Kluwer Arbitration Blog

Arbitration of Smart Contracts Part 3 – Issues to Consider When Choosing Arbitration to Resolve Smart Contracts Disputes

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This post, which continues the topic considered here and here, discusses the main issues to consider when choosing arbitration to resolve smart contracts disputes, and lists a number of red flags that emerge from a survey of white papers on arbitrating smart contract disputes prepared by the tech community.

(1) The Form of Smart Contract

As discussed by R3 and Norton Rose Fulbright here, there may be legal risks in some jurisdictions with having the smart contract entirely in code language. Accordingly, we advise parties to have a hybrid version of smart contract (sometimes called "**Ricardian Contract**") whereby there is a text-based version of the same force in addition to the encrypted-coded-language smart contract. Further, Article II of the New York Convention requires an agreement to arbitrate to be in writing. In addition, the New York Convention requires an agreement to arbitrate to be signed unless it's in the form of exchange of letters or telegrams. The definition of "an agreement in writing" and "signing" is interpreted differently across the various jurisdictions. It's difficult to predict whether a smart contract encrypted in code would satisfy these requirements beforehand. Therefore, smart contracts run the risk of not being enforced under the New York Convention, unless they have an equivalent traditional word-format contract signed by both parties.

(2) The Seat of Arbitration:

Parties to smart contracts should prioritize their choice of the seat of arbitration. In essence, a seat of arbitration underpins the legal framework controlling all legal aspects of the arbitral process. As discussed by Clyde & Co here, the seat of the arbitration will normally determine the law applicable to the procedure of the arbitration as well as the involvement/ intervention, as appropriate, which the courts of the seat, will have. Also, the seat of arbitration will determine the arbitrability of the subject matter of the dispute. Unfortunately, some jurisdictions are not "arbitration-friendly" as they have laws which restrict party autonomy, for example, by allowing the courts to intervene extensively in the arbitral process. On the other hand, some jurisdictions' laws are relatively "arbitration-friendly" and allow the parties a high degree of procedural autonomy. Whether an arbitral award may be challenged will be determined according to the seat of the arbitration. Further, the extent to which judicial review is available to parties will be dependent on the law of the seat of arbitration. Also, the law of the seat of the arbitration will

govern the extent to which an award is considered final.In this regard, it is important to consider a myriad of questions, particularly when deciding upon the seat, including, how the local arbitration law of the seat operates, whether the local courts are “arbitration-friendly, and whether the seat acknowledges the legal binding effects of smart contracts.

(3) The Validity and Arbitrability of the Subject-Matter of the Smart Contract:

Before entering into a smart contract, the parties should be aware of the identity of the subject matter of their contract. They should try to investigate whether such a subject matter is valid under the law of the seat of arbitration and also under the law applicable to the merits. In this regard, the parties should also ensure that the subject matter of their smart contract is arbitrable under the law of the seat of arbitration. Failing to inquire about the validity and the arbitrability of the subject matter of the smart contract could deem the arbitration process entirely useless.

(4) The Capacity of the Parties to Enter into the Smart Contracts:

Parties to a smart contract must have legal capacity to enter into such a contract or otherwise it could be considered invalid. Parties should be aware that their capacity is usually determined by the law of domicile of each party, rather than the law of the seat of arbitration or any other law. Therefore, if one of the parties comes from a jurisdiction that does not recognize smart contracts, this might affect such a party’s ability to enter into the contract. Further, it might serve such a party as a legal loophole to evade its obligations under the smart contract in the future.

(5) The Law Applicable to the Merits of the Dispute:

The parties to smart contracts should choose the same jurisdiction for the seat of arbitration and the law applicable to the merits of the dispute. In this regard, jurisdictions such as Arizona, Tennessee, and Delaware are currently considered the friendliest jurisdictions for legal enforcement of smart contracts.

