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EDITOR'S NOTE

It is my pleasure to introduce the latest volume of Thammasat Business Law Journal. The Journal has been the primary publication platform for research works of students from the Master of Laws Program in Business Laws (English Program) of the Faculty of Law, Thammasat University. Due to the Covid-19 pandemic, the past year has been challenging. Having taken into account the students' difficulties, especially the impossibility of using the library services in person, Thammasat University decides to extend the graduation deadline for students in their last year. Hence, we can publish only four articles in this volume. They are concerned with the application of hardship and frustration doctrines, the principle of mistake, the problem of contribution in kind in company law, and the formation of smart contracts.

I would like to thank all authors, readers, members of the Advisory Board, and members of the Editorial Board for their works and dedication.

Amnart Tangkiriphimarn
Editor-in-Chief
Thammasat University

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THE DOCTRINE OF HARDSHIP: EXTENSION TO THE DOCTRINE OF FRUSTRATION IN MALAYSIA*

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Abstract

This article explores the impact of an unexpected change of circumstances relating to the performance of a party's contractual obligations and problems arising from the common law doctrine of frustration that appears to be restrictive in application.

In Malaysia, the doctrine of frustration would only be applicable in two limited circumstances, i.e. where parties' obligations have become impossible or when the change of circumstances will warrant a performance so radically different from what has been originally agreed upon. This limitation may cause problems as, at times, such unforeseen circumstances may not necessarily render parties' performances impossible, but excessively onerous. Whilst the former may be resolved by the doctrine of frustration, parties are left with no appropriate recourse to address the latter.

* This article is summarized and rearranged from the thesis "The Doctrine of Hardship: Extension to the Doctrine of Frustration in Malaysia", Faculty of Law, Thammasat University, 2020.

In addressing this issue, this article applies a comparative study on how other jurisdictions (i.e. Italy, Germany, France and the United States of America) address the issue of onerosity in performing contractual obligations via the doctrine of hardship. Reference is also made to the Principles of European Contract Law 2002 ("PECL"), UNIDROIT Principles of International Commercial Contracts 2016 ("UNIDROIT Principles") and the Draft Common Frame of Reference ("DCFR"). In summary, this article suggests that the doctrine of hardship should be adopted in Malaysia by including an enabling provision into the Contracts Act 1950, focusing on the requirements of hardship and remedies available, such as renegotiation and alteration of the contractual terms, which are not available under the doctrine of frustration.

Keywords: Frustration, Hardship, Change of Circumstances, Impossibility, Onerous

1. Introduction

Section 57(2) of the Malaysian Contracts Act 1950 ("CA 1950") provides that a contract will be frustrated and deemed to be void due to the unforeseen change of circumstances and parties will be relieved from their future obligations. However, the frustration doctrine appears to be restrictive as it would only apply when a performance has become impossible or where the performance will become radically different from what was originally contracted. On the other hand, the doctrine of hardship may provide some assistance when the contractual obligations have become, due to unforeseen circumstances, excessively onerous to be performed.

For instance, COVID-19 measures such as closure of business operation (e.g. non-essential services)[1] may restrict certain activities (e.g. mining), leading to shortage of building materials (e.g. steel bars), resulting in the decrease of supply and sudden surge of demand, which in turn leads to an abnormal spike in their prices.[2] Consequently, a party is forced to procure the material at an unusual and exorbitant price. Here, the doctrine of frustration will not bite and the aggrieved party is left with no remedy as the obligation can still be performed, though extremely onerous.

In this situation, the doctrine of hardship may shed some light. Under this doctrine, parties are expected to, amongst others, renegotiate the

[1] Ashley Tang, 'Malaysia announces movement control order after spike in Covid-19 cases (updated)' (The Star, 16 March 2020) <https://www.thestar.com.my/news/nation/2020/03/16/malaysia-announces-restricted-movement-measure-after-spike-in-covid-19-cases> accessed 12 August 2021.

[2] 'The pandemic has caused the price of steel bars and iron to increase in Malaysia' (Construction +, 3 February 2021) <https://www.constructionplusasia.com/my/the-pandemic-has-caused-the-price-of-steel-bars-and-iron-to-increase-in-malaysia/> accessed 18 August 2021.

contractual terms and, if necessary, the court is empowered to either alter the contractual terms or put an end to the contract. Further, parties are no longer imposed with a higher factual burden of proof (i.e. impossibility to perform) before seeking legal remedies. Unfortunately, to date, the doctrine of hardship is still a foreign subject in Malaysia.

Therefore, this article aims to summarise the limitations of the frustration doctrine and how it could be supplemented by the doctrine of hardship, as practised by several jurisdictions including Italy, Germany, France and the United States of America as well as those which are embodied in the soft law instruments. In this article, the term "aggrieved party" is employed to refer to a party who is affected by the unforeseen change of circumstances.

2. Frustration of contract under Malaysian law

Malaysian law adheres strictly to the concept of "what has been promised must be kept", which is the underlying principle of an absolute contract.[3] However, a contract is only absolute when it is not qualified.[4] Therefore, section 57(2) of the CA 1950 provides that upon an unforeseen change of circumstances, a contract will be rendered "void when the act becomes impossible or unlawful" to be performed. Consequently, parties will be relieved from their further performance of the contract.[5] When the contract is frustrated, the law will reinstate the parties to their original position and "any person who has received any advantage under the agreement or contract is bound to restore it".[6]

[3] CA 1950, s 38(1).

[4] ibid.

[5] ibid s 57(2).

[6] ibid s 66.

In *Guan Aik Moh (KL) Sdn Bhd & Anor v Selangor Properties Bhd,*[7] the Malaysian Court of Appeal had set out the elements of the doctrine of frustration.[8] Firstly, the purported change of circumstances must have not been governed under the contract. If such provisions exist, the doctrine of frustration will not be applicable.[9] Secondly, such change of circumstances must not be self-induced. If the "frustrating event" is attributed to the party who invokes frustration, the law would not step into the matter.[10] In *Dato Yap Peng v Public Bank Bhd*,[11] the Malaysian Court of Appeal ruled that the aggrieved party must have used its best endeavours in fulfilling its undertaking under the contract. Failure to do so would render the alleged frustration as self-induced and therefore has no place whatsoever under the doctrine.[12]

Lastly, the change of circumstances would, had the contract still be performed, render the performance so radically different from what was initially agreed upon by parties. In *Sentul Raya Sdn Bhd v Hariram a/l Jayaram & Ors*,[13] the Court of Appeal observed that the 1997 financial crisis did not render the performance of the contract impossible, but merely "more onerous or perhaps more expensive for the appellant to perform its obligations. It did not render the contract radically different".[14] Therefore, a contract will not, even due to an unforeseen regional financial crisis, be

[7] [2007] 4 MLJ 201.

[8] ibid 207.

[9] Syed Ahmad Alsagoff, Principles of the Law of Contract in Malaysia (3rd edn, Lexis Nexis 2010) 493.

[10] ibid 512.

[11] [1997] 3 MLJ 484.

[12] ibid 493.

[13] [2008] 4 MLJ 852.

[14] ibid 861.

frustrated simply because the performance has become more cumbersome to be performed.

2.1 Drawbacks of the doctrine of frustration

Although the doctrine of frustration attempts to relax the rigidity of an absolute contract, it may not be flexible enough given that the doctrine will only become handy when the change of circumstances results in the impossibility to perform. Though it also applies when the performance has become "radically different", this threshold is nevertheless extremely difficult to be satisfied. This leaves little room for the aggrieved parties to seek remedies when their obligations have instead become excessively onerous to be performed, but not necessarily radically different.

Further, the doctrine of frustration, arguably, does not conform with the good faith principle. For instance, when there is an unforeseen change of circumstances rendering a party's obligation extremely onerous, the aggrieved party is left with no alternative but to face potential legal action as the difficulty to perform its contractual obligation due to extreme onerosity will not be considered by the Courts. This is exacerbated by the fact that the counterparty is not obliged to, by law or otherwise, take into account the aggrieved party's predicament before proceeding with legal action. This approach certainly does not promote the duty to act in good faith between parties.[15] Though there is no general duty to act in good faith in Malaysia (in contractual relationships), this author believes that the time has come for the law to acknowledge its importance and how it can improve contract managements and disputes in Malaysia.

[15] Egidijus Baranauskas and Paulius Zapolskis, 'The Effect of Change in Circumstances on the Performance of Contract' (2009) 4(118) Jurisprudence 197, 198.

Additionally, the doctrine of frustration does not promote the idea of contract preservation. When a contract is frustrated, it will be deemed as void and parties are exonerated from their further performance.[16] This outcome may not be commercially desirable as parties should be encouraged to exhaust their best endeavour to save the contract when it is still possible to do so (e.g. altering the contractual terms). With respect, the author believes that this warrants a new law to be introduced to better address this issue—the doctrine of hardship.

3. Doctrine of hardship under foreign jurisdictions and soft laws

3.1 Italian law

Under Article 1467 of the *Codice Civile* 1942, a party shall demonstrate that there has been a change of circumstances rendering its obligation excessively onerous (*eccessiva onerosità*) which shall be assessed objectively whilst considering all relevant factors surrounding the dispute.[17] Further, such party must also establish that such change of circumstances was extraordinary and unforeseeable at the time of contracting, considering the frequency of occurrence and magnitude of the consequences.[18]

If the plea of hardship is legitimate, the aggrieved party is entitled to terminate the contract.[19] However, such termination may be circumvented

[16] CA 1950, s 57(2).

[17] Rodrigo Andrés Momberg Uribe, 'The Effect of a Change of Circumstances on the Binding Force of Contracts: Comparative Perspectives' (DPhil Thesis, Utrecht University, 2011) 78.

[18] Guido Alpa and Vincenzo Zeno-Zencovich, Italian Private Law (1st edn, Routledge-Cavendish 2006) 241.

[19] Codice Civile 1942, Article 1467.

by the counterparty by proposing an equitable solution (e.g. alteration of terms) with a view to adapt the contract to the new circumstances.[20] This way, the contract may be preserved accordingly. However, such proposal by the counterparty is not meant to restore the contractual equilibrium to its original position but merely to remove the excess portion of risks that were not part of the original contemplation.[21]

3.2 German law

The doctrine of *Störung der Geschäftsgrundlage* (disturbance of the foundation of the contract) has been developed as early as post World War I and was later codified into the German Bürgerliches Gesetzbuch ("BGB"), via §313. Essentially, an aggrieved party may be excused if there is a significant disturbance to the basis of the contract which was not foreseen by the contractual parties.[22] In this respect, the alleged hardship must be so vital that the parties would not have concluded the contract as they did, had they known such change(s) would transpire.[23] By narrowing such disturbance within the "basis of the contract" realm, it would prevent a party from frivolously pleading hardship.

When hardship is proven, the court may modify the contractual terms to adapt the contract to the new circumstances.[24] However, if adaptation is

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[20] ibid.

[21] Elena Christine Zaccaria, 'The Effects of Changed Circumstances in International Commercial Trade' (2005) 9 International Trade and Business Law Review 135, 148.

[22] BGB, §313(1).

[23] Hannes Rosler, 'Hardship in German Codified Private Law – In Comparative Perspective to English, French and International Contract Law' (2007) 15(4) European Review of Private Law 483, 489.

[24] Momberg Uribe (n 17) 191.

impossible or if one of the parties may not reasonably be expected to accept such modifications,[25] the contract will then be put to an end and parties will be discharged from their obligations.

