

The Contract (Third Party Rights) (Scotland) Bill: resetting the law

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The Contract (Third Party Rights) (Scotland) Bill was introduced to the Scottish Parliament on 31 January 2017 and Parliament agreed to the general principles of the Bill on 25 May 2017. It passed Stage 2 process on 27th June 2017 and now proceeds to Stage 3. The Bill is the third Scottish Law Commission Bill to have been considered by the Delegated Powers and Law Reform Committee (DPLRC), under the relatively new Scottish Law Commission Bill process which was introduced in 2013.¹

The objective of the Bill is to codify and modernise the law of third party contract rights in Scots law and this is to be welcomed in light of the well recognised deficiencies of the current common law of *jus quaesitum tertio* (JQT).² The Bill replaces the common law of JQT with a new statutory regime.

Far from being an obscure and archaic aspect of law, third party rights are an important area of practice and so it is right that the law should be updated to ensure that it is fit for purpose in the modern economy. The need for a straightforward system in which legal pathways can be constructed between the contracting parties and a party outside the contract – a third party – is clear.

The circumstances in which this might be necessary or desirable are varied and the Scottish Law Commission gives some key examples in its Report on Third Party Rights.³ These include everyday contracts entered into by thousands of people such as the holiday booked by one parent for the family where the other family members (third parties) may wish a right of redress if things go wrong. Similarly, employee pension schemes in which the employee nominates a beneficiary (third party) should they die in service, may need to create rights which are enforceable by the beneficiary should that happen. Groups of companies, separated as they are by the corporate veil may want to create rights in favour of all members of the group where one of the companies contracts for a new IT system to be

¹ Delegated Powers and Law Reform Committee, *Stage 1 Report on the Contract (Third Party Rights) (Scotland) Bill*, SP Paper 138, 25th Report (Session 5) (2017), paras 15-18; Rule 9.17A of Standing Orders.

² Scottish Law Commission *Review of Contract Law Report on Third Party Rights*, SCOT LAW COM No 245, SG/2016/98, para 1.37. For discussion about confusion around current law, see W.W. McBryde, *The Law of Contract in Scotland*, 3rd ed, (Edinburgh, W. Green, 2007), paras 4-32-4.43 and 10-20 and H.L. MacQueen, "Third Party Rights in Contract: Jus Quaesitum Tertio" in K. Reid and R. Zimmermann (eds), *A History of Private Law in Scotland* (Oxford: University Press, 2000).

³ Scottish Law Commission Discussion Paper on Third Party Rights in Contract, No 157, 2014, Chapter 3 and SCOT LAW COM No 245, paras 1.13-1.26.

used by all within the group. Those involved in construction contracts will be very familiar with the convoluted attempts to create third party rights through collateral warranty agreements so that, for example, a developer which contracts with a main contractor also has rights against sub-contractors appointed by the main contractor.

The effective creation of third party rights creates a legal pathway between the contracting parties and the third party. This determines whether that party - who by definition, is not one of the two parties to the contract - falls into a legal black hole with no remedies or is able to take action to enforce those rights. The parties to the contract itself should also expect certainty over whether anyone else has been given rights under the contract.

The problem with the current common law is that it has remained under-developed and, specifically, grinds to a halt in 1920 with the decision in *Carmichael v Carmichael's Executrix*,⁴ in which the current fundamental requirement for irrevocability, evidenced through delivery or an equivalent, is affirmed. Thus, in addition to the intention to create third party rights and an identifiable third party, the common law of JQT requires that the contracting parties go further and demonstrate that the right is irrevocable – they cannot change their minds about it. This requires an additional step which may include delivery of the contract, registration of the contract, intimation of it to the third party, reliance by the third party or third party knowledge.⁵ Of these, the requirement of irrevocability and the meaning of delivery have drawn the most criticism on two main grounds: it is not clear why that should be required and it is not clear what irrevocability means and how it can be proved. The law therefore lacks flexibility and clarity.

This lack of flexibility and clarity has led to a lack of workability. And if parties and their legal teams cannot be sure how to create an effective legal pathway between themselves and a third party using the law of JQT, how have they reacted? They have done so by using 'work arounds': that is, using other solutions to create the legal relationship. In particular, two methods have been used: using choice of law rules to apply English law to the contract so that the terms of the English Contracts (Rights of Third Parties) Act 1999 can be relied upon; or, in construction contracts in particular, drafting collateral warranty agreements specifically designed to create a direct legal relationship between the contracting parties and the third party.⁶ As a result, the law of JQT is not used and has stagnated. The Bill therefore also provides an opportunity to re-assert the role of Scots law in commercial contracts in particular – at least, within Scotland.

