

The next (or first?) evolution of contracts

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Banking & Finance analysis: Akber Datto, CEO and Founder of D2 Legal Technology, as well as PRIME Finance Expert and Chair of the Law Society of England & Wales Smart Contracts and Digital Assets Subcommittee, discusses the digitisation of legal agreements, and, in respect of master trading agreements such as the ISDA Master Agreement and ISLA'S GMSLA, the path to smarter contracts.

Original news

The International Swaps and Derivatives Association (ISDA) and Linklaters have made the ISDA Master Agreement and ISDA Clause Library digitally available for the first time via ISDA Create.

See: ISDA launches digital master agreement, [LNB News 22/01/2021 66](#).

It is said that modern English contract law is fundamentally a creature of the nineteenth century, providing the approach to establishing an agreement between parties, and rights regarding enforcement. Beyond this development of contract law two hundred years ago, it is unfortunately probably true to say that there have been few truly innovative and/or disruptive changes to contracts. The last forty years have seen the use of computers to prepare contracts on word processing software, and in the last twenty years, the increasing use of electronic and digital signatures—which have only become acceptable in day-to-day use over the last five to six years (certainly expedited by the coronavirus (COVID-19) pandemic). Fundamentally, this has been a change to the process in which contracts are put in place. The next decade however, threatens to disruptively change the very concept of a contract, though digitisation of legal agreements and the [emergence of a smart contract](#).

What is meant by 'digitisation of a contract'?

The term contract digitisation has been used across a number of different areas. Fundamentally, it is referring to an increased data-driven view of contracts. This is of course no surprise, given the fact that our societies and economies are becoming more and more data driven.

Most important contracts are in written form, simply because having them in this form provides the best record of the terms of agreement, both from the point of ensuring performance and, should dispute occur, understanding the terms of the contract against the relevant fact pattern. This has evolved from handwritten contracts, to those typed on a machine and typically scanned as an image so as to record the execution of the contract by the parties through evidence of their wet-ink signature (or more recently, through digital signatures).

This is however, a rather analogue approach in today's digital world. Contractual obligations increasingly are given effect to through the medium of systems and data. For example, an obligation to make a payment, is often performed through an instruction online to transfer a specific sum of money between bank accounts, themselves digital records. And these instructions are not spoken or written by hand, rather, communicated through data exchange. It is therefore only apt that we record the terms of a contract in a manner that is machine readable and in structured data form to best facilitate not only the performance of contractual obligations, but also the management of them. And although this representation can be created from paper contracts, there is the valid question of why contracts aren't therefore simply created in a natively data form—for any analogue to digital transformation after the event, will necessarily be lossy in some aspect.

The written word has been king since Dickensian times and tradition dictates that for many, there is no reason to adapt. Yet the digital form comes with many advantages that a modern day lawyer needs to embrace. Automated performance of contractual obligations is clearly one (and more on that shortly), but it also allows us to better utilise LegalTech, through the use of document generation tools and negotiation platforms, as well as artificial intelligence and natural language processing tools to search through swathes of legacy contracts, to assist with identification of relevant items (to the extent they are not already recorded and managed through a structured data form).

The role of clause taxonomies and libraries

As discussed, digitised contracts have taken many forms to date, with many showing innovation and an ability to bring efficiencies and add business value. However, there has been little through the way of standards to guide this. Standards play a crucial role in building focus, cohesion and critical mass in the emerging stages of new technologies and business processes, codifying a 'diffuse state of the art' and creating a better sense of best practice. Without a common language through which to refer to particular clauses and business outcomes of clauses found in legal contracts, the promise and hope of LegalTech has turned into a false dawn of business value. Miscommunication between lawyers and operations—between what is meant by the data representation of a clause and its therefore system interpretation—have led to some feeling the technology is not yet ready. An argument against the Susskinesque 'End of Lawyers'.

It is for this reason, that both [ISDA](#) and [ISLA](#), trade associations in respect of the OTC derivatives and securities lending industries respectively, have developed clause taxonomies and libraries, in respect of their trading master agreements (the ISDA Master Agreement and related collateral agreements, and the Global Master Securities Lending Agreement (GMSLA)). These have been member led initiatives, to develop (1) a standard definition for each of the clauses contained in these agreements; (2) detail the clause variants that exist for each clause by reference to their business outcomes; and (3) develop model wording for each of those clause variants to foster better standardisation of clause drafting in the future.

These three elements are the foundation of successful digitisation of a document, to ensure that we do not only make these documents digital, but to enable business value from this digitisation step. The clause taxonomy provides the starting point to a data model to represent the contractual obligations in a contract. In the case of these trading master agreements, this is through the ability this provides to optimise resources (such as capital, liquidity and collateral), regulatory reporting (such as qualified financial contract recordkeeping requirements) and operational management.

The path to smart(er?) contracts

A smart legal contract can be thought of as a legally binding contract in which some or all of the contractual obligations are recorded in or performed automatically by a computer program—without the need for human intervention. Automating a contractual obligation, without a definition of the clauses being automated and their business outcome, threatens to simply lead to disputes, where undoing performance on a seemingly immutable distributed ledger is many times more problematic than the case with traditional contracts. It is for that reason that clause taxonomies and libraries are a crucial step forward in the evolution towards smart contracts. However, these cannot stand alone. In addition to standards to represent the contractual obligations, there is a need for the events, rights and conditions enshrined in these clauses themselves to have an agreed digital representation. This requires a domain model, such as the [ISDA Common Domain Model](#).

It is only once we have fully developed the Clause Taxonomy and Library, as well as the Common Domain Model—that we can truly unlock business value through [smarter contracts](#).

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