(6) The Number of Arbitrators:

The parties in international arbitration are usually allowed to choose their arbitrators. The norm is that each party chooses one arbitrator and then both parties or the selected arbitrators, as the case may be, will choose the chair of the arbitral tribunal. The parties should try and avoid choosing an even number of arbitrators as this could be considered to be in violation of various arbitration laws around the world. Also, the parties should not try to choose a number of arbitrators more than three arbitrators or otherwise they might run afoul of the law of the seat of arbitration. The provision regarding the number of arbitrators could be considered a public policy issue at the seat of arbitration.

(7) The Technical Qualifications of the Arbitrators:

Parties should try to choose arbitrators who possess the technical knowledge to adjudicate the smart contracts disputes, especially if the dispute is concerning a technical bug for example. This will save the parties time and money when they proceed with arbitration and will enable them to benefit from one of the most important benefits of arbitration.

(8) The Confidentiality of the Smart Contract Disputes:

Parties should be aware that arbitration is not confidential by default. Therefore, they should provide explicitly for the confidentiality of their dispute under the smart contract. Otherwise, they might run the risk of exposing their confidential information to the public.

Survey of Blockchain-Arbitration White Papers – Red Flags

The author has surveyed 6 white papers prepared by the tech community as blockchain-based arbitration solutions for smart contracts' disputes. The author has carefully selected the white papers included in this survey; so, this is not an exhaustive survey by any means of all the white papers promoting blockchain-based arbitration services. The author tries to assess how far the tech community is taking into consideration all the potential legal dilemmas associated with arbitrating smart contracts' disputes. The blockchain tech community has not developed a single project that analyzes thoroughly all the risks associated with using the international arbitration mechanism for smart contracts dispute resolution. Therefore, the tech community needs to develop their models exponentially to accumulate enough experience in the field of arbitration of smart contracts, if/when the rate of smart contract dispute raises to a level where it's profitable enough to engage in the field of arbitrating smart contracts.

Red Flags:

1. **The Seat of Arbitration and the Applicable Law**: This issue is usually crucial because it has so many legal implications ranging from determining the applicable procedural law to being the exclusive forum for annulment proceedings of any arbitral decision or award issued within the seat. The issue of choosing the applicable law is as important as determining the seat of arbitration. However, only one project decided to select the seat of arbitration and the applicable law for its arbitration services.
2. **Arbitrability**: Smart contract disputes can be of various categories; this means that we need to determine whether any of such disputes would be arbitrable under the chosen applicable law. Only one project selected the seat of arbitration and the applicable law for its arbitration services, it's quite surprising that none of the other projects has considered this issue despite its significance.
3. **Code Language**: Only one project contemplates the legal risks associated with the code language of smart contracts, and tries to handle this issue by introducing the concept of "**Ricardian contract**."
4. **Formal Requirements of the New York Convention**: Although 4 out of 6 projects acknowledge the existence of the New York convention, only one project has contemplated the legal risks associated with the formal requirements of arbitration agreements and arbitral awards under the New York convention.
5. **The Capacity of the Parties**: Arbitration contracts usually take the form of arbitral clauses embedded in the main contract in traditional arbitration. In this regard, the issue of the capacity of the parties to enter into the smart arbitration contract would be one of the first issues that would need to be dealt with. However, it seems that only two projects have expressly or impliedly dealt with this issue.
6. **Confidentiality**: The majority of arbitration practitioners are under the impression that arbitration is confidential by default. However, this is an entirely mistaken belief. Therefore, the projects should provide expressly for the confidentiality of the smart contract disputes to resolve this issue. In this regard, only 50% of the projects handled this matter.
7. **Availability of Annulment Proceedings and Penalizing the Arbitrators**: Arbitration is usually in the form of one phase, whereby the merits cannot be reviewed again by any court whatsoever.

(There is an exception for example under English Law allowing for appealing the Merits of the Arbitration provided it relates to a point on English Law, and the Court provides its leave for such an appeal.) Despite this, two projects allow for appeal process of arbitration. In addition, the same two projects foresee that there is a right and a wrong answer. In this regard, they penalize the arbitrators whose awards get annulled in the following stage.

This entry was posted on Thursday, August 30th, 2018 at 5:38 am and is filed under Applicable Law, Appointment of arbitrators, Blockchain, Confidentiality, Contract Drafting, New York Convention, Seat of the arbitration
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