are future profits and proceeds used vs. distributed if additional funding entities are onboarded?
- What are the funding requirements for new member onboarding?
- How will future funding participants be treated?
- Is there funding from external sources?

Legal entity structure

Vetting and implementing the right legal entity structure to support the consortium can be one of the most complex considerations in the design process. These considerations may require input from the business, tax, accounting, and legal.

Because consortia often include members based in various legal jurisdictions—whether in one country or in several countries around the world—it can be critically important to develop an understanding of the key concerns the entity is likely to face and the applicable regulatory frameworks.

While most consortia are legal entities separate and distinct from their members, examples exist of consortia formed as contractual agreements between the parties that govern the rights of developed IP, revenue sharing, etc. Participants must decide two key questions: What type of legal entity should be formed, and in which jurisdiction? Typically, prospective members look at the location of the people who would be running the business, but in this case, you may not yet know where those key roles will be located. And true to form in blockchain, the team is likely to be decentralized.

Consideration should be given to charting out the jurisdictions of the known or likely stakeholders—consortium members, management, customers, and influential regulatory bodies. Next, diagram—literally draw a picture of—the operating flows, and vet some of the impacts of the activities of a recommended entity type and jurisdiction:

- Applicability of withholding taxes of a dividend distribution from a consortium with entity type A, located in jurisdiction B, and whose members are treated as owners in jurisdictions X, Y, and Z
- Application of VAT to the transactions between the consortium located in country Q and dealing with customers who might be consumers or businesses located across 87 different jurisdictions
- The flexibility to redomicile the consortium if the regulatory environment shifts or if there are new consortium members who take issue with the historical jurisdiction of the consortium
- The tax implications to consortium members (considered owners) if they are domiciled in a jurisdiction that taxes worldwide income (inclusive of the consortium), regardless of distributions
- The financial reporting requirements and applicable attestation standards relevant to each consortium member
- Any accounting considerations for the consortium member, including consolidation or collaborative arrangement accounting, and applicable disclosure requirements

Some key structuring considerations

- Will consortium members establish a separate legal entity and, if so, where is the optimal jurisdiction; what is the optimal type; and will every member have equal participation, representation, and ownership?
- Is this consortium for-profit or not-for-profit?
- Are there any withholding taxes on distributions to owners?
- What banking relationships will need to be set up for the entity, and who will have access to those banks?
- Should a jurisdiction treaty network be considered for the consortium?
- Have the financial reporting requirements and relevant accounting been considered and addressed for each member of the consortium?

While the consortium may face many business issues over its lifetime, it's important not to design an overly complex structure that can have the effect of hindering the group's goals and progress. Consideration should instead be given to designing a comprehensive, yet lightweight and flexible legal entity structure with financial reporting requirements that can, at their essence, be explained using a simple whiteboard.

Intellectual property considerations

Since IP begins to exist in the ideation phase of consortium design, it can be critically important that this be addressed as early in the process as possible.

IP takes the form of technology, processes, or even just an idea. Members should decide the types of IP relevant to the consortium, how and with whom it will be shared, and who will take ownership of the IP. Once the structure of the consortium being created is decided, IP considerations should be addressed early in the development process. Ownership and protections can vary greatly, depending on whether the consortium is designed as a nonprofit or a for-profit organization, as well as the jurisdiction.

IP access and use are important considerations to be agreed upon by the members, some of whom may want to use direction and some who want to license it to others.

In cases where the consortium decides to license itself to earn a profit, it may be recommended that the consortium itself be incorporated into its own, stand-alone entity with access and profits attaching to its various members based on uniquely designed terms for them.

Consortium members should also consider how members are compensated based on any existing IP they may bring to the group at its creation. For example, if member A provides access to its preexisting IP, which is then modified or built upon by the consortium to create something new, does member A earn a greater share of the profits for providing the underlying IP? As the members address these questions, it is important to consider tax and accounting treatment of the agreements. These scenarios should be addressed in the earliest stages of creating a consortium.

Some key IP questions which drive tax and accounting considerations

- What type of IP could become relevant in the consortium?
- Who owns the IP and how much is shared vs. not shared?
- What happens when consortium members bring IP to the consortium?
- How are legacy consortium members compensated for the value of developed IP by new entrants to the consortium?
- Do any of the consortium members have preexisting patents or IP that might allow them to collect royalties for the consortium's future works and, if so, do ex ante disclosures need to be put in place?
- Where is the IP deemed to exist?
- Does the consortium need to have a separate legal entity to house the IP?
- What are the rules around copyright, trademark, patents, and confidentiality?

Conclusion

Like any key business decision, joining or forming a consortium is a very involved process. While there may be some element of uncertainty surrounding what the consortium may eventually produce—or evolve into—it's important to realize that there are serious business and governance areas that should be addressed early in the process. There can be value in pushing these decisions into the early stages to protect your individual organization's rights and IP and to develop the necessary business structures to let the consortium thrive and grow without undo interference or infighting among its members.

We see many examples of failed consortia because organizations ignored some of these key topics until they were too far down the path of consortium membership. A thoughtful approach that incorporates specialists who represent important consideration points early in the planning process and throughout setup (such as specialists for tax, cybersecurity, financial reporting, and IP protections) can mean the difference between success or failure for your consortium.

Further, it's important to understand that it typically isn't enough to merely vet the consortium's goals, membership, operating, business, and profit-sharing structures; you, and the consortium's other members, also must be true believers in the consortium's mission.

Joining a consortium isn't something organizations can try out for six months and then back out. It requires a long-term commitment with realistic time horizons, practical financial and material commitments, and achievable goals. If you're too aggressive, too optimistic, too uncertain, or unable to align your individual company's interests with those of the consortium, then the consortium is more than likely to fail before it ever has a chance to succeed.

With the right balance of due diligence, scenario planning, and alignment, the upside potential can be limitless. Consortia can help entire sectors to rise through the development of new marketplace efficiencies, greater transparency, and access to new markets.

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