

Real Estate Smart Contracts and Legal Intricacies in India

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Abstract

Smart contract, also known as self-executory contracts are gaining popularity across different sectors due to its faster execution and enforcement with added cyber security feature. It is self-executory as its enforcement is automated triggered with or without human input. This research is qualitative investigation into legal issues associated with use of smart contracts in Indian real estate sector. Author has done a literature review of existing laws in India affording legal recognition to smart contracts. Doctrinal analysis on pros and cons of smart contract in real estate, is also substantiated with secondary data of a real estate entity from UK which had surveyed 544 respondents from real estate sector upon benefits of smart contracts. Author has also analyzed some legal issues associated with enforcement of smart contracts and proposed some suggestion to avoid the same. Some of the prominent suggestions proposed under the research includes, incorporation of force majeure clause in contract, identifying liquidated damages, notice and opportunity to represent before initiating action for breach etc.

Keywords: Smart contract, Real estate, Construction, Legal Issues, Technology

Introduction

Traditional way of thoroughly drafted, discussed, modified, updated, amended and duly signed contract to the modern form of smart contract bearing digital signature having no or minimum human intervention, the practice of contract execution has undergone a tremendous change.

“Smart contracts can be understood as agreements, the execution of which is automated by systems such as block chain. These contracts are self-executing contracts that ensure performance without recourse to the courts and without involvement of human discretion. One of the simplest examples of a smart contract is that of a vending machine which upon insertion of money dispenses the product.”(Nisar, 2022)

“A smart contract is an agreement whose execution is both automatable and enforceable. Automatable by computer, although some parts may require human input and control. Enforceable by either legal enforcement of rights and obligations or tamper-proof execution.”(Christopher D. Clack, 2016, p. 2)

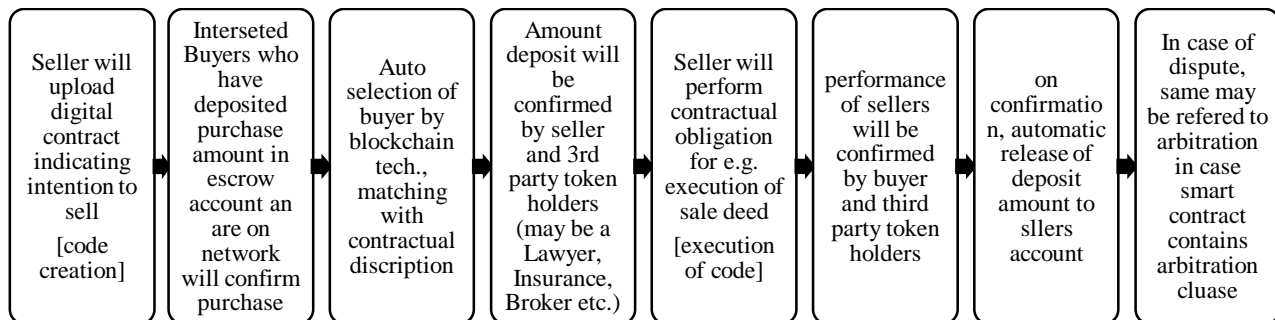


Figure 1: Process of real estate smart contract

Digital transformation is an ever evolving phenomenon across different sectors. Block chain technology is one such major component of digital transformation that has gained lot of popularity over a period of last decade. Privacy and security have been the driving force behind this gaining popularity of Block chain technology. Even in India, “the Mahindra Group and IBM revealed in November 2016 that they are co-developing a cloud-based block chain framework with the potential to reinvent supply chain finance in India.”(STA Law Firm, 2019)

Smart Contracts and Laws in India

In India, Contracts are governed by the Indian Contracts Act, 1872. The Act lays down the basic legal framework about meaning and essentials of contract and remedies in case of breach of contract. The law was drafted way back

in 1872, in an era when digital technology was nonexistent. The law doesn't have any direct mention about form, content or manner of execution of contract. However, the language of statute is such, that even smart contracts can be recognized as valid contract under the present framework of law.

According to Section 10 of the Act, "all agreements are contracts if they hold the free consent of parties willing to contract, for a lawfully accepted consideration and with an object."

From aforementioned section, in order to qualify for valid contract, three things are essential, namely- offer, acceptance and consideration. Smart contracts fulfilling these essentials will be recognized and capable of enforcement under the Act of 1872.

The conjoint reading of Indian Contract Act, 1872 and Information Technology Act, 2000 (IT Act, 2000) further provides clarity about legal recognition of smart contracts in India.

Section 4 of the IT Act, clearly provides legal recognition to all forms of electronic records if same is "usable for a subsequent reference."