3.3 French law

Article 1195 (*imprévision* (unforeseen circumstances)) was incorporated into the French Civil Code 2016 to rectify the serious disproportion and contractual imbalance resulted from an unforeseeable change of circumstances.[26] In this respect, Article 1195 of the French Civil Code provides that a party may be excused from its further performance if it can be proven that there was an unforeseeable change of circumstances, rendering its performance excessively onerous. The plea for hardship shall be assessed objectively and all relevant factors shall be considered.

The remedies under Article 1195 are divided into two phases, which are consensual and non-consensual.[27] During the former, the aggrieved party may request for a renegotiation of the contract before the counterparty commences legal action. However, the renegotiation process is not mandatory.[28] Whilst renegotiating, the aggrieved party is not allowed to suspend its performance[29] to avoid any mala fide tactical manoeuvre to prematurely cease its performance.

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[25] BGB, §313(3).

[26] Solène Rowan, 'The New French Law of Contract' (2017) 66(4) International and Comparative Law Quarterly 805, 820 – 821.

[27] Alain Pietrancosta, 'Introduction of the Hardship Doctrine ("théorie de l'imprévision") into French Contract Law: A Mere Revolution on the Books?' (2016) 3 RTDF 1, 5.

[28] ibid 6.

[29] French Civil Code, Paragraph 1 of Article 1195.

If the above fails, the court may, upon the request of the parties involved, adapt the contract by altering the contractual terms. If there is no request being made, the court may, on the application of either party, revise the contract or put an end to it. In doing so, the court may grant the most appropriate remedy as it thinks fit.

3.4 American law

Section 2-615 of the Uniform Commercial Code ("UCC") exempts a party from its performance in a contract of sale, if such performance has been made impracticable due to an unexpected event and that the non-occurrence of the same was the parties' basic assumption when the contract was concluded. This "impracticability" excuse is also codified in section 261 of the Restatement (Second) of Contracts 1981 ("2nd Restatement") with similar requirements though allegedly more liberal in application, as the latter is not restricted to a contract of sale.

Nevertheless, the judges' attitude towards the same may not be as welcoming. For instance, the courts have been reluctant in invoking impracticability due to various reasons, including the element of foreseeability. In most cases,[30] the courts have employed the term "unforeseeable" as opposed to "unforeseen", making it nearly impossible to demonstrate that the change of circumstances was completely unexpected.[31]

[30] *Transatlantic Financing Corporation v United States of America* 1966 U.S. App. LEXIS 6004. See also *Bende & Sons, Inc. v Crown Recreation, Inc.* 1982 U.S. Dist. LEXIS 15119.

[31] Jennifer Camero, 'Mission Impracticable: The Impossibility of Commercial Impracticability' (2015) 13(1) The University of New Hampshire Law Review 1, 17.

Besides, the inconsistency in applying the objective[32] and subjective[33] standards in determining whether a performance has become impracticable also contributes to the rejection of the "impracticability" excuse.

3.5 PECL

Article 6:111(2) of the PECL recognizes hardship when the performance has become excessively onerous due to the change of circumstances that cannot be reasonably anticipated at the time of contracting. In this regard, a performance is excessively onerous when the change of circumstances has overturned the contract, rendering it to be significantly imbalanced. Article 6:111 of the PECL provides two levels of remedies. Once hardship is proven, the parties are bound to renegotiate[34] and failure to do so (in bad faith) will entitle the court to award damages to the claiming party as it thinks fit. If renegotiation fails, the court has the jurisdiction to either terminate or revise the contract to distribute the gains and losses between the parties, as it deems equitable.[35]

3.6 UNIDROIT Principles

Article 6.2.2 of the UNIDROIT Principles defines hardship as the occurrence of events that fundamentally alter the equilibrium of a contract. However, it limits the application of hardship in two circumstances, i.e. the increase of performance's cost and the diminution in the performance's value. Interestingly, the UNIDROIT Principles has extended the timeline of

[32] *Eastern Air Lines Inc. v Gulf Oil Corp* 1975 U.S. Dist. LEXIS 15673.

[33] *Asphalt International. Inc. v Enterprise Shipping Corp. S.A.* 1981 U.S. App. LEXIS 15322.

[34] PECL, Article 6:111(2).

[35] ibid Article 6:111(3).

which the change of circumstances may occur. Contrary to other jurisdictions, the happening of such event shall only transpire after the contract is concluded. However, Article 6.2.2 (a) states that the excuse of hardship may also be available when such an event had transpired before or at the time of contracting but only discovered at a later stage. With due respect, this approach may not be proper as such a situation may appropriately fall under the principle of "mistake" in contract law.

Article 6.2.3 of the UNIDROIT Principles provides a two-tier level of remedies. Firstly, the aggrieved party is entitled to demand for a renegotiation with a view to revise the contractual terms.[36] However, pending renegotiations, the aggrieved party's performance is not suspended.[37] If the renegotiation is unsuccessful, the court may either terminate the contract or amend the contractual terms. In doing so, the court shall use its best endeavour to prioritise the preservation of the contractual relationship and treat the termination of a contract as a last resort.[38]

3.7 DCFR

Article III.-1:110(2) of the DCFR provides that hardship occurs when an exceptional change of circumstances renders a party's obligation so onerous that it would be manifestly unjust to expect the said party to hold up to their bargain. If the alleged hardship exists, the court may vary the contractual terms or terminate the contract. Contrary to the PECL and UNIDROIT Principles, the DCFR only provides judicial intervention as the sole remedy

[36] UNIDROIT Principles, Article 6.2.3 Comment 5.

[37] ibid Article 6.2.3 Comment 4.

[38] Baranauskas and Zapolskis (n 15) 210.

and that renegotiation is not compulsory.[39] However, before the court can intervene, it must first be shown that the aggrieved party has made a reasonable attempt to renegotiate in good faith with the counterparty to preserve their contract.

4. Applicability of the doctrine of hardship in Malaysia

4.1 Benefits and challenges in implementing the hardship doctrine

Based on the analysis on how the doctrine of hardship is being applied in other jurisdictions, it appears that the doctrine of hardship offers benefits to contractual parties whose performances have become so onerous due to the occurrence of an unexpected change of circumstances. Firstly, the hardship doctrine may relax the strict application of an absolute contract. Though the notion of an absolute contract seeks to bind parties to their bargain, it shall be relaxed when a change of circumstances results in the fundamental variation of the contractual equilibrium, creating undue advantages to one party and prejudice to the other.[40] After all, parties shall only be bound to their contract so long as the fundamental conditions at the time when the contract was formed remain unchanged.[41]

Further, the excuse of hardship offers alternative remedies where parties' performances have become more burdensome due to unforeseen

[39] Emanuele Tuccari, 'Change of Circumstances and Judicial Power: A European Perspective of Contract Law' (The European Conference on Politics, Economics and Law 2015 Official Conference Proceedings, The International Academic Forum, 2015) 6 <https://papers.iafor.org/submission17377/> accessed 1 June 2020.

[40] Zaccaria (n 21) 136.

[41] Baranauskas and Zapolskis (n 15) 198.

events, something that is not governed by the frustration doctrine. Here, the aggrieved party has been driven to a corner where the doctrine of frustration may not offer any remedies whatsoever. For instance, instead of being exposed to the probabilities of breaching the contract, the doctrine of hardship offers the parties to, amongst others, adapt the contract to the new circumstances.

Regardless, the introduction of the hardship doctrine may be a daunting task due to several challenges. For instance, the core of the hardship doctrine essentially lies on the principle of good faith, which is prevalent in most civil law countries.[42] In essence, the doctrine of good faith requires a party not to enrich itself from the unforeseen change of circumstances at the detriment of the counterparty.[43] However, the concept of good faith in contract law seems to be a foreign subject in common law jurisdictions (including Malaysia),[44] given that common law jurisdictions handle this issue differently (i.e. frustration).[45] Nevertheless, the Malaysian Court of Appeal[46] had signified its willingness in acknowledging the importance of the good faith principle, though some "major qualifications have to be factored in".[47] Further, it may assist the judges in creating greater security upon the parties

[42] Ingeborg Schwenzer, 'Force Majeure and Hardship in International Sales Contracts' (2008) 39 VUWLR 709, 721.

[43] Klaus Peter Berger and Daniel Behn, 'Force Majeure and Hardship in the Age of Corona: A Historical and Comparative Study' (2019-2020) 6(4) McGill Journal of Dispute Resolution 78, 86.

[44] Baranauskas and Zapolskis (n 15) 203.

[45] Ewan McKendrick, Contract Law: Texts, Cases and Materials (5th edn, Oxford University Press, 2012) 494.

[46] *Aseambankers Malaysia Bhd & Ors v Shencourt Sdn Bhd & Anor* [2014] 4 MLJ 619.

[47] ibid 724-725.

against the "risk of opportunism and exploitation",[48] in the case of an unforeseen change of circumstances.

Additionally, given that the court has the power to adapt the contract in the case of hardship, such process may lead to arbitrariness as the court may not have standard guidelines in doing so.[49] However, this issue may be mitigated by the fact that the court may not, despite such power, rewrite the entire contract to the extent of changing its very nature[50] and shall conform with the good faith principle.[51] Ultimately, the court's adaptation is never meant to completely restore the contractual equilibrium to its original position completely, but merely to make the excessively onerous performance bearable for the aggrieved party.[52]

Nevertheless, the reluctance of the Malaysian courts to rewrite a contract[53] is not wholly devoid of merit. Though contract alteration in the case of hardship appears to be fair, it would go to the extreme if we blindly allow the courts to do so as this will promote uncertainty in contracting. Hence, an alternative mechanism will be proposed to circumvent this legal restriction, as will be illustrated in paragraph 4.2 below.

4.2 Proposed mechanism to be adopted in Malaysia

Based on the analysis above, this author believes that it is time for Malaysia to incorporate the doctrine of hardship into its contract law regime.

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[48] Roger Brownsword, Contract Law: Themes for the Twenty-First Century (2nd edn, Oxford University Press, 2006) 495.

[49] Momberg Uribe (n 17) 276.

[50] ibid.

[51] Tuccari (n 39) 5.

[52] Momberg Uribe (n 17) 277.

[53] *Bank Islam Malaysia Berhad v Lim Kok Hoe and Anor* [2009] 6 MLJ 839, 852.

This proposal is to supplement the doctrine of frustration as it only offers remedies primarily where performance is impossible, leaving no room for those whose performances have become extremely onerous. Thus, an amendment to the CA 1950 by incorporating a new provision on the excuse of hardship may be helpful.

4.2.1 Elements of hardship

In invoking hardship, the aggrieved party shall first demonstrate that there is indeed hardship by establishing several key elements, which are as follows:-

(a) The circumstances relating to the conditions forming the basis of the contract have been significantly changed rendering the performance excessively onerous;

(b) The change of circumstances must be unforeseen; and

(c) The alleged change occurs after the formation of the contract.

Akin to German law, it must first be proven that there is a change of circumstances that relates to the "conditions" forming the basis of the contract. Though CA 1950 does not clearly define what the term "condition" means, the Malaysian courts have distinguished the term "condition" and "warranty" in several cases. For instance, the Court of Appeal in *Ching Yik Development Sdn Bhd v Setapak Heights Development Sdn Bhd*[54] held that payment for the property's purchase price constitutes a condition and failure to deliver such payment would amount to a breach of condition and consequently, entitling the innocent party to repudiate the contract. Essentially, this would depend on whether or not a particular term is being regarded as of fundamental importance by the parties.

[54] [1996] 3 MLJ 675.

