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Four Reasons to Put an Arbitration Clause in Your Company's Smart Contracts

By Jared Butcher on February 27, 2017
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Many in the blockchain industry expect smart contracts to enjoy significant (perhaps exponential) growth in real-world applications beginning this year. This was the general consensus at the industry's first ever Smart Contract Symposium in New York City this past December. More than 250 leaders in blockchain, finance, law, and other industries gathered at the Microsoft Technology Center to discuss and promote the adoption of smart contracts for commercial use. The Digital Chamber of Commerce followed up with a whitepaper identifying twelve business use cases for this technology, ranging from simple identity verification and payment processing to more complex processes like supply chain management and even cancer research.

The bottom line is smart contracts are coming (and may have arrived already for some). No doubt smart contracts will offer many benefits in terms of decreased transaction costs and increased transparency and security, but even the best-designed smart contracts may deviate at times from the outcomes anticipated by the parties and may have vulnerabilities that can be exploited by the parties or outsiders. So what happens when contract disputes arise? Particularly if you are in-house counsel (or if you count in-house counsel among your clients), how can you be sure that the historical best practices for dispute resolution will continue to yield optimal results? Or even tolerable results?

There is no blockchain for litigation (at least, not yet). For the time being, smart contract disputes will continue to be subject to traditional methods of dispute resolution. And although contract laws and the UCC are well established in most jurisdictions, no one knows for sure what will happen when the first such disputes enter litigation.

In coming months, we will address more of the potential issues that may arise when smart contracts go awry. The general focus will be two-fold: what can be done at the outset of a smart contract to reduce the likelihood of future litigation? And what are some approaches for reaching efficient and reasonable results when litigation does arise?

Today, we start by re-examining the question of whether arbitration is a preferable alternative to court. We offer four reasons why that may be the case, which are ensuring a knowledgeable decision-maker, protecting proprietary information, gaining flexibility, and pre-selecting the forum.

1. *Ensuring a knowledgeable decision-maker*: This point is not meant to be critical of courts, which obviously have a great deal of knowledge regarding contract disputes. It simply recognizes the fact that smart contracts, and their underlying technologies, are new and, in some ways, very different. An arbitration clause can be drafted to allow the parties to select their arbitrator(s), which at least creates the potential to have the dispute considered by someone with specialized knowledge of a specific industry or of smart contract technology in general (or both).
2. *Protecting proprietary information*. Smart contract disputes are likely to involve some issues that implicate proprietary systems and technologies. Arbitration typically offers privacy and limited discovery, both of which significantly curtail the risk that this proprietary information will be disclosed to competitors or the general public. Although courts have rules for protecting confidential information, the bar is often very high for parties that wish to avail themselves

of this protection. Even then, the back-and-forth of legal filings during the ordinary course of a lawsuit may publicize details that one or both parties would prefer to keep to themselves.

3. *Gaining flexibility in scheduling and procedures*: All of the ordinary pre-trial events and procedures may be unnecessary in smart contract litigation. Consider, for example, if the only issue is whether the code performed as designed and agreed to. Although expert testimony may be required, that evidence can be adduced without expending effort on a year or two of pleadings, discovery, and ultimately, summary judgment arguments. Properly drafted, an arbitration clause can expedite the process (but be sure to provide for summary disposition without a merits hearing, either in the arbitration clause explicitly or by incorporating arbitral rules that authorize this option).
4. *Pre-selecting the forum*: This is not about selecting the physical location, which can be achieved in court-based litigation through a standard forum selection clause. Rather, an arbitration clause can go a step further and select a specific arbitral body with expertise in technology disputes. For example, WIPO (World Intellectual Property Organization) offers mediation, arbitration, and other services geared towards technology disputes. And organizations like WIPO may have access to bigger pools of skilled neutrals to assist with technology-related disputes.

At the end of the day, the decision of court vs. arbitration continues to depend on the individual circumstances of the affected parties. Strategic reasons for selecting court may offset the benefits of arbitration. Still, it is a good idea to re-consider those benefits from the perspective of a potential smart contract dispute. And in so doing, don't assume that the usual procedures and precedents will apply or that centuries of traditional contract litigation in the courts necessarily make the results predictable when the element of blockchain technology is added to the mix.