

MFSA FinSights | Enabling Technologies

Smart Contracts – Legality?

The financial sector is continuously evolving through the rapid development and adoption of new technologies. The term 'FinTech' generally refers to financial innovation that seek to provide enhanced financial service offerings through the utilisation of enabling technologies. These generally include Distributed Ledger Technology & Smart Contracts; Artificial Intelligence, Machine Learning & Big Data, Cloud Computing, Web 3.0, Application Programme Interfaces and Micro-Services; Robotic Process Automation and the Internet of Things.

As part of the MFSA's initiatives to generate awareness, drive culture and deliver a cross-sectoral knowledge platform which can support the MFSA's functions in preparing for the financial services of tomorrow, these insights will delve into enabling technologies, enabling innovations and their sectoral applications.

1 Smart Contracts - Recap

Smart contracts may be best described as a computerised transaction protocol, implemented on Distributed Ledger Technology which applies **(IF, THEN) logic** to automatically execute the terms of a contract.

For further information on **Smart Contracts**, their features, benefits and risks refer to our [FinSight](#).

2 Are Smart Contracts Legally Binding?

2.1 Smart Contracts VS Legal Contracts

Although some platforms are presently incorporating smart contracts in the running of their operations, it remains unclear whether smart contracts may, for all intents and purposes, be recognised as valid contracts in terms of Maltese Law, or whether the smart contract is limited to perform administrative functions that are complimentary to or in addition of a traditional contract.

The importance of establishing whether a smart contract qualifies as a valid contract derives from the principles emanating from the Civil Code of Malta which establishes that contracts legally entered into shall have the force of law for the contracting parties. The implications of such a proviso are wide ranging since such a legal standing would enable contracting parties to, amongst others, resort to the remedies available at law in case of a defaulting contract.

From a reading of Article 960 of the Civil Code of Malta, one may denote that for a contract to have the force of law, the contract shall necessarily be an agreement or an accord between two or more persons by which an obligation is created, regulated, or dissolved. It involves a meeting of the minds wherein one person's offer is accepted by another person, resulting in unity of consents and ultimately a contract, which may then only be terminated or revoked by the contracting parties themselves or on such grounds as permitted by our laws. Article 966 of the Civil Code of Malta then provides that for a contract to be validly formed, it must satisfy the following elements: (a) the capacity of the parties to a contract; (b) the consent of the party who binds himself; (c) a certain thing which constitutes the subject-matter of the contract; and (d) a lawful consideration. In some cases, such as a contract of sale of immovable property, the law also stipulates that the contract must be drawn up following a particular form.

2.2 Legal Considerations

In light of the abovementioned criteria, one ought to take note of the following considerations when assessing whether or not a smart contract may be recognised as a legally valid contract between contracting parties:

- **Capacity**

In order to ascertain whether or not the parties to a contract possess the required capacity to enter into a contractual agreement, the identity of the parties must be clearly determined, which identity is, within the context of blockchain technology, easier to conceal. This may in turn impinge on the ability of the contracting parties to determine whether or not the other party to the contract has the required capacity to be bound by a contract.

- **Consent**

This is traditionally denoted as being the concurrence of the identical wills of the contracting parties, the rules on offer and acceptance will in principle not pose an obstacle to smart contracts' recognition as legally binding. However, it remains desirable to establish clear guidance on the elements necessary for the valid acceptance of such agreements as well as on whether cryptographic keys are tantamount to signatures under Maltese Law.

- **Subject-matter**

When dealing with the issue of whether the subject-matter of the contract is a thing which is certain, one may argue that this may only be guaranteed in the event that the parties to the contract fully understand the terms of the agreement. This may be problematic within the context of smart contracts since they are represented in code, and therefore fail to be clear unless one is well versed in programming. Such issue may be addressed by requiring that a smart contract is accompanied by a natural language contract as is the case in terms of the ITAS Act.

Smart contracts, and the protocols supporting them, may indeed satisfy the essential requirements of contract law to constitute a legally valid contract. However, on a practical level, they are likely to fall short from recognising intrinsic issues which may affect them. One also has to bear in mind the issues which may surface when dealing with a decentralised entity, in terms of inter alia, whether such entity may be considered as a legitimate counterparty to a contract. One may argue that the legal certainty denoted to electronic contracts is not, as of yet, present in the context of smart contracts and that such legal certainty may only be achieved through legislative intervention. However, one may conclude that at present the practical application of smart contracts may need to draw on traditional practical solutions to address disputes.

Supplementary Reads...

MFSA FinSight | [Smart Contracts](#)

MFSA FinSight | [Distributed Ledger Technology](#)

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