Conversely, if the term is merely subsidiary, it may be regarded as a warranty.[55] Where there is a breach of warranty, the innocent party is only entitled for damages and not repudiation of the contract.[56] By applying the same notion here, the aggrieved party must demonstrate that such hardship is not merely minor but shall relate to the essential terms of the contract to warrant the application of such legal excuse. By imposing a higher standard, we may avoid the doctrine of hardship from being invoked arbitrarily as they fancy.

Secondly, the alteration to the conditions of the contract must have "significantly changed" rendering the obligation "excessively onerous" to be performed. In determining the issue of "significantly changed" and what would amount to "excessively onerous", a two-tier test (i.e. quantitative and qualitative methods) may be adopted and an objective standard shall be employed in determining the same.

Under the quantitative method, the court may come up with a numerical threshold (e.g. percentage) as a yardstick. For example, the American courts would usually consider an increase of more than 100% of performance's cost as impracticable. However, this numerical threshold may not be conclusive given that not all hardship cases can be quantified.

Thus, the quantification analysis shall be supplemented with the qualitative method. In this regard, other factors may also be helpful in assessing the alleged hardship. For instance, the court may consider, amongst others, the party's overall profits in the preceding years and the ability to spread losses to other similar contracts.

[55] Alsagoff (n 9) 232.

[56] ibid 235.

Further, the aggrieved party shall demonstrate that such change was unforeseen by the parties at the time of contracting. The importance of the element of "foreseeability" directly correlates with the allocation of risk in a contract. When a party has agreed to accept the risk of the occurrence of an event, such party is forbidden from excusing itself from its performance. In assessing the same, the author believes that the main concern regarding the "foreseeability" issue is not merely about the possibility of occurrence per se, but also the severity of the consequences.

Lastly, it shall be proven that the change of circumstances must have only occurred after the contract was concluded. If the change had already transpired before or at the time of contracting, then such case will fall within the ambit of mistake in contracting and therefore, shall be dealt with its peculiar elements thereof (i.e. sections 21 to 23 of the CA 1950).

4.2.2 Available remedies

This author proposes for a three-tier remedy to be formulated, which consists of renegotiation, contract adaptation and termination of the contract via judicial intervention. Once hardship is proven and similar to Article 6:111(2) of the PECL and Article 6.2.3 of the UNIDROIT Principles, the aggrieved party is entitled to renegotiation to modify the contractual terms. In this regard, the court is empowered to order the parties to enter into renegotiation to adapt the contract, where the circumstances deem it to be commercially possible and just. This judicial intervention in compelling parties to renegotiate is not completely alien in Malaysia. In practice, it is not unusual for the court to order parties to undergo a mediation process, before proceeding to the merits of the case. Additionally, the concept of renegotiation is not devoid of merits

given that the parties themselves are in the best position to pan out the most sensible solution for them.

Where the renegotiation is fruitless, the court is then empowered to alter the original terms of the contract. In doing so, the court must adhere to the general principle of distributing losses and gains arising from the said hardship equitably amongst the parties. However, such distribution is not meant to restore the parties to their original position as if the said hardship never existed, but merely to limit the losses within the normal range of commercial sacrifice. Though the Malaysian courts are generally reluctant to rewrite a contract, this author believes that a proper mechanism may be drawn to address this issue.

For instance, the court may, instead of modifying the contract by its own volition, order the parties to provide their own proposals for the court's consideration. This way, the court does not simply exercise its faculty of mind and modify the contract on its own accord but merely choosing the best solution based on the parties' arguments. Arguably, the court is not trying to rewrite the contract but merely facilitating the parties to redesign their contract by examining their proposals to achieve an equitable solution for all.

Where the court believes that an adaptation is not prudent despite the parties' proposals, the court may have no other option but to put an end to the contract, discharging parties from their future obligations. In doing so, further reliefs may be ordered, including but not limited to, assessment of damages in favour of the party unaffected by such hardship given that generally an innocent party may terminate its contract and claim for damages when there is a breach of condition of the contract.[57] Further, it shall also be noted that the right to terminate would only dispense the future obligation,

[57] *Tan Chong & Sons Motor Company (Sdn) Berhad v Alan Mcknight* [1983] 1 MLJ 220, 227.

not to restore the parties to *ex-ante* position,[58] except when there is a total failure of consideration.[59] Therefore, if the party invoking hardship does not abandon its obligation in its entirety, the innocent party may not be restored to its original position (i.e. restitution) but can merely be awarded with damages.

Further, in granting the said orders and reliefs, the court is implored to consider, amongst others, the existence of the hardship as proven and that the alleged breach of the contract on the part of the aggrieved party was not wholly attributable to the party so alleged. After all, the change of circumstances which has affected the performance was not only unforeseen by the promisor, but the promisee as well. Therefore, to impose the losses arising from the said hardship in its entirety to only one party whilst no one is at fault would, arguably, be unfair and commercially burdensome.

4.2.3 Further requirements and provisos

The party invoking hardship shall demonstrate that the contract does not contain any specific clause governing the alleged hardship. If such provision exists, the said provision will prevail, and the doctrine would not step into the matter in dispute. This requirement may encourage parties to exercise due diligence in identifying any possible change of circumstances at the earliest time possible. Besides, parties will also have the incentive to draft more cohesive contractual provisions by allocating the risks in the most efficient manner, instead of leaving their fates in the hands of an outsider (i.e. the court).

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[58] *Abdul Razak bin Datuk Abu Samah v Shah Alam Properties Sdn Bhd* [1999] 2 MLJ 500, 506.

[59] *LSSC Development Sdn Bhd v Thomas a/l Iruthayam and Anor* [2007] 4 MLJ 1, 8.

Further, pending the disposal of the dispute, the aggrieved party will not be allowed to abandon its obligation in its entirety. Notwithstanding the plea of hardship, this author believes that the law shall require such party to use its best endeavour to fulfil its obligation to the extent that the situation permits. This would prevent any party from invoking hardship as a tactical manoeuvre to put a halt to its obligations prematurely.

5. Conclusion

Though the doctrine of hardship is alien to the Malaysian contract law framework, one may not deny the benefits that such doctrine may offer. Considering today's climate where unforeseen events may occur at any time which may disrupt contractual performance, a change of law by adopting the hardship doctrine may offer some guidance to the affected parties. It is undeniable that the doctrine may not be perfect, but perfection needs time and time needs consideration. Though the doctrine of hardship as summarised in this article may be vigorously opposed due to the existing legal restrictions (e.g. lack of good faith principle in the Malaysian contract law), the author implores that the said doctrine deserves a spotlight and further analytical discussion is certainly required in ensuring that the application of the same, though novel, is not contrary to the Malaysian basic legal framework.

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LEGAL ANALYSIS OF THE PRINCIPLE OF MISTAKE IN THAI LAW*

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Abstract

There are two types of mistakes enshrined in the Thai Civil and Commercial Code "CCC"), namely, a mistake of an essential element of a juristic act resulting in voidness as per section 156, and a mistake of a quality of a person or of the property that is deemed as an essential element of the juristic act resulting in voidability as per section 157. Apparently, these two provisions provide protection to the mistaken party to preserve the actual will. Hence, this is a reflection of the subjectivity, rather than the objectivity, principle at play. There is only one exception in the case of gross negligence pursuant to Section 158 to protect the other bona fide party which is inadequate to maintain the trust between parties and would lead to injustice and uncertainty of commerce. A question arises as to the adequacy of such three existing provisions in tackling current problematic situations.

Therefore, the author has conducted a comparative study to analyze the principle of mistake under English law, French law, and the UNIDROIT

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Principles of International Commercial Contracts 2016. Accordingly, the author proposes additional conditions and exception for nullification or avoidance of a bilateral juristic act which is similar to Article 3.2.2 of the UNIDROIT principles. In so doing, the principle of mistake in Thai law would be more fair and compatible with the current state of the economy.

Keywords: Mistake, Objectivity, Subjectivity

1. Introduction

Intention is one of the vital elements of a juristic act. Nevertheless, a declaration of intention could be void or voidable if it is made under mistake, fraud, or duress.

The definition of mistake depends on each legal system. Under Thai law, a mistake is not defined in the code. Rather, its interpretation can be found through jurist's opinion such as a mistake is an understanding or a belief that is not the same as the truth.[1]

If the mistake is substantial, it could vitiate the consent and may therefore render the juristic act void or voidable. There are two theories related to mistake—the subjective theory and the objective theory, each of which leads to opposite outcomes. The subjectivity theory mainly insists on the result of nullity if one party has an essential mistake. Under this approach, which is generally applicable in civil law countries, nullification is always the effect to maintain freedom of contract but disregards fairness to the other party. From that consequence, internal law has tried to manage this severance by establishing some exceptions. This is also true for Thailand, which has enacted Section 158 in the case of gross negligence. On the other hand, under the objectivity approach adopted by common law countries, even if such a mistake exists, the validity of a contract is always upheld, as parties are obliged to be bound to their expressed intention. To decrease such rigidity, several exceptions have been introduced. For example, in England, a party could escape from contractual liability if the mistake is due to ambiguity in the circumstances of the case. From these two doctrines, it is

[1] Sak Sanongchart, The Commentary on Juristic Act and Contract under the CCC (10th edn, Nithibunnakarn 2008) 167. (ศักดิ์ สนองชาติ, คำอธิบายโดยย่อประมวลกฎหมายแพ่งและพาณิชย์ว่าด้วยนิติกรรมสัญญา (พิมพ์ครั้งที่ 10, นิติบรรณการ 2551) 167).

manifest that if they are purely applied, both of them would have flaws as each is too extreme and may generate unsatisfactorily inequitable results. Thus, there is an attempt to combine both standards to acquire the most equitable consequences for both parties, such as several model laws including UNIDROIT Principles of International Commercial Contracts 2016.

At a glance, a mistake seems to be a minor point in a juristic act. Nevertheless, upon more thorough inspection, it is a crucial legal issue because it directly determines the validity of the juristic act. Furthermore, it could generate several debatable issues, some of which are issues that have not been solved yet, including the balance of fairness to all parties under the circumstance of the one-sided mistake in the juristic act, especially in contracts.

Thus, the author studies the principles of mistake provided in section 156 - section 158 under the CCC. Furthermore, the comparative study of the matter in the following countries or legal instrument would be conducted: England (representing the objectivity approach adopted by common law countries), France (representing the subjectivity approach adopted by civil law countries), and UNIDROIT Principles of International Commercial Contracts 2016 (the model law applicable to international commercial contracts which combines both objectivity and subjectivity approaches).

2. Conflicting legal treatment in relation to the principle of mistake

2.1 Subjectivity

The subjectivity approach is concerned with the actual intention of the parties to the contract. This principle concentrates on what the parties truly intend at the time the contract was formed without considering what

they externally express. Thus, it prioritizes the doctrine of freedom of contract above all other doctrines as the parties are bound to the agreement only if they are subjectively and actually intended themselves to be.[2] Still, it is doubtful to find the way to measure the internal intentions of the parties because no one could access the other people's mind to know their true intent. From that, the party who claims that his intent was deviated from the actual one has to offer the evidence of his past behaviors and surrounding circumstances with the attachment of its meaning.[3] Obviously, it still has a connection with external expression.

Yet, modern scholars believe that applying this theory alone would adversely affect certainty to the law.[4] Besides, it would be incorrect to seek for a central notion of mistake only in subjectivity, which is a pure will theory. Rather, it should be evaluated with objectivity to allow smooth continuation of commerce. Therefore, if the mistaken party has an unlimited right to avoid the contract, it would establish an unacceptable threat to the security of transactions. Thus, it should not be solely interpreted but better intermingled with the objective theory to find the fairest outcome for all related parties.

