

Enforceability of Smart Contracts in Malaysia

Introduction

In 1994, 'smart contracts' were introduced to the world by Nick Szabo, an American computer scientist and cryptographer. Briefly, 'smart contracts' are programmes that are stored on a blockchain, which can run when certain predetermined conditions are met. They are effectively user-defined programs that specify rules governing transactions and are enforced by a network of peers. This enables the automated execution of an agreement, where the parties thereto can be (almost) immediately certain of the outcome, without the involvement of an intermediary.

Presently, around the world, companies such as Walmart require food suppliers to use blockchain and smart contracts to ensure food safety, and other companies such as Nestlé and Unilever are doing the same. Smart contracts are also being experimented with by insurance companies to process claims' payouts in a more efficient manner.

In the burgeoning space of fintech and digital assets, and in view of the recent boom in smart contract-based transactions featuring Non-Fungible Tokens, it is not uncommon to wonder as to whether 'smart contracts' are in fact legally enforceable as traditional contracts.

This article seeks to outline the nature of smart contracts and the general viewpoint on whether they are enforceable, from the perspective of Malaysian contract and electronic commerce laws.

How do smart contracts work?

Smart contracts generally consist of recorded transactions, and an automated ledger.

Smart contracts are executed through a blockchain network (i.e. a decentralized automated ledger), where the code in the smart contract is replicated and recorded on the many computers that comprise the

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E: general@shinassociates.com.my | T: +603 2201 5584

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network. This enables a more transparent and secured facilitation and performance of the terms of the smart contract.

Generally, smart contracts are simple, and function on an “if-this-then-that” basis. For example, a potential use of smart contracts for purchase of goods is by integrating smart contracts into vending machines, which release goods when a cryptocurrency payment is made by the purchaser to the vending machine operator. The smart contract is then notified regarding the payment via data distributed on the blockchain, which then triggers the release of the goods in the vending machine to the purchaser. In this case, the basis for the operation of the smart contract would be ‘if payment is received, then release the goods’.

In essence, once a set of objective criteria are met, the smart contract self-executes where it becomes effective and nothing else is required from any party.

The Legal Status of Smart Contracts in Malaysia

In common law, a legally binding contract requires 4 main elements for it to be valid and enforceable. These are namely, offer, acceptance, consideration, and the intention to create legal relations. Generally, if there are no vitiating factors such as misrepresentation, fraud, illegality, or duress and all the contractual elements are met, the law will enforce any promise. This then concludes the formation of the contract and generates the relevant rights and obligations for the parties thereto.

In Malaysia, the Contracts Act 1950 (“CA”) governs the formation, performance, and enforceability of contracts. Historically, it has been applied to traditional contracts, however, if the basic elements of a contract as described above are fulfilled, and satisfy the requirements under the CA, a smart contract could arguably be recognised as valid and legal under Malaysian law.

Some of the key provisions of the CA which would be relevant in considering whether smart contracts are legally enforceable under Malaysian law are as follows:

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- Section 10 (1): *“All agreements are contracts if they are made by the free consent of parties competent to contract, for a lawful consideration and with a lawful object, and are not hereby expressly declared to be void.”*;
- Section 2 (a): *“When one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other to the act or abstinence, he is said to make a proposal”*;
- Section 2 (b): *“When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted: a proposal, when accepted, becomes a promise”*; and
- Section 5 (1): *“A proposal may be revoked at any time before the communication of its acceptance is complete as against the proposer, but not afterwards.”*

As can be seen from the common law elements to form a contract, and the provisions of the CA above, the requirements to form a contract under Malaysian law are fairly conceptual in nature and can be applied flexibly to a variety of circumstances. It is through this lens that smart contracts could potentially be valid and enforceable from a Malaysian law context.

The Malaysian legal framework in general is quite receptive to the changes which blockchain technology and smart contracts have brought, and which they may continue to bring to the business landscape in the country.

As an adjunct to whether smart contracts may be legally enforced in Malaysia, the Electronic Commerce Act 2006 (“**ECA**”), recognises the validity of electronic contracts and signatures.