In so doing, the Bill seeks to abolish the common law of JQT and replace it with a statutory system addressing the following key issues: creation of third party rights; changing the third party right; the effect of modification or cancellation of the contract on third party rights;

⁴ *Carmichael v Carmichael's Executrix* 1920 S.C. (HL) 195; 1920 2 S.L.T. 285, HL

⁵ SCOT LAW COM No 245, para 2.19 summarises Lord Dunedin's statement on how irrevocability can be achieved with admirable brevity. For the judgment itself, see *Carmichael v Carmichael's Exx* 1920 S.C. (HL) 195, at 201-203

⁶ Evidence of this was provided to the SLC by a number of solicitors, advocates, academics, the Law Society of Scotland and others during the consultation process on the draft Bill: submissions can be read at <http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/103675.aspx> accessed 10th June 2017

remedies of the third party; defences available against the third party; the use of arbitration in dispute resolution; renunciation of third party rights and prescription.

The Bill

The Bill preserves much of the current law: the “crucial reform”⁷ is around irrevocability but the codification also addresses “terminological as well as substantive” reform⁸ which is broader in scope. The Bill can be broken down as follows:

(1) Who is the third party? The Bill retains the rule that the third party must be identified or identifiable but not necessarily in existence at the time the contract is made.⁹ The old terminology in which the Debtor, Stipulator and Tertius formed the triangular relationship is modernised so that the parties to the contract are called “the contracting party/ies” and the third party is more simply, “the third party”. In terms of plain language, accessibility and workability, this is clearly an improvement. There is still no requirement for the third party to accept the right.

(2) What is the right? The Bill replaces JQT with ‘third party rights.’ There was some discussion in the consultation period on whether the term ‘benefits’ should be used instead of rights. However, the Commission used a broad analysis of rights to determine that the term ‘rights’ could include “benefits, immunities and indemnities”¹⁰ and is thus a broad enough term to encompass the different circumstances in which the third party might gain something under the contract. In the Bill, this right is defined as the right to enforce or otherwise invoke ‘an undertaking that one or more of the contracting parties will do, or not do, something for the person’s benefit’.¹¹ The word ‘undertaking’ has been criticised by respondents to the consultation. In particular, the Faculty of Advocates’ written submission to the DPLRC notes that the word ‘undertaking’ is unfamiliar in a Scottish and international law context and therefore could provide a point for contention and litigation.¹² However, no change was made in the Stage 2 amended Bill published on 28th June 2017 and ministers took the view that the Commission had given this matter much consideration.¹³ Sections 2(5) and (6) do clarify the term to a certain extent by including both an undertaking to indemnify a party within the definition and an undertaking not to hold someone liable or not to enforce (partially or fully) their liability. Nevertheless, it might have been helpful to include a full definition of ‘undertaking’ within the Bill to promote the clarity which the Bill purports to provide.

(3) How is the third party right created and can it be changed or cancelled? As at present, the contracting parties must intend to create the third party right and this can still be implied or express in the contract.¹⁴ Whether the right is implied will remain a matter for

⁷ SCOT LAW COM No 245, para 1.41.

⁸ SCOT LAW COM No 245, para 3.2

⁹ Ss 1(3) and 1(4) Contract (Third Party Rights) (Scotland) Bill

¹⁰ SCOT LAW Com No 245, para 3.12

¹¹ S1(1)(a)

¹² Faculty of Advocates written submission to the Delegated Powers and Law Reform Committee, further cited in DPLRC SP Paper 138 25th Report (Session 5) at para 80.

¹³ Scottish Parliament Official Report, 25 May 2017, column 47

¹⁴ Ss1(1)(b) and 2(3)

current law of interpretation and implied terms.¹⁵ As now, there is no need for formal writing to create the right.

Section 2 (2) confirms that the third party right can be future or conditional: that is, depending upon something happening or not happening. The Bill confirms that the 'something' may be an event which will definitely happen (future) or it may be an event which may or may not happen (conditional). The general law relating to suspensive and resolute conditions will continue to apply.¹⁶

Section 2 also lays the foundation stone for the abolition of the much-maligned irrevocability rule which has been a major obstacle in the development of this area of law and its fitness for purpose. Section 2(4)(a) does this by stating that a third party right can be acquired 'despite the fact that the undertaking may be cancelled or modified.' Section 2(4)(b) goes on to clarify that the third party right can be acquired despite the fact that 'there has been no delivery, intimation or communication of the undertaking to the person.' Whilst the latter may provide good evidence of an intention to create the third party right, this section clarifies that it is not a requirement, removing more of the ambiguity in the current law.