2.2 Objectivity

The objectivity doctrine is opposite to the subjectivity doctrine in that it accepts only what is expressed externally as explicit evidence proving the literal intention of the party. Bahr explains that when a contract is made, one

[2] Marija Karanikic Miric, 'A Critical Look at the Subjective and Objective Purposes of Contract in Aharon Barak's Theory of Interpretation' (2016) 9(2) Baltic Journal of Law and Politics 1, 11.

[3] ibid 11-15.

[4] ibid 15.

party has the responsibility to form a serious intent.[5] Therefore, the other honest party in an agreement is served the right which the mistaken party cannot take away by claiming that in fact he has not had such intention.

Common law countries once had adopted the principle of subjectivity. Nevertheless, with passage of time, it was eventually replaced by the objectivity approach. This is because the court had to take into regard commercial activities and prevent an unfavorable effect from the subjectivity approach. It also had to ensure reliability for contractual parties. Therefore, this principle has been developed to be more flexible. In the past, the classical objective theory concentrated only on the "reasonable person" as the intentions from the parties shall be bound if the reasonable person in the position of that party shall understand that expressed circumstance. Later on, under the modern doctrine, pure objectivity is no longer in use but the subjective theory is incorporated.[6]

From all of this, it can be seen that these two pure doctrines at either end of the spectrum are far from producing justice to either party as it could be seen that modern legal systems have attempted not to adopt either doctrine exclusively but make a combination that could better lead to the fairest consequences and strike a right balance.

[5] Dwin C Mckeag, Mistake in Contract: A Study in Comparative Jurisprudence (2nd edn, the Law Book Exchange 2004) 41.

[6] Wayne Barnes, 'The French Subjective Theory of Contract: Separating Rhetoric from Reality' (2008) 83 Tulane Law Review 359, 365.

3. The principles of mistake under Thai law and the relevant problems

In Thailand, there are three main provisions of mistakes embodied in the CCC under Section 156 to Section 158. These three provisions divide the types of mistake into two types that could obstruct the validity of the juristic act as stated under Section 156 and Section 157, whereas Section 158 provides the exception that, if the mistake is due to gross negligence, it would not affect the validity of juristic act.

The first type of mistake is a mistake of an essential element of the juristic act as per Section 156.[7] This provision applies when a declaration of intention is diverted from the actual intent without noticing the material diversion.[8] For additional clarification, paragraph two of Section 156 provides examples of what would be considered a mistake of an essential element of a juristic act. As such, it could be said that Section 156 has a wide scope of application. Consequently, the extreme effect of mistake under this section is that such a declaration of intention would be void, which means that it is invalid from the very beginning.

The second type of mistake is a mistake as to the quality of the person or the property that is usually deemed as an essential element of the juristic act as per Section 157.[9] Under this section, the misunderstanding has been created at the time of making an internal intention. After that, the mistaken party makes a declaration in accordance with such mistaken intention. Also, the mistake of the quality under this section must be an essential element

[7] The Civil and Commercial Code of Thailand, s 156.

[8] Prakob Hutasingh, The Principle of Juristic Act and Obligation (Nitibunnakarn 1964) 45 (ประกอบ หุตะสิงห์, กฎหมายแพ่งลักษณะนิติกรรมและหนี้ (นิติบรรณการ 2507) 45).

[9] The Civil and Commercial Code of Thailand, s 157.

of the juristic act in ordinary dealings. The legal consequence of this type of mistake is that the juristic act would be voidable, meaning that the juristic act could still be valid. Nevertheless, the party subject to the mistake has the preference to nullify the juristic act within a specific period of time.

Finally, Section 158 is an exception to Sections 156 and 157 that on the one hand aim to protect the mistaken party. Section 158, on the other hand, does not extend protection to the party who is mistaken as a result of gross negligence. It prohibits him from availing himself of such invalidity.[10] It is to be noted that the threshold of gross negligence is higher than negligence, which is a simple carelessness or a failure to act. Gross negligence is willful behavior done with extreme disregard,[11] and thus does not deserve protection.

As a result, the principle of mistake in Thai law places an emphasis on the freedom of contract and protects the party who is subject to mistake. The underlying rational is that no one should be liable for what he does not intend as stated under Section 156 and Section 157 of the CCC. This is particularly pronounced in Section 156 whereby the consequence of such mistake is the extreme measure of being absolutely nullified without any recourse for the other party who is innocent and was not under any mistake. Furthermore, if the affected party is to seek damages which have arisen as a result of the unenforceability of a juristic act, it is questionable which legal grounds could be raised to claim for such damages. Still, there is an exception stipulated in Section 158 protecting the other party by stating that if a mistake

[10] The Civil and Commercial Code of Thailand, s 158.

[11] Jeed Sethabutr, The Principle of Juristic Act and Obligation (7th edn, Faculty of Law Thammasat University 2013) 137. (จี๊ด เศรษฐบุตร, หลักกฎหมายแพ่งลักษณะนิติกรรมและหนี้ (พิมพ์ครั้งที่ 7, คณะนิติศาสตร์ มหาวิทยาลัยธรรมศาสตร์ 2556) 137).

is made by gross negligence, the mistaken party shall not be protected. Nevertheless, it aims to punish the mistaken party rather than to protect the other party because all consequences depend on the action of the mistaken party alone. This is the reflection of applying the subjective theory in an extreme way. Although some countries including France that also adopt the subjective theory have developed the principle of mistake to provide more fairness to the other party, Thai law still does not pay much attention to equalize both parties.

For example, A had intended to hire B who is a tailor to make a wedding dress without knowing him before. However, when A `entered the shop, she mistook that C is B because their names are spelled similarly. Consequently, A made a hire of work agreement with C but, after that, A found out the truth and would like to terminate the contract by claiming that the mistake was in relation to a party to the contract which shall be void under Section 156. Under such circumstances, even C may have suffered from damage such as expenses for the preparation to perform the contract, A still holds the right to claim for such voidness without any liability which is obviously unfair to C.

In the author's opinion, Thailand has consistently applied these three sections of mistake for a long time and the development in this area has been minor. This leads to the current negative results. Firstly, the trust between the parties could be decreased as he cannot be sure whether the existing juristic act would later be claimed a mistake and subsequently avoided or, for worse, fall under Section 156 and be treated as if it had never existed. Secondly, it could reduce the interest in commercial transactions as there is an unfair protection between the mistaken party and the other innocent

party. Lastly, this principle may cause legal proceedings in court to be delayed as a result of the difficulty in proving facts relating to a mistake.

4. The comparative study with principle of mistake in foreign laws

4.1 English law

The doctrine of mistake in most common law countries, including England, has relied on objectivity, whereas most civil law countries have applied the subjective principle. Accordingly, in the event of a one-sided mistake, also known as a unilateral mistake, where the other party is in good faith, the outward intention would be considered to be the actual will without having to examine the internal intention, as shown in *Smith v. Huge*[12] by Blackburn J. Therefore, the contract would generally not be void due to mistake except in the event of ambiguity based on the standard of the reasonable man. In such a scenario, the mistaken party could claim that the contract is void on the ground of mistake.

Compared to Thailand which is a civil law country and has applied the subjective principle, Thai law adopts some similar perceptions to English law in the aspects of the rectification and *non est factum* as stated under Section 94 of the Thai Civil Procedure Code. According to this provision, if documentary evidence is required by law, oral evidence would generally not be admissible, except in a number of situations, including to prove that such document is inaccurate.[13] Thus, it may not be necessary to amend this issue.

[12] Smith v. Hughes, [1871] LR 6 QB 597, Court of Appeal.

[13] Pinai Nanakorn, The Story of Nakorn Si Thammarat's Province: Royal Funeral Memorial Book of Nukul Nanakron (1999) 204. (พินัย ณ นคร, เล่าเรื่องเมืองคอน: อนุสรณ์ในงานพระราชทานเพลิงศพ อาจารย์นุกูล ณ นคร (2542) 204).

However, several concepts of mistake under English law are different from those under Thai law in many aspects, as the CCC gives more weight to the protection on the mistaken party to nullify the juristic act as could be seen under Section 156 and Section 157 with the only exception stated under Section 158. On the otherhand, under English law, the contract would generally be valid and enforceable except where the parties are at cross-purposes, the mistake is known to the other party, the reasonable man under the same situation would also mistake the circumstances as the mistaken party does, or the parties make the same mistake in material, such as the subject matter never exists.[14] Obviously, the operation of mistake under English law itself that has limited allowance to nullify the contract on the ground of mistake is adequate to protect the other innocent party, whereas under the Thai system, the opposite can be said.

As a result, although the legal treatment of mistake under the CCC follows the subjective principle to recognize the actual will rather than an outwardly expressed declaration, it is interesting to adopt a more objective approach from England to increase equality and certainty of transactions, especially the criteria of the reasonable man by considering whether such expression is believed by a reasonable man that it is an actual intention or not. If not, it is sensible that the mistaken party should be bound by his declaration. Accordingly, the English system could be the model for Thai law in the aspect of adequate protection to the other party to preserve the good faith principle. Still, besides such perception, the author is hesitant to adopt other principles of mistake under English law because several disorganization still exists, as it has a much narrower application compared to the mistake in

[14] Richard Stone and James Devenney, Text, Cases, and Materials on Contract Law (3rd edn, Routledge Press 2014) 386-389.

civil law countries, as the English law has instead developed a principle of misrepresentation.[15]

4.2 French law

The CCC has been influenced by the French Civil Code as a result of the drafting committee being composed partly of French jurists. The former Code Civil of France had laid down several principles similar to those under Thai law, indicating what types of mistakes could affect the validity of a contract. For example, the mistake in quality of substance and person under the former Code Civil of France would result in voidability known as relative nullity which is similar to Section 157 of the CCC, whereas the *Erreur-Obstacle* developed by legal scholars and judgments would prevent the contract from even forming, resulting in the consequence of absolute nullity which is similar to Section 156 of the CCC. Furthermore, the *Cour de Cassation* of France played an important role to harmonize equality.[16] For example, a mistaken party could not avoid a contract if such mistake was inexcusable as could be seen in a famous case that a seller who bought velvet could not claim that this material was not proper for making a woman's clothes as the seller had experience in this manufacturing area which meant he should be aware of the normal use of the fabric.[17]

Consequently, after the reform of the Civil Code of France, the Code has maintained the division of the mistake into a mistake in the essential

[15] Hugh Beale, Cases, Materials and Text on Contract Law (Oxford, Hart Publishing 2019).

[16] John Bell, Sophie Boyron, and Simon Whittaker, Principles of French Law (2nd edn, Oxford University Press 2007) 312-313.

[17] Cass. Com., 4 July 1973, B IV.238; D1974.538.

qualities of the act of performance[18] and a mistake in the essential quality of the other contracting party.[19] Accordingly, the case law has been codified into Article 1333. This revision putting a definitive end to the debatable issue on what substantial mistake is, as it is shifted from "the very substance of the thing that is the object of the agreement" to "the essential qualities of the act of performance". Thus, the mistaken quality that could nullify the contract shall be agreed by the contractual parties to be essential which means the new Code chooses to apply an objective approach to avoid taking into account fanciful qualities which were not known to the other party because he should not bear a risk on such a one-sided mistake.[20]

Besides, the author could differentiate further points between the reformed Civil Code of France and the CCC. Firstly, French law clearly emphasizes the important role of the good faith principle in relation to a mistake in several provisions as it would cover every process of intention and declaration making, including the pre-contractual stage.[21] Secondly, it explicitly imposes the mistake of law besides mistake of fact. It explicitly legislate a type of mistake of law in the code; thus, it is clear that the determination would be the same as a mistake of fact.[22] Last but not least, French law has already codified judgments to the reformed code that a motivation and a mistake as to value generally does not affect the validity of a contract.[23]

[18] The Code Civil of France, art 1133.

