

Smart Contracts And The Law: What You Need To Know

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More businesses are using automated “smart contracts” to handle transactions. Based on blockchain technology, these contracts execute automatically and are lauded as a way to efficiently digitize transactions.

But how enforceable are these contracts? Do they have any legal ramifications that could arise down the road? We’ll explore these questions here.

What are smart contracts?

First, it helps to know exactly what we’re looking at when it comes to smart contracts. These are not merely digitally signed agreements. Rather, they are computer programs based on blockchain technology. The terms of the agreement are handled through code, allowing their execution to be fully automated.

Any time a smart contract is drawn up, it’s stored as a block of data on the blockchain. Once the conditions of the contract are met, it then executes the terms. For example, in the case of a purchase agreement, once the agreed-upon product is delivered, the payment is released automatically.

Smart contracts are an innovative way to handle complex agreements, and they may even influence the shape of future contracts due to their automated nature.

Making Smart Contracts Enforceable

Given the unique nature of smart contracts and the ways they differ from traditional paper agreements, there are concerns surrounding their enforceability. In general, smart contracts are enforceable as long as they follow the basic rules of contractual agreements. These include the following.

1. Offer, Acceptance, Consideration

As with any agreement, there must be an offer, an acceptance of that offer and consideration. Put simply, these are defined thusly.

- **Offer:** One or both parties offer the terms of the agreement.
- **Acceptance:** Both parties accept the terms as offered (often after some negotiation).
- **Consideration:** There is something of value being offered to each party.

If any of these components are lacking, it is not a legally enforceable contract.

2. Legally Permissible Terms

In general, you cannot use a contract to bind parties to terms that are illegal to enforce. For instance, asking parties to waive certain rights that cannot be legally waived will likely nullify that section of the agreement. This may present a special challenge for smart contracts since making sure such terms are severable from the rest of the agreement—which cannot be edited once executed—may be more difficult than it would be with a paper contract.

3. Legal To Sign Electronically

Finally, smart contracts need to be legally eligible for electronic signatures. Some types of agreements cannot be signed electronically, including wills and other estate documents; court orders; product recall notices involving health and safety; documents required to accompany hazardous substances being transported; notices of cancellation of utility services; and eviction notices.

Most transactions involving smart contracts won't involve any of these categories, but it's still worth remembering what can and can't be signed electronically.

Legal Challenges Of Smart Contracts

Smart contracts execute automatically, and once they're set in place, they cannot be modified. These facts create some interesting challenges, particularly in the event of disputes or unenforceability.

Automatic Enforcement: If it turns out that the terms of a smart contract are not legal to enforce, it creates a more difficult situation than one would have with a traditional paper contract. Once the contract is programmed and agreed upon, it will execute automatically, which may lead to some difficulty in remedying any unlawful enforcement.

Modifying the Contract: Making modifications to the contract can also be a challenge, at least once it's set into motion. Once a smart contract is in force, it cannot be modified. This means if any changes are desired, the entire contract needs to be canceled and redrawn. For this reason, maintaining a backup copy of the code is recommended.

Handling Disputes: Due to the difficulty of adjusting a smart contract once it's in place, it's important for each party to be absolutely clear on the terms from the outset. The agreement needs to be treated as if it's going to be permanent from the very beginning, so great care should be taken to make sure it doesn't lead to disputes. If a dispute does occur, both the contract's permanence and automatic execution could pose a barrier to enacting changes.

Are smart contracts the future?

Smart contracts will likely become more widely used, and that may require a change of mindset. Those who are party to these agreements will need to adopt a more results-based outlook rather than maintaining an ideology that revolves around the malleability of paper contracts. It will ultimately change the way we create contractual agreements, which can have positive results in spite of the challenges it currently poses.

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