

UK LAW COMMISSION CONFIRMS FLEXIBILITY OF THE COMMON LAW TO ACCOMMODATE SMART LEGAL CONTRACTS

Last week, the UK Law Commission (the “**Commission**”) published its much anticipated [advice](#) to Government on the application of the legal framework in England and Wales to support the use of smart contract technology. While there continue to be some potential areas of uncertainty about the application of smart contracts, particularly in the area of deeds and private international law, the Commission has concluded that the flexibility of the common law is capable of adapting to the likely range of legal issues and only incremental developments to common law are needed.

The advice follows a formal call for evidence, published in December 2020, to which Slaughter and May submitted its views, and expands on the November 2019 [findings of the UK Jurisdiction Taskforce’s \(“UKJT”\) legal statement on cryptoasset and smart contracts](#) which concluded that smart contracts are capable of giving rise to binding legal obligations, enforceable in accordance with their terms.

Key observations include:

1. Smart contracts can be used to establish legally enforceable relationships

Smart legal contracts, where some or all of the contractual obligations of a contract are recorded in and performed automatically by a computer program, can be used to enter into legally binding contractual relationships. Although some types of contracts, for example those concluded and ‘documented’ via distributed ledger (“**DLT**”) systems, may give rise to certain novel legal issues and factual scenarios, the Commission’s view is that the existing legal principles for contract formation, interpretation and remedies are sufficiently flexible to accommodate smart legal contracts.

2. Solely code smart legal contracts present the most complex challenges, but are unlikely to be in frequent use

The Commission divides smart legal contracts into three different forms, depending on the degree of automation:

- Form 1 - Natural language contracts with automatic performance through code
- Form 2 - Hybrid contracts with terms in both natural language and code
- Form 3 - Contract recorded solely in code

The most widely used form of smart legal contracts, natural language contracts with automatic performance through code (Form 1), tend not to raise novel legal issues. Businesses that intend to use code to automate specific processes within an accompanying natural language contract can be confident that the traditional rules of contract law apply. At the other end of the spectrum, automatically-performed contracts written entirely in code (Form 3) present new challenges for existing laws relating to contract formation, interpretation and remedies. However, the Commission points out that because commercial contracts tend to be highly complex, nuanced documents, the likelihood of concluding smart legal contracts solely in code is low.

3. Adopt the “reasonable coder” test

The Commission concludes that “coded terms can (and should) be susceptible to contractual interpretation.” Although there may be difficulties in ascertaining the meaning, and intended meaning, of code, the Commission considers that the “reasonable coder” test is the appropriate test to apply - ask what a person with knowledge and understanding of code would understand the coded term to mean. The Commission distinguishes this from asking what the code meant to a functioning computer and

suggests the “reasonable coder” test is more consistent with the existing approach to contractual interpretation. The advice suggests that expert coders could assist the court with its enquires in much the same way as a translator can assist the court to interpret a contract written in another language.

For businesses which have adopted, or are considering adopting, smart legal contracts the Commission suggests a number of natural language aids to interpretation. This includes a business process document or term sheet, natural language explanation of the code or even natural language comments contained within the source code. Parties should expressly state that the relevant explanation or comments form part of their legally binding agreement or incorporated by reference to ensure that the explanation of the code is taken into account.

4. Allocate risk for defective performance of code as part of the contracting process

Defective contract performance is a common occurrence regardless of the method of technology used to conclude a contract. The Commission does however raise the fact that smart legal contracts may increase the possibility of problems in the lifecycle of a contract, because of the comparatively high probability that code may performed in unexpected and unintended ways. Although the Commission suggests that the current range of remedies including rectification and termination should generally be available to affected parties (subject to technological limitations and the recommended inclusion of a “kill” switch in the code components of smart contracts), well-advised individuals and organisations should consider and cater in the contract for the possibility of their code having unintended consequences as well as the impact of external events.

5. Retailers wishing to adopt B2C smart legal contracts should avoid solely code smart legal contracts unless accompanied by a pre-contractual explanation of the coded terms

The Commission flags that coded terms of a B2C smart legal contract may not be considered “transparent” to a non-code literate consumer unless a natural language explanation accompanies the code. Retailers and others dealing with consumers should therefore consider including clear and informative pre-

contractual explanation of coded terms in any smart legal contract as well as a mechanism for consumers to bring the smart contract to an end.

6. Further consideration of deeds and private international law is required

On the whole, the Commission concludes that the current laws of England and Wales are sufficiently capable of accommodating smart legal contracts. However, some concern is expressed about the creation of deeds wholly or partly defined by code, and also about the application of private international law. The Commission has highlighted that further work may be necessary in these areas to support the use of smart contract technology.

Deeds

- It is not currently clear how a signature authenticating the coded terms of a deed could be witnessed and attested. Unless technology can be developed to allow a witness to record on a smart legal contract that the witness has observed the execution of the deed, it is difficult to see how this requirement can be satisfied.

Private international law

- Conflict of law rules are not readily applicable to smart legal contracts and similar technology such as DLT systems, because of the multiple connecting factors across multiple jurisdictions. The problem of ascribing real-world locations to digital actions and digital objects is proving to be a consistent challenge in relation to DLT as well as other emerging technologies. The Commission has highlighted a number of difficulties around determining the place of formation of a smart legal contract as well as the area of law that applies to resulting dispute.
- The Commission has already agreed to undertake a separate project considering the rules around conflict of laws in the context of emerging technology, including smart legal contracts. Work is anticipated to begin in mid-2022.

7. Smart clauses for smart contracts

As the market for smart legal contracts develops, the Commission anticipates that established practice and model clauses are likely

to be developed to simply the process of negotiating and drafting smart legal contracts however in the interim, the Commission has included a helpful appendix of issues that it recommends parties address expressly in their smart legal contracts to promote certainty and party autonomy. For example:

- The role of code, including any non-executable comments in the code, and whether the code and/or comments are intended to define the parties contractual obligations or only to perform them.
- If parties intend to create legal relations via a DLT system or similar, those parties should consider expressing this in natural language.
- The relationship between natural language and code and the order of precedence in the event of conflict or ambiguity between those layers of the contract.
- How risk should be allocated in the event of errors or performance issues with the code

e.g. a malfunctioning oracle, inaccurate data inputs, external events beyond the parties' control, bugs and coding errors and mistakes about the performance of the code.

- Designing the contract in a way that permits performance of the code to be terminated and/or suspended e.g. including a "kill" switch.
- Including a choice of jurisdiction and choice of laws clause.

Smart legal contracts have the potential to revolutionise the way that businesses engage with each other, and with their customers, across all sectors. This advice from the Commission provides welcome clarity on the future potential and adoption of smart legal (and enforceable) contracts in England and Wales and includes a number of practical guidelines for businesses to build into their smart legal contract platforms and processes.

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