Section 3 develops the flexibility missing from the current law. It sets out the new general rule that allows the contracting parties to alter the third party's entitlement by cancelling or modifying the undertaking. In keeping with the Bill's commitment to freedom of contract, the contracting parties can choose to make the undertaking irrevocable by providing that an undertaking will not be cancelled or modified but are not bound to do so.

Abolition of the irrevocability rule as a pre-requisite for creation of the third party right does not mean that it remains subject to cancellation or modification forever. The right to cancel or modify later is subject to restrictions. These are found in ss 4, 5 and 6 which address retroactive cancellation/modification, the effect of giving notice and third party reliance respectively. These sections attempt to pinpoint when the right to cancel or modify ends, thus rendering the third party right irrevocable at that stage.

Section 4 sets out a general rule that the third party's entitlement is not subject to retroactive change once any condition set for its enforcement has been fulfilled. Section 4(1) states that no account is to be taken of cancellation/modification when the right 'is being' enforced or invoked as a consequence of the event happening (or not) before the cancellation/modification. Nevertheless, this is still subject to contract: the right to cancel or modify can be retroactive and postdate fulfilment of any such conditions if the contract permits it.

¹⁵ SCOT LAW COM No 245, para 4.23.

¹⁶ A resolute condition means that the right ends when the condition is fulfilled, whereas a suspensive condition is one where the right is delayed or suspended until the condition is fulfilled. See *Love v Amalgamated Society of Lithographic printers of Great Britain and Ireland* 1912 SC 1078 for a case on JQT with suspensive condition and *Kelly v Cornhill Insurance Company Ltd* 1964 SC (HL) 46 for a JQT case with resolute condition.

Subject to certain exceptions, s 5 provides that giving notice of the undertaking to the third party prevents cancellation or modification. The exceptions are (1) if the undertaking was conditional and it remained uncertain whether the event would happen or not at the time when the notice was given¹⁷ or (2) when the notice was given to the third party, they were told that the undertaking may be cancelled or modified¹⁸ or (3) the third party has consented to cancellation/modification.¹⁹ The form of notice is not prescribed by the Bill which retains flexibility.

Furthermore, under s 6, if the third party has already relied on the undertaking in the contract then the undertaking cannot be cancelled or modified if the third party's position would be adversely affected to a material extent as a result. This protection for the third party is conditional on the contracting parties acquiescing to the third party's actions/omissions or the actions/omissions being reasonably foreseeable by the contracting parties. However, this restriction on cancellation or modification does not apply if the contract provides that the contracting parties are entitled to cancel/modify and the third party knew or ought to have known about this provision of the contract before they acted (or not) in reliance on the undertaking.²⁰

Addressing irrevocability is the 'crucial reform' at the heart of the Bill and these sections do abolish the irrevocability rule relating to creation of the third party right and provide detailed rules for when the third party right can become irrevocable and no longer subject to cancellation or modification. All are subject to freedom of contract.

However, there has been criticism of the wording used in ss 4 – 6 in particular, which may undermine the objective of providing clarity and improving workability. The wording has been called 'difficult to follow' in the DPLRC's Stage 1 Report²¹ but there has been no change in the Stage 2 Bill. The Bill's wording in these sections is indeed convoluted and would seem to undermine the objective of making the law accessible.

(4) What are the third party's remedies? Section 7 states that subject to the terms of the contract itself which can contract out of this, the third party will have the same remedies for breach of undertaking as a contracting party would if the undertaking had been in their favour.

(5) What defences are available to the contracting parties? Section 8 sets out that the contracting parties have any defence which is relevant to the undertaking itself and would be available against any other contracting party.

(6) Can the third party be party to any arbitration agreement in the contract? At present, where a contract includes an arbitration agreement to deal with disputes, the contracting parties will be party to it but the third party will not: the Arbitration (Scotland) Act 2010 does not recognise third party rights and the relevant Scottish Arbitration Rules mean that

¹⁷ S 5(3) Contract (Third party Rights) (Scotland) Bill

¹⁸ S 5(4)(a)

¹⁹ S 5 (4)(b)

²⁰ S 6 (3)

²¹ DPLRC Stage 1 Report, paras 84-87

the third party is not a party to the arbitration agreement.²² This means that disputes involving the third party could not be determined under the arbitration agreement without changes to the law.

The Bill covers two situations in which the third party becomes a party to any arbitration agreement in the contract and disputes are to be submitted to arbitration under the contract. Firstly, where the third party has a substantive third party right under the contract and there is a dispute relating to that right;²³ and secondly, where the third party right is 'to enforce or otherwise invoke an undertaking to resolve a dispute on the matter by arbitration under the agreement' (i.e. a procedural right to submit another matter to arbitration).²⁴ In both cases, the third party right is one created under s 1 of the Bill.

