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Are Smart Contracts Legal?

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Smart contracts are an important feature of decentralized finance. These bits of code define the conditions of blockchain mediated crypto business arrangements. They make it possible to do business with people anywhere in the world without relying on middlemen. Or do they? What happens when someone reneges on a crypto blockchain business deal? How can such problems be resolved or mediated? What rules could or should apply when problems arise? A question at the bottom of this issue is this. Are smart contracts legal?

What Is a Smart Contract?

IBM says that [smart contracts](#) are digital contracts. They are kept on blockchains and automatically executed as preset conditions and terms are met. They speed up the process by which all parties know how a business deal will work. And they may be used to automate necessary parts of the workflow as terms of an agreement are met. For example, when one step is satisfied it may trigger the next phase of a smart contract. Such steps may include releasing funds or carrying out a step such as notifying all parties involved or doing something mundane like registering a vehicle. All relevant data is stored on a blockchain with access given only to parties involved.

Why Do We Need Contracts?

Contracts are used in business to formalize agreements. They set specific terms, conditions, and responsibilities. Contracts define payment conditions including when, by whom, and specific conditions such as payment in Bitcoin, Ether, dollars, or euro. They also set out rules for what happens when payments are not made, services are not rendered, or tangible assets are not delivered. Such conditions are especially important when business is being done by people in different legal jurisdictions where different laws will apply. Under whose rules and in which jurisdiction will problems be settled?

Legality of Smart Contracts

Just like traditional contracts, a smart contract is meant to include all of the terms of an agreement and rules for dealing with any problems that may arise. In order to be legal and binding in a given jurisdiction, a contract needs to fulfill various legal requirements like proof of intent to form a contract. Because a contract lays out the terms of an agreement in the jurisdiction where it is made, it reduces risk and helps avoid conflicts. This can be difficult when a contract needs to abide by the governing laws of two very different legal jurisdictions.

Problems With Smart Contract Enforcement

As a rule the better-written a smart contract is, the less likely it is that there will be problems. When the person or persons who write the contract anticipate any differences in contract requirements or interpretations across jurisdictions problems will be less likely. Very commonly in international contracts, where differences will be settled and whose laws will apply is specified up front. Nevertheless, problems can

arise because of the fact that smart contracts and decentralized finance cut out the middleman.

The Occasional Necessity of a Trusted Third Party

Consider this example. A company makes equipment for oil drilling and maintenance of existing oil wells. They want to sell to an oil rich but politically unstable nation in the Middle East. Their concern is that they will deliver the equipment, the current government will be overthrown, and they will not be paid. The folks in the Middle East are concerned that if they pay up front the United States government might impose sanctions on them and they will never get the equipment. The way this sort of situation is handled in the world of international traditional finance is with a third party. The money being paid is held in escrow by an international bank or other trusted third party. Funds are only released upon proof of delivery of any purchased assets.

No matter how smart a contract is and no matter how elegant its programming, there are times when real money or real tangible assets need to be held by a third party and released when the smart contract allows it. This includes when problems arise and differences need to be ironed out between parties and across legal jurisdictions.

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