[19] The Code Civil of France, art 1134.

[20] Bell, Boyron and Whittaker (n 16).

[21] The Code Civil of France, art 1107, art 1112, and art 1112-1.

[22] The Code Civil of France, art 1132.

[23] The Code Civil of France, arts 1135-1136.

When examining the reformed code of France, although its main principle is subjectivity, concrete judgments were codified with the attempt to bring more unity and certainty, such as providing that motivation and value cannot generally be the grounds to nullify the contract. Therefore, it is interesting to consider whether Thai law should follow such direction or not.

4.3 UNIDROIT Principles

The UNIDROIT Principles have attempted to bring about equality to all contractual parties and uphold certainty of commercial transactions by combining the subjectivity and objectivity approaches.[24] Consequently, the advantages of each approach are applied to this model law.

The UNIDROIT principles rectify the mistake of law besides the mistake of fact.[25] Also, the consideration to allow the mistaken party to invalidate the commercial contract due to a mistake under the UNIDROIT principles is outstandingly different from the CCC and thus the author would consider this point to be the most interesting suggestions for amendments to Thai law. Article 3.2.2 provides distinctive protection to the other party to be more fair by stating additional requirements that shall be satisfied for such mistake to be serious based on the reasonable man standard and that the other party is under the same mistake, the other party caused the mistake, the other party knew or should have known the mistake and it is contrary to reasonable commercial standards, or the other party had not yet acted in reliance on the contract at the time of avoidance. Besides, there are also exceptions under which a party is not allowed to avail himself from such invalidity as he

[24] UNIDROIT Principles of International Commercial Contracts 2016, International Institute for the Unification of Private Law (UNIDROIT), Rome, 101.

[25] UNIDROIT Principles, art 3.2.1.

was grossly negligent or when there is a risk of mistake that should be borne by the mistaken party.

Besides, the mistaken party would lose the right to avoid a contract if the other party had already performed as agreed or immediately informed his willingness to perform the contract before receiving the notification of avoidance.[26] Furthermore, UNIDROIT principles state that a mistaken party could notify the other party within a reasonable time to avoid the contract.[27] As a result, the contract would be considered as having never existed, which is less extreme when compared to a void contract.

In light of the above analysis, the author would like to propose that the UNIDROIT principles, especially Article 3.2.2, should be adopted into the CCC as the principles itself has already combined subjectivity and objectivity principles to ensure fairness for all contractual parties and benefit commercial transactions whereas English law still applies more objectivity and French law applies more subjectivity. As a result, these two countries could be model laws to the CCC in some aspects, but several concepts have still struggled within its own respective system and is also in the process of developing to rectify flaws.

5. Recommendations

The author proposes that there shall be further requirements that must be met in order for the mistaken party to nullify or avoid the juristic act on the ground of mistake. As mentioned earlier regarding the issue of unfair protection to the other innocent party who has a safeguard only under Section 158, the author has conducted a comparative legal analysis and,

[26] UNIDROIT Principles, art 3.2.9.

[27] UNIDROIT Principles, art 3.2.11 and art 3.2.12.

particularly with respect to UNIDROIT principles, have found interesting points to propose as further conditions to the CCC as follows.

Firstly, the other party must be under the same mistake. This is extracted from English law and UNIDROIT principles.

Secondly, the other party must have caused the mistake. This is extracted from UNIDROIT principles. Particularly, such cause could be done expressly or implicitly, with negligence or innocence, but it shall not be made by fraud; otherwise, it would be governed by provisions concerning fraud from Section 159 to Section 163 of the CCC. Moreover, it is proposed that silence could also be a cause of an error but, again, it must not have been done intentionally; otherwise the intentional silence would be fraudulent under Section 162 of the CCC.

Thirdly, it is proposed that the mistake is or should have been known to the other party. This is extracted from the English law, French law, and UNIDROIT principles. Accordingly, the criteria to determine what the other party should have known is based on a reasonable man standard from an objective principle. The UNIDROIT Principles state precisely that such mistake that the other party knows or should have known shall be contrary to reasonable commercial standards of fair dealing, which in turn gives rise to the duty to inform. However, the author proposes not to include this part of the UNIDROIT principle, because the CCC is applicable to civil and commercial matters which also covers non-commercial transactions. As a result, if the serious mistake is recognizable by the other party, there is enough ground to justify that he should not be protected by law because of his lack of good faith.

The author maintains that these first three conditions are sensible because the other party does not deserve the protection as he was involved in one way or another with the mistaken party's error.

Fourthly, the author proposes that the other party must, at the time the mistaken party gave the notice of avoidance, not have acted in reliance yet. This is extracted from the UNIDROIT principles. Under this condition, the other party must not have yet prepared himself under good faith to be capable to perform as agreed. Therefore, he would not have suffered any damage through relying on the juristic act, especially commercial contracts. It is understandable that this point may cause some concern, but as far commercial business is taken into account, good faith in the formation and performance of the contract should be fully protected and the possibility of avoidance should be ruled out.

The principle of mistake under French law and UNIDROIT principles would be applied to the contracts which entails a narrower scope in comparison to the CCC, which includes mistakes in juristic acts. Thus, when considering the above conditions which depends on the other party, it could not cover to unilateral acts because it does not require the other's declaration to be formed. Hence, the conditions from the side of the other party shall not be taken into account. Accordingly, the proposed amendments would only be applied to bilateral juristic acts, which includes contracts.

In addition to the conditions from the side of the other party, there shall be an exception under which a party is not allowed to avail himself from such invalidity viewing from the side of the mistaken party if he had assumed the risk of mistake or if he should bear the risk. This is extracted from French law and UNIDROIT principles. Consequently, such exceptions

could be applied to all juristic acts as it is considered from the side of the declarer which in this case is the mistaken party. Thus, it may be added to the existing Section 158 to supplement the case of gross negligence. If Thai law could adopt further required conditions and exception to nullify or avoid the juristic act besides the present requirements under Section 156 to Section 158, the protection of the other party would be increased. Accordingly, it would lead to equality, and thus would stabilize the commercial transactions as the mistaken party could not later too easily make a claim to nullify or avoid the juristic act on the ground of mistake. Therefore, the other innocent party could trust and have confidence. At the same time, the mistaken party's protection still exists, just with more limitations.

In light of the above analysis, the suggestions should be incorporated into the CCC and reflected via the following amendments.

Section 157/1 "a mistake under Section 156 or Section 157 could nullify a bilateral juristic act if the reasonable man in the same circumstance would have such a mistake and

(1) the other party made the same mistake; or

(2) the other party caused the mistake; or

(3) the other party knew or should have known the mistake; or

(4) the other party had not yet acted in reliance of the mistake at the time of avoidance".

Section 158 "If the mistake under Section 156 or Section 157 was due to gross negligence of the person making such declaration or the person assumed the risk or should bear the risk of mistake, he cannot avail himself of such invalidity".

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A REVISIT OF LEGAL PROBLEMS CONCERNING CAPITAL CONTRIBUTION IN KIND IN THAI PRIVATE COMPANIES*

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Abstract

Instead of cash, any other form of money's worth or "contribution in kind" may also be contributed to private companies. As the key difference between contribution in cash and in kind is that the latter is subject to valuation, laws and regulations in each jurisdiction are therefore differently legislated through the integration of legal theories to preserve the interests of company's stakeholders, particularly on the legal framework of characteristics and specific requirements of contribution in kind including additional liabilities to mitigate potential risks when there is an unlawful or fraudulent valuation. This article discovers that Thailand encounters the problems of legal uncertainty of characteristics of contribution in kind, valuation and law enforcement as a result of the lack of specific and sufficient provisions to stipulate statutory characteristics, requirements, duties,

* This article is summarized and rearranged from the thesis "A Revisit of Legal Problems concerning Capital Contribution in Kind in Thai Private Companies", Faculty of Law, Thammasat University, 2020.

responsibilities, civil and criminal liabilities including administrative order to the persons directly involving with contribution in kind.

In contrast, the study through the lens of comparative analysis from the Federal Republic of Germany ("Germany") and the People's Republic of China ("China") indicates that they have prioritized to resolve the aforesaid problems by stipulating specific provisions into legislation and regulatory framework in order to impose general characteristics, statutory obligations, specific requirements, restrictions, prohibitions, and additional liabilities of both civil and criminal to preserve interests of company's stakeholders. This article consequently suggests legislative and regulatory reform by adopting some of the findings that could cope with the existing problems that current Thai laws and regulations are unable to resolve.

Keywords: Contribution in Kind, Private Companies, Overvaluation

1. Introduction

Instead of cash, shareholders may also contribute their other assets to private companies in exchange for shares or so-called "contribution in kind", for instance, a plot of land, machinery, equipment, materials and buildings. Contribution in kind is beneficial to both company and investors in many aspects but it can also adversely affect company's stakeholders upon valuation. Once a company accepts a contribution in kind, there is a process of valuation to exchange it into the amount of new shares. If contribution in kind is worth "more than" the nominal value of new shares, such shares are considered being issued at a premium. Conversely, if it is worth "less than" the nominal value of the shares, or there is an overvaluation, the new shares are practically issued at a discount, which may be contrary to law.[1]

Overvaluation of contribution in kind causes mismatching between the registered capital and the actual value of the contributed asset, and if the asset is overvalued in a significant amount, it dramatically harms the company's stakeholders: from existing shareholders, creditors, to third parties. For existing shareholders, the shareholder who contributes overvalued contribution in kind claims a larger portion of control of shareholder's rights and ownership of the company although she is contributing less than others, therefore the rights of other shareholders, e.g., right to receive dividend and right to vote, will be diluted, while creditors in the insolvency proceedings will suffer a shortfall of their repayments as the proceeds of in-kind contribution are significantly lower than the specified amount in the company's registered capital. Lastly, third parties desiring to trade or engage with the company would be misled by the misrepresentation through the

[1] Sarah Worthington, Sealy and Worthington's Text, Cases, and Materials in Company Law (11th edn, Oxford University Press 2016) 529.

mismatching amount of registered capital shown in the company's documents.

To solve these problematic issues, as a result, company laws in many jurisdictions have been developed to devise tools to prohibit the danger that the share may be undervalued based on their concerned theories, case law, and company law's historical developments. For Thailand, it appears to the author that Thai laws and regulations together with its practices applied to private companies remain unclear, outdated, and contain legal deficiencies. As a result, this article aims to study laws and regulations from the Federal Republic of Germany ("Germany") and the People's Republic of China ("China") and adopt some of the results as guidelines in order to provide effective recommendations for resolving the current problems in Thailand.