Additionally, Section 5 of the IT Act 2000 provides that, in case of document requiring authentication by signature of a person, "such requirement shall be deemed to have been satisfied, if such information or matter is authenticated by means of electronic signature."

Execution of smart contract has become practicable with legal recognition of digital signature. The IT Act further provides a legal recognition even to the enforcement of electronic contracts by providing that, "Where in a contract formation, the communication of proposals, the acceptance of proposals, the revocation of proposals and acceptances, as the case may be, are expressed in electronic form or by means of an electronic records, such contract shall not be deemed to be unenforceable solely on the ground that such electronic form or means was used for that purpose."¹

Similarly, Section 65 (B) of the Indian Evidence Act, 1872 confers same evidentiary value on the electronic record/documents as the physical record/document has. It provides that, an electronic record shall be admissible in all proceedings.

Aforementioned statutory framework provides legal sanctity to smart contracts in India. However, there is still a lack of comprehensive regulation on smart contracts. Another issue with smart contracts is that, smart contract considerations are usually in the form of 'cryptocurrency,' which raises the concern as to its legal validity in India. As per Contract Act, "consideration is lawful when it is not forbidden by law, would not defeat the provisions of any law, is not fraudulent, does not involve or imply injury, and is not immoral or against public policy."(Section 23, Indian Contract Act, 1872) For smart contracts to be lawful, it must qualify the condition of legality u/s 23. In 2019, the Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019 proposed to outlaw cryptocurrencies completely. Following that, a law introduced in 2021 advocated banning all private cryptocurrencies. The Government in India has repeatedly made it clear, that crypto currency is not legal in India. In a statement given to reporters, Finance minister of India clearly stated that, "The Reserve Bank of India (RBI) and the union government have not given any sort of recognition to cryptocurrencies and, therefore, they are not legal in the country right now"(NDTV Profit, 2022) However, with recent declaration in budget session of 2022 of new crypto currency by the Reserve Bank of India, the problem of legal sanctity of crypto as consideration in smart contracts may get resolved.

In 2018, RBI had issued a notification thereby prohibiting all entities regulated by it from dealing in virtual currencies. This was overturned by the Supreme Court (SC) in Internet & Mobile Association of India (the "IAMAI") v. the Reserve Bank of India. Declaring the RBI circular as "...manifestly arbitrary, based on non-reasonable classification and it imposes disproportionate restrictions" bench comprising of Hon'ble J. Rohinton Fali Nariman, J. S. Ravindra Bhat and J. V. Ramasubramanian ruled that, "When the consistent stand of RBI is that they have not banned Virtual Currencies (VCs) and when the Government of India is unable to take a call despite several committees coming up with several proposals including two draft bills, both of which advocated exactly opposite positions, it is not possible for us to hold that the impugned measure is proportionate." Court finally ruled that, the VC's have no visible damage to banks. (Internet & Mobile Association of India (the "IAMAI") v. the Reserve Bank of India (2020))

In traditional contracts, sometimes parties wave off their right to take action considering the long term commercial relations. Parties may wave off penalties, late fees or may absolve the other from minor contractual obligations. As the smart contracts are self-executory, such waiver is difficult in smart contracts if the same is not specifically mentioned in the contract.

¹ Section 10A, the Information Technology Act, 2000 (inserted by amendment of 2008)

Even though the block chain technology is claimed to be safe, it still carries the risks of frauds and scams. \$300 Mn scam by Amit Bhardwaj is a strong indicator of how even the blockchain and smart contracts are immune from scams. (Suprita, 2019)

Use of Smart Contracts in Real Estate: Pros and Cons

The use of smart contracts in real estate sector of India is still at its nascent stage, however it is gaining popularity amongst the stakeholders. However, countries around the world have started exploiting possibilities of use of block chain in real estate sector with an object of corruption free and faster process of land registration. Georgia, for example, has become first country to adopt block chain technology for registration of land titles. The National Agency of Public Registry in Georgia will use this technology with an objective to "...show the world that we are a modern, transparent and corruption-free country that can lead the world in changing the way land titling is done and pave the way to additional prosperity for all." (Higgins, 2016) Similarly, on behalf of Swedish Government, the Swedish Land Registry has partnered with ChromaWay to explore block chain technology for land registration. Some of the prominent driving forces behind this increased popularity of use of smart contracts in real estate are as follows;

Speedier enforcement

Real estate sector in any country around the globe, suffers from biggest challenge in form of delay in projects. Several factors associated with projects such as regulatory approvals, natural calamities, economic, socio-political disturbances etc. are beyond the control of the parties and leads to delay in project.