The ECA provides important support for the concept that smart contracts could potentially be treated as legally enforceable agreements. The ECA applies to any commercial transaction concluded through electronic means, which also includes commercial transactions by the Federal and State Governments, and provides that information wholly or partly in electronic form shall not be denied legal effect, validity or enforceability on the grounds that such information is in electronic form. Arguably, the ECA could be broadly interpreted to cover smart contracts as well, given their electronic nature.

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The ECA also recognises that electronic signatures may be used to form a valid contract. The ECA defines an “electronic signature” as “*any letter, character, number, sound or any other symbol or any combination thereof created in an electronic form adopted by a person as a signature*”. It is arguable that the use of codes and digital keys or digital tokens to indicate an individual’s acceptance of the terms of a smart contract, could fall under the broad definition of an ‘electronic signature’ under the ECA.

The ECA further provides that a document in the form of an electronic message (i.e. information generated, sent, received or stored by electronic means) will be validly executed if it bears an electronic signature which is associated with the electronic message which adequately identifies and demonstrates the intention of the signer’s approval and is “as reliable as is appropriate” for the purposes the signature is required for.

Given the transparency and reliability of blockchain-based transactions which feature elements that allow for the identification of the parties to a smart contract, the ECA can be seen as broadly offering an avenue for smart contracts to be regarded as valid and enforceable in Malaysia as well.

Apart from the question of whether smart contracts can be given recognition for enforcement purposes at this point in time, it should be noted that not all contracts can be enforceable as smart contracts at this juncture. For example, certain contracts may have additional statutory or formal requirements such as notarisation or attestation for these documents to be valid and enforceable. Additionally, problems ensue where admissibility of smart contracts in Court proceedings is concerned. For example, the general rule is that for a contract to be adduced as evidence in Court proceedings, it must be stamped by the Malaysian Inland Revenue Board upon payment of the relevant stamp duty for the same. In the context of smart contracts, there may be various practical hurdles involved in producing the same for stamping (and in Court proceedings as well), and a question arises as to whether the Malaysian Inland Revenue Board would even accept smart contracts for the purposes of stamping. It therefore remains to be seen as to how the law will address these requirements from the perspective of smart contracts, if at all.

Additionally, notwithstanding the satisfaction of the elements to form a contract as stated above, there could be vitiating factors which may deny a smart contract legal enforceability (e.g. if the subject matter of the contract is illegal, or if there are elements of fraud involved in the transaction, etc.) and accordingly,

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the above should not be regarded as a comprehensive position on whether smart contracts are in fact legally enforceable in Malaysia given the fluidity of the developments in this space and the high potential for regulatory control to be imposed on the same by the authorities in future.

Conclusion

It would appear that the broad and conceptual nature of Malaysian law regarding the formation and enforceability of contracts would apply to smart contracts as well, and they should not be denied legal status by virtue of having been only fairly recently introduced to the global landscape. However, case laws have yet to further elucidate the legal aspects of smart contracts in Malaysia, and it will be pertinent to note the Courts' treatment of the same in future.

However, it should be noted that notwithstanding the foregoing, parties to a smart contract should not blindly take it that they can legally enforce the same, as there would still be formal or statutory requirements to be satisfied and there could be vitiating factors which affect the validity of a smart contract as a contract under law. Parties ought to therefore contemplate seeking legal advice on whether their contractual arrangements executed via a smart contract may be legally enforceable taking into account the facts and circumstances surrounding the formation of the smart contract, particularly where the smart contract involves significant liabilities and obligations on the parties thereto and the applicable legislation at the relevant time or developments thereto.

As smart contracts are becoming more common and accepted globally, it is almost a near certainty that they will be developed to withstand more complex transactions, and this may in turn promote greater standardisation of smart contracts in future, which may incorporate elements of ensuring that such smart contracts will be legally enforceable.

However, it should be noted that in view of the increase in smart contract adoption in the global landscape, the position on their legal enforceability would be subject to regulatory control being imposed over the same in future, to address the formalities, statutory requirements, rights, remedies, and obligations of parties to a smart contract with further clarity.

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As major players in important industries around the world are already utilising smart contracts, its presence cannot be ignored, and it is anticipated that we will see a greater adoption of smart contracts for an increasing variety of transactions in future. It would therefore be interesting to see how the authorities perceive smart contracts from a legal perspective and how laws in Malaysia may develop to specifically cater for the variability in the adoption and implementation of smart contracts in daily life.

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