2. Statement of problems of laws and regulations on contribution in kind in Thai private companies

2.1 Problem of legal uncertainty of characteristics of contribution in kind

Since the general provisions of equity capital contribution in private companies under Thai Civil and Commercial Code ("TCCC") mainly focus on "cash contribution",[2] consequently there is no specific provision directly regulating contribution in kind. The lack of specific provisions causes controversial issues in practice regarding the uncertainty of characteristics of contribution in kind because investors always find challenges and experience bars regarding inconsistency of interpretations. These challenges include whether or not the disputed contribution in kind can be registrable upon the

[2] Thai Civil and Commercial Code, s 1119.

stability of value and, if so, to what extent that the Department of Business Development ("DBD"), the Thai government agency controlling and regulating the registration of business in Thailand, will register such contribution in kind without delay or hesitation. Furthermore, the existing DBD's interpretations and practices concerning some forms of contribution in kind, e.g., intellectual properties, are unable to catch up with the rise and diversity of modern forms of capital contribution since DBD unreasonably rejects them upon DBD's orthodox interpretation that they contain instability of value. As a result, these practices create less investment choices to investors as they have indirectly limited the types of contribution in kind only to those traditional and tangible forms which have official prices, e.g., a plot of land, machinery, and gold.

2.2 Problem of valuation

TCCC lacks the standard of valuation process to deliver transparency, accuracy, and creditworthiness for the fair valuation. It merely controls the access of contribution in kind with minimum statutory requirements (an approval from the company's statutory meeting,[3] and a special resolution from the shareholders' meeting for the increase of capital[4]). In practice, DBD also considers the valuation as the business judgment of the company's internal affairs with its investors or shareholders. These roots of problem create the loophole on the possibility that contribution in kind may be overvalued upon the absence of valuation standard and expose the company's stakeholders to risks. Save for the exception under the Bankruptcy Act, furthermore, debt to equity swap is strictly prohibited under TCCC's

[3] Thai Civil and Commercial Code, s 1108 (5).

[4] Thai Civil and Commercial Code, s 1221.

provision[5] and DBD's opinion[6] since it poses risks to the company's capital due to the instability of value and the difficulty of assessing how many shares should be issued to fully satisfy a debt obligation.

2.3 Problems of law enforcement

Once there is an overvaluation of contribution in kind, Thai laws and regulations fail to control this corporate misconduct because they provide very limited access for civil liability, insufficient criminal liability, and ineffective administrative order.

2.3.1 Civil liability

There is no specific provision to impose civil liability, especially for shortfall liability, on the wrongdoers when there is an overvaluation of contribution in kind, and the question of who shall bear this responsibility (e.g., in-kind contributing shareholder, existing shareholders, directors, or promoters) remains unclear. Although the author applies the most nearly applicable provisions under TCCC, i.e., tort,[7] breach of company's statutory contract,[8] and breach of director's duties[9] to link this civil liability to the wrongdoers, the study shows that they remain unenforceable since Thai court

[5] Thai Civil and Commercial Code, s 1119 para 2.

[6] The Opinion of the Department of Business Development of Thailand, Por Nor 0805.04/3832 dated 4 November 2553 (2010).

[7] Thai Civil and Commercial Code, s 420.

[8] Thipchanok Ratnosot, Explanation of the Principles of Partnerships and Company Law by Sections (6th edn, Thammasat Printing House, 2013) 7. (ทิพย์ชนก รัตโนสถ, คำอธิบายเรียงมาตรา กฎหมายลักษณะห้างหุ้นส่วนและบริษัท (พิมพ์ครั้งที่ 6, โรงพิมพ์มหาวิทยาลัยธรรมศาสตร์ 2556) 7).

[9] Thai Civil and Commercial Code, s 1168.

rarely construes the aforesaid provisions to impose civil liability on the wrongdoers. As a result, the injured parties lose the rights to restitution, compensation, and rehabilitation for recovering their losses upon overvaluation, entitling them less opportunity to claim for compensation and to increase the possibility of their repayments.

2.3.2 Criminal liability

There is only one criminal punishment[10] of fine payment with a maximum of 50,000 Baht to be imposed on any person who dishonestly overvalues contribution in kind. This function addresses the problem of law enforcement because the punishment is prescribed at low level, which is not proportional to the seriousness of the crime and is unable to raise awareness and fear among the public. Furthermore, the litigation of this criminal liability is problematic in practice since the injured party always encounters difficulty in finding evidence to testify the offender's guilty mind upon the lack of documents of valuation.

2.3.3 Administrative order

Under the Order of the Central Partnership and Company Registration Office No. 66/2558 dated 24 March B.E. 2558 (2015 A.D.) ("Order 66/2015"), during the incorporation process, DBD is entitled to embed the warning statement(s) in the company's certificate of registration to keep the public informed of an incomplete capital contribution if the company with the initial registered capital of more than 5 million Baht fails to submit supporting documents to evidence that the ownership of contribution in kind is legally

[10] The Act Prescribing Offences Related to Registered Partnerships, Limited Partnership, Limited Companies, Associations and Foundations B.E. 2499 (1956), s 48.

transferred to the company for its free disposal within 90 days after the registration is completed. In addition, if no evidence is received after DBD's several calls to perform further clarification for the failure of submission, DBD is entitled to issue an order of revocation of business registration to the company.

The provided functions of administrative order are ineffective since the issuance of administrative orders to embed the warning statement(s) in the company's certificate of registration is not forceful enough to prohibit the overvaluation from the company and to refrain the public from engaging business with such a company because the orders do not constitute a compulsory action to provide the accurate valuation, but they are just warning and informing messages, in which the public may ignore the statement(s) and still engage in businesses with the company. Furthermore, the order to revoke a registration application is rarely issued upon the lack of DBD's procedural measures.

3. Foreign laws and regulations on contribution in kind in private companies

The author examines laws and regulations from Germany and China in order to find out how they regulate contribution in kind and resolve legal problems that are currently existing in Thai private companies. To effectively present the different levels of legal framework, the author classifies their laws and regulations into certain issues, i.e., characteristics of contribution in kind, general requirements, civil and criminal liabilities, and administrative or judicial order.

3.1 The Federal Republic of Germany

Germany has prescribed duties, responsibilities, and liabilities in connection with limited liability companies under the Limited Liability Companies Act 1892 A.D. ("GmbH Act"). In General, a limited liability company ("GmbH"), which in comparison is similar to Thai private companies incorporated under TCCC, is liable for its debts alone to its assets,[11] and the liability of subscribers or shareholders is limited to the amount of their subscription to the share capital. At a time of incorporation, a notary is mandatory to examine and notarize the accuracy and the validity of the articles of association, the company statutory agreement, and other required founding documents. Such a notary will complete the registry of GmbH by submitting the application to the competent register court. If the court finds no bar, it grants the incorporation status to GmbH in writing.

3.1.1 Characteristics of contribution in kind

The GmbH Act contains various provisions to set out the statutory characteristics of contribution in kind that it must be 1) able for an economic valuation, 2) having a certain period of usability under a balance sheet, and 3) transferable. There are specific provisions applying to specific types of contribution, e.g., enterprise as on-going business.[12] Furthermore, the GmbH Acts also defines "hidden capital contribution"[13] to avoid any inconsistency

[11] The Limited Liability Companies Act of Germany, s 13(2).

[12] The Limited Liability Companies Act of Germany, 5(4).

[13] The Limited Liability Companies Act of Germany, s 19(4) and s 56(2).

"A hybrid capital rule preventing the circumvention of the valuation of contribution in kind that is artificially splitting an arrangement involving that contribution in kind into two or more parts, and then taking them into cash contribution transaction"

of the court's interpretation. These increase investors' confidence and raise investors' perception that the equity capital market in GmbH is steady as there are various provisions concerning characteristics applied.

3.1.2 General requirements

The GmbH Act regulates contribution in kind with strength requirements at the time of company's incorporation and increase of capital. First, Documentation: corporate documents, e.g., articles of association, shareholders' report and resolution,[14] related agreements,[15] and the statement of the needs of contribution in kind,[16] are mandatory to specify in-depth details of contribution. This requirement is not only for the purpose of capital verification for the registrar but also the evidence for the public examination. Second, Valuation Report: the GmbH Act further controls the accuracy of valuation by requiring a valuation report[17] from external experts to deliver a fair market value, and the competent register court is also entitled to examine the method of valuation upon the statements of additionally appointed experts.[18] As a result, there is less possibility of mismatching between the registered capital and the actual value of the contributed asset. Last, Debt to Equity Swap: Germany extends its flexibility to allow debt to equity conversion along with the valuation report to benefit a company in

[14] The Limited Liability Companies Act of Germany, 5(4).

[15] The Limited Liability Companies Act of Germany, 8(1) 4.

[16] The Limited Liability Companies Act of Germany, s 56(1).

[17] The Limited Liability Companies Act of Germany, 8(1) 5.

[18] Marco Ardizzoni, German Tax and Business Law (1st edn, Sweet & Maxwell Ltd 2005) 7-051.

raising its finance and restructuring debts when the company suffers a business downturn.

3.1.3 Civil liability

When there is an overvaluation, the GmbH Act contains a set of civil liability provisions to be imposed on the individuals essentially linked to the valuation of contribution kind as follows: (1) During the early period of GmbH's incorporation, a pre-entry liability[19] will be imposed on the initial director and forming shareholders to mark up any deficiency of the assured contribution in kind if there is a misuse or a shortfall of value at the time of registration; (2) Shareholder with overvaluation of contribution in kind is subject to a shortfall liability[20] to mark up any differences upon the overvaluation; and (3) The injured parties, especially corporate creditors, are entitled to claim joint and several liability[21] from existing shareholders and managing directors once the shortfall amount cannot be obtained from the defective shareholder. These civil liabilities can be raised by the company itself, the creditors, or the insolvency administrator within 10 years[22] after the registration or the transfer of the assets.

3.1.4 Criminal liability[23]

The GmbH Act contains both fine payment and criminal punishment of imprisonment with a maximum period of 3 years for whoever makes false

[19] The Limited Liability Companies Act of Germany, s 11(2).

[20] The Limited Liability Companies Act of Germany, s 9(1).

[21] The Limited Liability Companies Act of Germany, s 9a.

[22] The Limited Liability Companies Act of Germany, s 9(2).

[23] The Limited Liability Companies Act of Germany, s 82(1).

statements of contribution in kind. False statements can be in any form of corporate misconduct, such as false report, and false amount of contribution through overvaluation. Also, this provision expressly stipulates the specific terms of shareholder and director to be criminally liable for their misconducts.

3.1.5 Judicial order[24]

The GmbH Act deals with the violation to issue a judicial order at first place in the process of registration. If the competent register court still finds any discrepancy of the valuation after it has severally investigated the valuation report on whether or not contribution in kind is accurately appraised into fair market value, the court is entitled to grant a judicial order to refuse registering to make entry to the commercial register.

3.2 The People's Republic of China

Certain characteristics of limited liability company ("LLC") under the Chinese Company Law 2018 ("PRC Company Law") are mostly similar to private companies of Thailand and Germany. LLC is liable for its debts to the extent of its assets, while the shareholders' liability is limited to the amount of their respective capital contributions stated in the articles of association.[25] In general, LLC is legally incorporated by way of registration of application form to obtain a business license and approval from the competent State Administration for Market Regulation ("SAMR") or so-called China's business registration authority.

[24] The Limited Liability Companies Act of Germany, 9c(1) and s 57a.

[25] The PRC Company Law (2018 Revision) (Official Translation), art 3.

3.2.1 Characteristics of contribution in kind

The PRC Company Law illustrates that the two statutory characteristics of contribution in kind, i.e., assessability and transferability,[26] must be met, and further exemplifies some contribution in kind in the provision to avoid any inconsistency of interpretation. There are specific regulations[27] to exclude what is not eligible as equity capital, e.g., franchise and goodwill. In addition, instead of total rejection, China relatively welcomes new forms of contribution in kind by imposing additional requirements to confirm the legality if they meet these additional requirements.

