Smart Contracts work – but do they hold up in court?

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Key takeaways

- **Smart contracts are sometimes expected to seriously challenge the rule of the established legal order, offering a simple, completely unambiguous and trustworthy tool for agreeing and executing party agreements without having to rely on lawyers and courts.**
- **A recent judgment by the German Federal Court of Justice on a lease agreement for batteries used in electric cars only incidentally referred to smart contracts. Nevertheless, the ruling serves as a useful reminder that when smart contracts interact with the "real world," the traditional legal rules of property law still prevail and set certain limits to the effectiveness of the concept.**
- **The arguments used by the court would apply to a similar case looked at under Swiss law.**

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Introduction

Smart contracts are considered an important component of the new world of digital finance and economy. The original key idea contends that the blockchain is set to replace the legal system as the ultimate and trusted third party. Instead of having a lawyer draft a written agreement to be enforced by a judge, if one party fails to meet its obligations, the execution of the parties' obligations is automated by software. The software is automatically executed as soon as the predetermined criteria for doing so are verified by the decentralized blockchain. By this means, the parties can securely rely on the outcome, without any intermediary's involvement, time loss or (substantial) transaction costs. Many types of standard contract clauses should thus become partially or fully self-executable or self-enforceable. Smart contracts usually also have a user interface and can technically map the logic of contractual provisions into a programming language. In a way, logic replaces the law! This leads some proponents of smart contracts to argue that a written form of the contract (on paper or in a file) is superfluous.

To name a real-life example: For a few years, a large French insurance company offered an automated flight delay insurance that was recorded and executed on the Ethereum blockchain. It triggered refunds as soon as a predefined condition, such as a flight cancellation, was satisfied.

Undoubtedly, smart contracts work very well from a technical perspective. There is yet, however, little case law on how reliably the traditional legal system recognizes and supports these blockchain-based provisions. A recent judgment by the German Federal Court of Justice (Bundesgerichtshof, BGH)

Recent BGH judgment

On the facts
A textbook example for a smart contract is a car lease agreement whereby the car is automatically blocked if the customer does not pay the lease on time. The German Federal Court of Justice recently had to decide a similar case (BGH, 26.10.2022 - XII ZR 89/21): A French bank that had been offering a variety of leasing agreements started to offer separate lease agreements for batteries to be used in electric cars. The bank's general terms and conditions included a provision that allowed the bank to turn off recharging of the battery in case the lease agreement was terminated, in particular, for cause.

The court ruling does not specify how this blocking was technically achieved. It merely refers to a "digital remote access" to the battery controls, possibly via the board computer of the car. Whether this remote access was triggered by a smart contract is not made clear. Nevertheless, smart contracts come into play when the legal grounds for the judgment are discussed one by one. A priori, these legal grounds are very traditional and related to German property law.

Unlawful interference (trespass)
Based on the general rules of contract, the customer is obliged to surrender the car's battery after termination of the lease. However, a lessor's right of access by way of self-help does not exist. This outcome is rooted in the clear legal distinction between property (Eigentum) and possession or ownership (Besitz), which originated in antique Roman law and applies in

German (and, inter alia, Swiss) law. According to this distinction, even a thief is an owner. § 858 Abs. 1 of the German Civil Code (BGB) states that whoever deprives the owner of possession without the owner's will, or disturbs the owner in possession, acts unlawfully, unless the law specifically permits the deprivation or the disturbance, so called unlawful interference (verbotene Eigenmacht).

In other words, this rule forbids the withdrawal or disturbance of the possession without the consent of the person in possession. The rule is meant to protect the state's monopoly on the use of force by prohibiting unauthorized interference with objects in the possession of others, irrespective of the legal position under the law of obligations. As a result, the interference with the owner's direct control of the property may only take place on the basis of a state enforcement order.
In the case at hand, the lower court, the Oberlandesgericht (OLG) Düsseldorf, had ruled that the blocking of the recharging possibility represented an instance of unlawful interference. It is true that the tenant still has de facto control over the battery, even after the recharging option has been blocked. However, he or she can no longer use this recharging possibility as intended in order to charge it, use it in his or her electric vehicle and drive around with it. The possibility of use is, however, part of the actual control of the goods and thus of the possession. By blocking the possibility of charging, the tenant's power of influence is restricted.