The predictive AI technology can help in eliminating these issues by well-planned schedule of contract. Auto enforcement makes the process smooth and faster.

Automation of various stages in contract enforcement like, payment, contract schedule/duration, penalties for default and auto renewal of contract etc. further adds up in avoiding delay. As per survey, conducted by Savoy Stewart, a Commercial Property Agents and Surveyors firm UK, 71% of the respondents (out of total 544 respondents who were commercial real estate professionals) were of the opinion that smart contracts speed up the real estate project. (Davis, 2019)

Secured technology

Block chain technology is considered to be the most secured one as no one can make changes in the documents once they are uploaded on block. As the technology stores uploaded data on several computers on the network, hacking and damaging of document becomes almost impossible. Even if one of the device is intervened into, several backup of blocks will still be available to the parties.

Faster dispute resolution

With advent of block chain technology, the faster dispute resolution mechanism in form of block chain arbitration is now available to the parties to the project. "In the quest for a tool that would reduce cost and time, but still ensure all due process requirements are duly complied with, block chain is just one in the line of technologies that have been explored thus far (the most common ones so far being audio and video conferencing tools) ... The benefits of using block chain technology to authenticate and validate smart contracts are worth the technological transition that the field will have to accommodate." (Jevremović, 2019)

Transparency

Accessibility of all data to authorized individuals, immutable data and measures such as encryption of data for cyber security ensures the transparency in smart contract transactions. Since, all the documents are available and accessible but not changeable, there is possibility of unilateral changes in documents leading to fraud.

A survey, conducted by Savoy Stewart, a Commercial Property Agents and Surveyors firm UK found out following benefits of smart contracts in real estate sector.

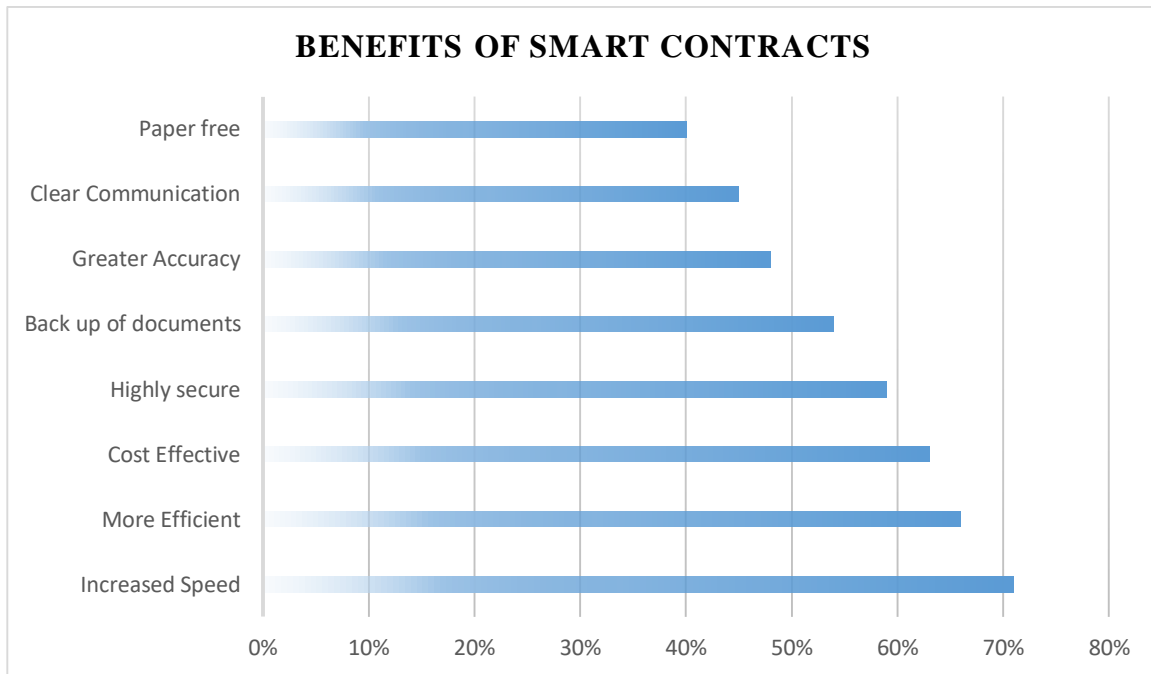


Figure 1: Source: Savoy Stewart(Davis, 2019)

Legal Issues in use of Smart Contracts

In spite of several benefits, use of smart contracts has, by and large remained limited as it suffers from various legal issues and challenges. Some of the prominent issues associated with use of smart contracts are as follows;

Requirement of registration

In India, it has been commonly accepted position that, contract in any form can be executed and enforced even without registration of it with Registration Department. However, in the event of occurrence of dispute and its referral to the Court, Courts have often mandated the registration of contract for want of payment of stamp duty. The process of registration and payment of stamp duty is very cumbersome and time consuming. Unless, the government brings legal reforms, block chain technology could never replace the administrative process of registration, notarization etc.