3.2.2 General requirements

First, Documentation: The articles of association are mandatory to specify the method, amount, percentage, time of contribution, including contribution period to set out the time limit for shareholder's obligation to complete the whole contribution.[28] Second, Valuation Report: Although the valuation report is no longer required, the PRC Company Law sets the corporate governance provision that the internal valuation must not be overvalued or undervalued.[29] This internal valuation may also be challenged in court by a request from the company, other shareholders, or creditors for a professional valuation to be performed by a legally qualified appraisal

[26] The PRC Company Law, art 27.

[27] The Administrative Regulations on Administration of Company's Registration, effective date 6 February 2016 art 14 <https://wfyaulawyers.com.au/2020/08/12/regulation-of-the-peoples-republic-of-china-on-the-administration-of-company-registration/> accessed 15 June 2020 (Unofficial Translation).

[28] The PRC Company Law, art 25.

[29] The PRC Company Law, art 27 para 2.

agency.[30] Last, Debt to Equity Swap: China also accepts debt-to-equity conversion under certain circumstances[31] to benefit a company to survive by way of restructuring its outstanding debts rather than prohibiting debt-to-equity swap and letting the company goes bankrupt.

3.2.3 Civil liability

The PRC Company Law and its regulations facilitate the affected parties with various legal principles to litigate a claim of civil liability when there is an overvaluation of contribution in kind: (1) Shareholder with significant overvaluation of contribution in kind is subject to shortfall liability,[32] and directors and senior managers[33] will also be subject to this shortfall liability as it is deemed that they fail to preserve their duty of care to the company's capital;[34] (2) Creditors can further pursue the shortfall payment from other shareholders who established the company and promoters based on joint and several liability;[35] and (3) Other existing shareholders, who have paid their capital contributions within the contribution period stated in the articles of association, are entitled to claim

[30] The Judicial Interpretation of the Company Law (3), effective date 1 January 2020 art 9 <https://baike.baidu.com/item/中华人民共和国公司法司法解释三/9561359> accessed 15 June 2020 (Unofficial Translation).

[31] The Regulations on the Administration of Registered Capital Registration of Companies No. 64, effective date 1 March 2014 art 7 <http://www.gov.cn/zhengce/2014-03/03/content_2627034.htm> accessed 15 June 2020 (Unofficial Translation).

[32] The PRC Company Law, art 30.

[33] The Judicial Interpretation of the Company Law (3), art 13 para 4.

[34] The PRC Company Law, art 147.

[35] The PRC Company Law, art 30.

for compensation from the defective shareholder on the basis of a breach of contractual obligation.[36]

3.2.4 Criminal liability[37]

Making a false capital contribution through significant overvaluation of contribution in kind that causes serious damage to the public is subject to severe punishments of fine payment and imprisonment with a maximum of 5 years under the PRC Criminal Law. Interestingly, the terms "shareholders and promoters" are additionally worded in the provision in order to raise their awareness of severe sanction of imprisonment.

3.2.5 Administrative order

The PRC Company Law[38] and its regulations[39] contain general to severe sanctions of administrative orders to prohibit the violation of overvaluation. The company registration authority may issue (1) an order to make a shortfall payment, (2) a fine payment, and (3) fine penalties. In addition, if the public is adversely impacted by the significant overvaluation, severe orders to cease the business operations, i.e., (4) an order to revoke the company registration, and/or (5) an order to cancel the business license may be granted.

[36] The PRC Company Law, art 28 para 2.

[37] The PRC Criminal Law 1997, art 159.

[38] The PRC Company Law, art 198.

[39] The Administrative Regulations on Administration of Company's Registration, arts 64-65.

4. Conclusions and recommendations

The findings of this comparative study show that legal frameworks of contribution in kind in Germany and China with respect to private companies are more strikingly vivid to preserve the stakeholders' interest by containing more distinctive and complex features to stipulate statutory characteristics, mandatory requirements, including additional liabilities, and judicial or administrative orders. By contrast, the existing laws and regulations of Thailand remain unclear and provide ineffective and insufficient legal measures, resulting from the lack of specific and insufficient provisions to regulate contribution in kind. As a result, the author suggests the following legislative and regulatory reform in order to diminish the underlying problems and improve the legal framework of contribution in kind in Thai private companies:

First, the problem of legal uncertainty of characteristics of contribution in kind: the author proposes legislation that includes a specific provision in TCCC outlining general characteristics of contribution in kind as being capitalizable, accessible, and transferable with open-ended approach, a ministerial regulation prohibiting certain types of contributions in kind that pose risks to the company's capital, and additional regulations imposing more requirements for qualifying some types of contribution in kind to welcome more forms of contribution. These would provide legal certainty and reduce controversies of investors and DBD's interpretations.

Second, problem of valuation: TCCC should establish strength requirements into the security system of valuation. The author proposes that TCCC imposes an additional statutory requirement requiring mandatory disclosure of details of contribution in kind in main public documents for public examination. In terms of accuracy and creditworthiness, a valuation

report by experts appointed by the company's statutory meeting or the shareholders' meeting is suggested to deliver a fair and accurate market value, with the exception for certain types of contribution in kind. It is also recommended that certain individuals should be granted the right to contest the report if they discover any inaccuracy in the valuation. Furthermore, when viewing debt-to-equity swap as contribution in kind, the valuation report can relax the prohibition of this conversion because the professional valuation of indebtedness confirms the legality and the instability of its actual value against DBD's current opinions.

Third, problems of law enforcement when there is an overvaluation of contribution in kind: for the lack of specific provisions of civil liability, the author suggests that TCCC includes strict liability provisions of shortfall liability and joint and several liability (with the right to recourse) to be imposed on individuals who directly control the valuation of contribution in kind in order to establish the rights to restitution and compensation to the injured parties. In term of insufficient criminal punishment, the author suggests imposing additional criminal punishment of imprisonment with a maximum of three years and including specific terms of "shareholders and directors" in the provision of relevant law in order to create more efficiency and enforceability of this criminal liability. Lastly, for the ineffective administrative order, the author suggests abolishing the condition concerning the amount of registered capital and implementing DBD's additional severe administrative order of temporary revocation of business license requiring the company's compulsory action for re-valuation of contribution in kind with additional promulgation of ministerial regulations concerning DBD's procedural guidelines from the Ministry of Commerce.

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APPLICABILITY OF SMART CONTRACT IN THE BHUTANESE LEGAL SYSTEM*

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Abstract

Since e-commerce in Bhutan is still in its infancy, the laws regulating electronic transaction has not been long since its enactment. This paper will try to scrutinize the existing laws on contract and electronic transactions and examine if smart contracts can be legally binding in Bhutanese legal system. This paper focuses specifically on the formation and formalities of contract under the existing laws in Bhutan to identify the legal tension that rises with the application of smart contracts that encompasses issues like formation and formalities.

The legislation governing electronic transaction has no specific and clear provision to accommodate smart contracts, which warrants a new law regulating electronic transactions in Bhutan to give smart contracts a legal status. The comparative study of the two foreign jurisdictions imparts the best practice of the laws in common law jurisdictions, which Bhutan could acquire.

Keywords: Smart Contract, Blockchain, Formation of Contract

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1. Introduction

With the overwhelming emergence of advanced technology over the years, the digital transformation has had an enormous impact on the people. One such technology that has drawn a huge amount of attention lately is the blockchain technology. Blockchain technology is an innovative data archiving platform wherein storage of multiple data can be accessed in an interconnected domain, where individual participants can be in possession and maintain the whole record inclusive of updated transcription of the data archived.[1]

Indeed, there has been a rife of curiosity and interest in the blockchain based smart contracts, which is known for its reliability, transparency and trustworthiness, which have increased interest in transforming legal agreements into codes. Nick Szabo was the mastermind of smart contract technology. According to his manuscript he elucidated that the methodology of cryptography has the potential to transcribe the contractual terms agreed between parties into digital program, which is denoted by computer codes that would narrow the contingency of possible termination of its contractual performance obligation due to immutable characteristics of smart contracts.[2] The parties can take effect of smart contracts by jointly computing and using software to manage contractual performance, with minimum interaction amongst parties. A "smart contract" is a digitally signed, computable and self-executed agreement between two

[1] Haider Dhia Zubaydi and others, 'A Review on the Role of Blockchain Technology in the Healthcare Domain' (2019) 8(6) Electronics 679.

[2] Nick Szabo, 'Smart Contracts: Building Blocks for Digital Markets' (1996) <www.truevaluemetrics.org/DBpdfs/BlockChain/Nick-Szabo-Smart-Contracts-Building-Blocks-for-Digital-Markets-1996-14591.pdf> accessed 22 August 2020.

or more parties.[3] Smart contracts are an application of the blockchain technology, referring to computer codes, which verify and execute the terms of a contract by an electronic agent, removing the need for humans to monitor compliance and enforcement.[4]

The legal analyses that are often brought to limelight are the question as to whether contractual relations that are built in smart contract can be legally binding or not and whether the contractual agreements that are encrypted as codes in a computer satisfy the requirements for formation of contract and written evidence in the laws governing contract. There are various areas of enforceability of smart contracts that are subject to legal controversy. Some of the issues pertaining to the enforceability complex surround the formation and formalities of smart contracts.

For the purpose of synchronizing formal requirements under the contract laws making it parallel to the traits of blockchain smart contracts, an amendment on the Bhutanese Law is recommended. Thus, smart contract may be able to hold a legal status in the Bhutanese jurisdiction.

2. Overview of smart contracts

The concept of smart contract was a brainchild of Nick Szabo since 1996. He defines smart contract as a set of promises, specified in digital form, including protocols within which the parties perform on these

[3] Alan Morrison, 'The End Game for Public and Private Blockchain Isn't Just Digital Currency—It's Digital Business Flows' <http://www.pwc.com/us/en/technology-forecast/blockchain/digital-business.html> accessed 5 August 2020.

[4] Boonyaorn Na Pombejra, 'The Rise of Blockchain: An Analysis of the Enforceability of Blockchain Smart Contracts' Faculty of Law, Thammasat University (2016).

promises.[5] He tries to explain the simple operation of a vending machine as the best example for smart contract, wherein the instructions and conditions are already programmed. For instance, when you insert a 10 baht coin, a bottle of mineral water comes out. However, with the evolution of advanced technology and emergence of Bitcoin blockchain and Ethereum, smart contracts are much more than how it was initially conceived. The creation of smart contracts is one of the recent developments in blockchain technology. The benefit of technology facilitates the parties in making an agreement by encoding the contractual performances into the blockchain. This can be performed on a decentralized distributed ledger, which is amongst the most special characteristics of blockchain technology, alongside the use of digital signatures and computer codes.

Szabo also explained that smart contracts could improve execution of the four basic contract objectives, i.e. observability, verifiability, privacy and enforceability. Among other use cases to be discussed in the following sections, smart contracts according to Szabo would enable both parties to observe the other's performance under the contract, verify if and when a contract has been performed, guarantee that only necessary details required for completion of the contract are disclosed to both parties and be self-enforcing to disregard the time spent in monitoring the contract.[6]

The development of smart contracts has been one of the significant technological inventions of the latest blockchain over the years. The application of smart contracts to the traditional contractual agreements will have more value by minimizing risk and ensuring security. So as to better fathom the correlation between smart contracts with blockchain, we need

[5] Szabo (n 2).