The OLG Düsseldorf found that since the bank's terms and conditions violate the statutory rule of § 858 Abs. 1 BGB, the terms are unlawful and are to be set aside without further considerations (§ 307 Abs. 2 BGB). The fact that the customer accepted the terms does not change this position, according to the lower court.

The Federal Court of Justice upheld the result of the lower court's ruling. It also concluded that the bank's terms and conditions were ineffective because they inappropriately disadvantaged the customer. However, the Federal Court of Justice did not rely on unlawful interference (which it did not finally comment on) but rather on a careful assessment of the parties' interests. Essentially, in the court's view, it was inappropriate that the blocking of the recharging possibility also prevented the customer from using the car, a much more valuable asset than the battery (since the cars only operated with the batteries of the same manufacturer, the customer could not simply replace them).

Where do smart contracts come in?
The Federal Court of Justice opined that "in this respect, digital intervention in the control of the rental object is no different from physical intervention in an electronic or mechanical control of the object. The digital blocking of the charging option accordingly achieves the same result as its electronic or mechanical blocking." The OLG Düsseldorf was therefore correct in considering it irrelevant whether the battery is accessed manually or automatically. Even an automated intervention would be attributable to the technology designed by the defendant and thus ultimately to measures taken by it. In such a situation, for the purposes of legal assessment, there is no essential difference between a manual and an automated intervention in the control of the battery.

In other words, with the Federal Court of Justice not expressly relying on unlawful interference, its reasoning shows that the use of a smart contract to automate a lease agreement,

as the one in the case at hand, could likewise be challenged. Of more general importance, the careful balancing of the involved interests by the Federal Court of Justice questions whether simplistic approaches ("If X holds, then Y applies") are able to correctly comply with the value-based rules of the law.

Swiss law perspective

Similar arguments around trespass, used by the German courts, apply under Swiss property law (Article 928 of the Swiss Civil Code (ZGB)). A contractual provision that asks the customer to accept trespass would have to pass the test of unfair terms. By statutory law, it is unfair to use general terms and conditions -that provide for a significant and unjustified imbalance between contractual rights and obligations to the detriment of consumers- in a manner that violates good faith (Article 8 of the Law Against Unfair Competition (UWG)). In a case like the one discussed above, however, at any time, the customer could unilaterally withdraw his or her consent to a lessor's trespass and thus render the relevant clause ineffective.

Next steps

We must highlight that the actual statements made on smart contracts are confined to so-called obiter dicta (i.e., additional comments, which are connected but do not serve as proper legal grounds for the decided outcome; obiter dicta might, however, indicate a future direction of thought). Last but not least, the case decided by the German Federal Court of Justice offers its own particularities, which might not prevent a different outcome in another, more or less distinct case. Nevertheless, the case shows that while new technologies may have the reputation of being disruptive novelties, they still must account for the existing legal system. In many instances, existing legal rules are worded in a technology-neutral way and offer wide flexibility for new technological developments. For example, rules against money laundering essentially apply to payments in virtual currencies as much as to payments in fiat currencies. But the same is not true for the rules of property law, which is limited to real, tangible assets and, by analogy, certain natural forces such as electricity. The analogy does not extend to digital assets, so that the concept of unlawful interference does not apply to them. It would be up to the legislator to extend the rules of property law to digital assets by analogy or to introduce new concepts. Until then, when programming smart contracts, challenges must be dealt with at the intersection between the digital and the traditional world, and it is a wise programmer who speaks to a lawyer.

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No legal or tax advice

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