Knowledge about Legal Implications

At the time of execution and registration of any legal instrument, the registering authorities check and convey all the possible shortcomings, implications of instruments and may even advice rectification of same in the interest of the parties. Block chain technology used in smart contracts may not advise about possible adverse implications of contract and will not allow any subsequent rectification of contract. In the event of need for rectification, replacement/substitution of existing contract document is the only option that parties are left with. In such case, all the time and efforts taken in execution of previous contract goes in vein.

Difficulties in case of right in rem

Enforcement of Right in rem (right available against entire world) such as preventing trespass, right to protect property etc. cannot happen through smart contracts and Court intervention in such case is mandatory. Parties have to mandatorily approach a Court for enforcement of its rights against the third parties. Besides, creation of any public rights/*right in rem* requires a public document registered with public registries. Hence, block chain cannot create and/or enforcer *right in rem*.

Possible unenforceability

If the consideration for the contract was not reciprocal, then it's possible that it wouldn't be enforceable under Indian law. If the contract is unilateral in nature, this can happen. However, smart contracts without mutual consideration can still be enforced through code. However, a breach of such a contract would not be considered a breach in Indian Courts because, in their opinion, there wouldn't have been a contract in the first place because of a lack of mutual consideration, an essential component of a contract.(STA Law Firm, 2019)

No legal sanctity of hash key in block chain

U/S 35 of the Information Technology Act, 2000 only the certifying authority designated by the Government can issue digital signature. Only digital signatures issued by such designated authority will have legal recognition u/s 5 of the Information Technology Act, 2000. In smart contracts, the hash key used as identification signature, is issued by block chain platform, which is not the “designated authority” as mentioned u/s 35. Hence, such hash keys and the contracts executed using such hash keys may not have legal sanctity in front of Courts of law.

Possibility of absence of free consent

“Smart contracts provide a platform for contracting with parties who may or may not know each other.”(STA Law Firm, 2019) This may result in absence of free consent or even a minor executing a smart contract. It will render the contract voidable or void in later case. Indian Contract Act strictly mandates every contract to contain a free mutual consent. Moreover, smart contracts may be unilateral leaving no scope for the other parties to contribute in preparation of draft of a contract. This, practically will have same effect as in case of standard forms of contracts.

Breach of Principles of Natural Justice

As the smart contracts are self-executory in nature, it may not afford any opportunity of being heard to the party at fault. For e.g. in case of construction of any project, natural calamities or any other force majeure event may delay the project. In such case, block chain based smart contracts may recover the penalty from contractor without finding out the reasons behind delay.

Suggestions

In order to simplify the process of execution of smart contract and to avoid legal complexities, author would propose following suggestions;

- To avoid adverse impact of poorly drafted smart contract, parties must, before uploading the code on block chain, get it verified from legal counsel.
- In case of international contract, parties must determine the law applicable to the contract and its performance. Both parties to contract must undertake comply with such applicable law to avoid dispute in future.
- Liquidated damages may be mentioned in the contract in order to avoid subsequent disputes over the quantum of damages. Similarly, *force majeure* clause must be incorporated in every contract as in case of any construction contract, the performance may span over a longer duration.
- In case of dispute, parties must agree on alternative methods of dispute resolution i.e. ADR as proposed method for dispute resolution.
- In order to avoid possible breach of principles of natural justice, parties must incorporate a system of communication of warning, affording a chance for the other party. Form of operation of such warning may be decided by the parties with mutual consensus.

Conclusion

Lack of comprehensive law or policy on smart contracts has always led to speculations about its possible validity and legal recognition in India. As observed hereinabove, the conjoint reading of Indian Contract Act and Information Technology Act do provide a legal protection to smart contracts. However, there is still a need to have some clarity over legal sanctity of cryptocurrency and its use as consideration under smart contracts. Smart contracts with digital signatures can definitely be registered with registering authorities in India and be legally enforced in same manner in which traditional contracts are enforced. However, in any form of contract, parties must stick to the basic essentials of valid contract laid down under Indian contracts and accepted by all commonwealth countries as well as some of the international statutes. Once this is taken care of, enforcement of smart contract will certainly become fruitful, affording speedier contract management mechanism. In real estate sector, smart contracts will certainly play a transformative role, as most of the projects in the sector suffer from delay.

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