[6] ibid.

to know the process of how smart contracts work. For instance, in a typical contract of buying a land, it entails a lot of paperwork and interaction with numerous individuals. Most often then not, these transactions involve risk of financial scam, ownership transfer, fraud and etc. However, to eliminate that burden on such transactions, people prefer to get the deal done through real-estate dealers who generally bear the responsibility of paperwork and relevant services. This results in lesser hassle and risk, although there still remain some grey areas with enforcement of such transactions especially when it involves financial issues.

While in the smart contract, the process would be absolutely hassle-free and reliable. Smart contracts run on a pre-programmed condition created on the rule "*if this then that*", which addresses the transfer of ownership concern when the transfer of ownership gets automatically processed only if the financial and terms agreed upon are met. This is possible when the relevant users on the blockchain have access to detailed information of the land and its rightful ownership in the ledger. Such information and data gets stored in an invariable distributed ledger where all relevant participants can have easy access in their computers instantaneously. In addition, there are slighter chances of fraud due to transfer of payments being seen by parties in the chain. Not only does smart contract make the entire process of various transactions effortless but also enhances the trust factor in the contract by removing intermediaries, which usually invokes issues of trust in a normal contract. In a nutshell, the services and communications that require human intervention during making or enforcing a contract are replaced by the codes that are stored into the blockchain.

3. Comparative study on legal status of smart contracts in Bhutanese and foreign laws

The noteworthy concept of smart contracts, which is not very unfamiliar around the globe, is entirely a new concept in the Bhutanese Legal System. This echoes the foremost concerns of His Majesty Jigme Khesar Namgyel Wangchuck, the Fifth King of Bhutan, who, during the Royal Address on the 112th National Day on 17 December 2019, commanded the importance of economic growth propelled by technological advances in artificial intelligence, big data, blockchain, quantum computers, fintech-digital currencies, digital wallets and digital banking, automation, and Robotics.[7]

Although it is a worldwide concept and many companies have started to apply smart contracts to remove intermediaries and also to run a cost-effective business, the enforceability of smart contracts is still questionable with regard to its legal status. The contract law of Bhutan prescribes that a valid contract can be either in writing, attested by witnesses or registered or complies with any other formality, only if such contract complies with such prescribed formalities.[8] Since smart contracts are executed electronically, the prescribed formalities of contract for the

[7] Royal Address by His Majesty the Fifth King of Bhutan on 17 December 2019, (Kuensel News Paper, 18 December 2019)

[8] Section 19 of the Contract Act of Bhutan (2013) provides that "notwithstanding what is stated in this Act, if under any law in force in the Kingdom of Bhutan, any particular contract, irrespective of the value of its subject-matter, is required to be in writing or attested by witnesses or registered or comply with any other formality [...]".

formation of electronic transaction, laid under section 283 [9] of the Information, Communication and Media Act of Bhutan, 2018, shall be enforceable in the eyes of the law. Since the execution of smart contract is an automated process performed by an electronic agent that maintains the digital records, the fact that ICMA 2018 provides legal recognition only for data messages hinders its execution.[10]

The legal question of enforceability of smart contracts in Bhutan arises in the context of formation and formalities of existing contract laws, which are not in consonant with the formation and formalities of smart contract and the absence of specific legal recognition of electronic agents.

The Information Communication and Media Act 2018 gives lawful recognition of data messages ensuring enforceability of the information in the form of electronic and data messages.[11] Concerning the validity of contract formed by use of data message[12] as per section 284 of the ICMA, no legal recognition shall be denied on the grounds of not having attested

[9] Section 283 of ICMA (2018) provides that "an offer and acceptance of offer mandated by Contract Act Bhutan to form a contract, may be expressed by means of data messages".

[10] Section 284 mentions that "the use of data messages to form a contract shall be given legal recognition and cannot be denied validity on the reasons that legal stamp has not been affixed or has not be attested by witness".

[11] Section 279 of the ICMA states that "information shall not be denied legal effect solely based on the ground that it is in the form of electronic document or data messages".

[12] Section 461 (31) of ICMA defines data message as "information generated, sent, received or stored by electronic, optical or similar means including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy".

witness or legal stamp affixed. However, this provision solely caters to the data messages, and going by the definition of data message, contracts formed electronically by use of data messages shall not be denied validity, but justifying the essence of program codes in smart contracts within its definition is impractical. In other words, the provision on data message does not elaborate on the contracts formed by interaction of automated message system or electronic agents where no human being is involved. Although the data message could include the electronic communication like emails, telegram and etc., the provision on data message fails to recognize the contractual transactions by automated message system. For example, a contract formed between two persons doing online business transaction through social media platform like Facebook by way of electronic means shall not be considered invalid solely on the grounds that the interaction to form contract was done by using data messages. Although such contracts formed by using data messages are considered valid by virtue of section 284 of ICMA, it fails to cover contracts formed by automated message system. Therefore, the absence of recognition of interaction between computer programs or electronic agents would hinder formation of contract. Thus, the legal issue as to whether it could be judicious to reckon programme codes as "in writing" for the purpose of satisfying the requirement of formation of contracts still remains unanswered.

Hence, this brings about the issue as to whether smart contracts codes bear legal recognition to enable the enforceability of smart contracts in this context since the legal recognition extends only to data messages as per the ICMA. The very name "smart contract" suggests that it should be legally enforceable, replacing ordinary contracts. At the same time, a smart contract is not subject to legal restrictions on transactions with digital assets

solely on the grounds that there was no human intervention. While the implementation of smart contracts has been legally recognized in Australia and Singapore, Bhutan does not recognize the legal force of a smart contract in the existing legislations.

With the enactment of the Information and Communication Act 2018, Bhutan had ventured towards improvising the business methods electronically by using digital technologies. This law vaguely gives legal effect to the data message, inclusive of contract formation unlike Australia and Singapore where the emphasis is given to the regulatory frameworks. The Act recognizes any electronic communication through data messages to be at par with the traditional requirement for contractual terms to be written. In other words, any communication of offer and acceptance to form a contract through data messages cannot be denied legal effect because they are expressed by means of data messages. However, considering the fact that smart contract is run by a computer programme where contractual terms are translated into codes and are self-executed without human involvement, a legal debate arises whether such automated system can be given legal validity and whether codes in such system can be considered to be in writing. The enforceability of smart contracts in Bhutan concerns whether the law recognizes the legal validity of use of automated message system, where human intervention is not involved in the execution of such contract. According to the United Nations Convention on the Use of Electronic Communications in International Contracts, it ascertains a general principle that legitimacy of communications should not be questioned for a mere fact that it was communicated in electronic method.[13]

[13] United Nations Convention on the Use of Electronic Communications in International Contracts, art 8.

Since the Bhutanese Law on E-commerce does not legally recognize such automated message system per se, the legality of the contractual agreements formed through such automated message system becomes questionable. Under Singapore and Australian laws, there are certain bills and laws enforced to reflect the importance, reliability and economic dependence on the electronic transactions. Singapore's Electronic Transactions Act ("ETA") 2010 governs the use of electronic contracts, electronic signatures, communications, and other electronic transactions in the country. The laws of Singapore are in accordance with worldwide practices (UN's) concerning electronic contracts and transactions. This law not only improves the legal legitimacy of e-transactions, but also promotes Singapore-based enterprises to utilize electronic communications and transactions in their daily activities. In this situation, it is necessary for all enterprises and companies in the country to comply with the Act and so contribute to Singapore's aim of turning the country into a smart nation. Section 15 of the ETA provides that the use of an automated system and a natural person or between any two automated message systems is considered valid. The validity cannot be denied only on the basis that no natural person reviewed the contract.[14] Hence, the execution of contractual transactions by electronic or automated means stands valid and enforceable even without the intervention of a human being, thereby making smart contracts enforceable in the eyes of law in Singapore.

Similarly, the underscoring transformation of the amendment of Electronic Transaction Act in Australia is the accommodation of smart contracts by enunciating the importance of use of automated message

[14] 'The Electronic Transaction Act' <https://www.corporateservices.com/singapore/electronic-transactions-act singapore/#records> accessed 30 May 2021.

system[15] provided under Section 15C of the Australian ETA, to form a contract without any human involvement. The essential feature of smart contracts being "automated" wherein the contractual obligations are performed automatically without any human intervention is well embraced and satisfied by the provision which states that a contract formed by the interaction of an automated message system and a natural person; or the interaction of automated message systems,[16] cannot be invalidated merely because the existence of human intervention is absent during the course of the execution of contracts. Therefore, the execution of contractual transactions by electronic or automated means stands valid and enforceable even without the intervention of a human being, which brings us to the conclusion that smart contracts are enforceable in the eyes of law in Australia.

Although there are various legal issues starting from formation of contract to execution of contract followed by enforcement of such contracts, the comparative study specifically focuses on applicability of smart contracts in meeting the requirements of the formation of contract and formalities of contract in these jurisdictions. It is understood that both

[15] Automated message systems refer to "a computer program or an electronic or other automated means used to initiate an action or respond to data messages in whole or in part, without review or intervention by a natural person each time an action is initiated or a response is generated by the system."

[16] Section 15 C of the Electronic Transaction Act provides that a contract formed by;

a) the interaction of an automated message system and a natural person; or

b) the interaction of automated message system;

is not invalid, void or unenforceable on the sole ground that no natural person reviewed or intervened in each of the individual actions carried out by the automated message systems or the resulting contract.

jurisdictions give legal recognition to the use of automated message systems, which in turn facilitates the enforceability of smart contracts.

4. Recommendations and conclusions

The analysis that can be drawn from the above comparison of legal provisions pertaining the application of smart contracts in three different jurisdictions is that there is a need for amendment in the Bhutanese laws for better implementation of smart contracts in Bhutan. The specific area of law that needs amendment is the insertion of use of automated message system in the ICM Act of Bhutan. Both Australia and Singapore who already have laws in place for implementing smart contracts have validated the contracts formed by the use of automated message system. The languages of the provision used in the laws of both the jurisdiction are identical to that of the UN Convention on Electronic Commerce. The Electronic Transaction Act of Singapore confirms legality of contract formation by computer programme without the involvement of natural person by virtue of Section 15. Similarly, Section 15C of the Electronic Transaction Act 1999 of Australia also states that no contract formed by interaction of an automated message system and natural person or the interaction of automated message systems shall be denied legality solely on the ground that no natural person reviewed or intervened in the activities carried out by the automated message system or resulting contract.

Since laws of both jurisdictions are in line with the UN Convention on the Use of Electronic Communication in International Contracts, the proposed amendment for the Bhutanese laws could be adopted based on these provisions. Therefore, the provision on use of automated message

system could be inserted as one of the amendments to the Information Communication and Media Act of Bhutan.

5. Proposed amendment provision

The proposed provision should be in alignment with Article 12 of the UN Convention on the Use of Electronic Communication in International Contracts as follows;

"Use of automated message system for contract formation"

A contract formed by;

a) the interaction of an automated message system and a natural person, or

b) the interaction of automated message systems;

shall not be denied validity or enforceability on the sole ground that no natural person reviewed or intervened in each of the individual actions carried out by the automated message systems or the resulting contract.

This means that a contract formed by communication between automated message systems and natural person or between automated message system shall not be considered invalid solely on the ground that there were no natural persons involved. Basically, the contract formed between computer programs where there is no intervention of human individuals shall not be considered invalid solely based on the fact that there were no natural persons involved.

The amendment to Bhutanese laws on electronic commerce shall be replica of not just the two foreign jurisdictions who are digitally advanced, but will also be in conformation with Article 12 of the UN Convention which will assist Bhutan to be at par with the international standard.

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