In the former case, s 9(2) is designed to bring the third party into the arbitration agreement for any future disputes concerning the third party's substantive rights. Section 9(3) addresses the second scenario which will arise less frequently. The Scottish Law Commission's Report gives the example of construction contracts in which a delictual claim may arise²⁵: this is not a substantive contractual claim so could not be dealt with by section 9(2). However, the arbitration agreement may make provision for submitting such disputes to arbitration. If the third party right is to resolve a dispute on that delictual claim by arbitration and the third party submits the dispute to arbitration or seeks a sist of court proceedings because the contract provides for arbitration, then the third party becomes a party to the arbitration agreement.

The wording of s 9 was changed at Stage 2 to make the distinction between the two scenarios more clear but whether the third party right is a substantive one arising out of the contract or a procedural one arising out of the contract, both must be third party rights created under s 1 of the Act.

(7) Can the third party renounce the right? Under the current law, a third party can renounce their third party right and this remains the case under general law. Section 10 as originally drafted included the third party's right to renounce the right which has been deemed superfluous and removed from the Stage 2 Bill as the third party has the right to renounce the right without the need for statute. In the Stage 1 Bill, it was also explicitly stated that the third party is not deemed to have renounced rights to arbitration by bringing legal proceedings in relation to a relevant dispute. That has been retained and moved to section 9.²⁶

(8) How does prescription apply to third party rights? Section 11 clarifies that a third party right is an obligation for the purposes of the Prescription and Limitation (Scotland) Act 1973.

(9) Abolition of JQT: subject to transitional arrangements in respect of conditional rights noted below, no new common law *jus quaesitum tertio* can be acquired after

²² Scottish Arbitration Rules, Rule 1, Schedule 1, Arbitration (Scotland) Act 2010

²³ S 9(2)

²⁴ S 9(3)

²⁵ SCOT LAW COM No 245, Explanatory Notes to Draft Bill, pp127-128

²⁶ S 9 (4A)

commencement of the Act. Rights acquired before commencement will still be subject to the common law, unless the contracting parties have adopted the Bill's rules under s13. Third party rights created post commencement will be statutory rights and dealt with under the Act. The Bill was amended at Stage 2 to take account of conditional rights where the contract pre-dates commencement but the right depends on an event which postdates commencement: s 12(1) has been amended to apply to 'contracts', rather than 'rights', created post commencement so that those rights continue to be JQT if crystallised. As s 13 allows contracts concluded before commencement to adopt the Bill's rules, ss 12 (1A) and (1B) have been added to ensure that any pre-existing contracts which are modified cannot give rise to rights which are enforceable through both common law and statutory law which is to be welcomed.

Conclusion

The Bill has universal support: in the Stage 1 debate on principles, MSPs from all parties agreed that it was important that this aspect of the law was clear and workable. In so doing, the Scottish Government Minister for Community Safety and Legal Affairs, Annabelle Ewing said that the Scottish Government was committed to clear, accessible and effective legislation. Others highlighted the desirability of ensuring that Scots law is fit for purpose and the need to make law accessible to those on limited means who cannot afford complex legal 'work arounds.'

It is recognised that the law will take time to filter through but it is expected that it will be taken up more quickly than the equivalent English reforms, given that this is a modernisation of current third party right law, rather than the creation of a novel concept.²⁷ The aims of the Bill and the removal of the need for irrevocability for creation of a third party right should clear the current logjam. The wording of the Bill may well prevent it becoming as workable and accessible as hoped; however, time will tell.

It is perhaps surprising that it has taken almost 100 years since *Carmichael* in 1920 to reform the law on third party rights. This is not a criticism of the Scottish Law Commission or successive Parliaments but recognition of the limitations of the common law's ability to evolve when there are quicker and cheaper ways to work on a day-to-day basis than going to court.

In this context, the Bill is to be welcomed, but it serves as a reminder of the need to ensure that areas of law which become unworkable and stagnate are addressed. It is therefore encouraging that the debate in the Scottish Parliament highlighted the efficacy of the Scottish Law Commission Bill process and the potential to increase the role of the DPLRC in law reform: these should facilitate future efforts to ensure that Scots law is fit for purpose in the 21st century.²⁸

²⁷ Scottish Parliament Official Report, 25 May 2017, columns 46 and 51.

²⁸ Scottish Parliament Official Report, 25 May 2017, columns 55 and 58.