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## **Collateral Commentaries: Construction law and the Contract (Third Party Rights) (Scotland) Bill**

**David S. Christie, Senior Lecturer**

**Law School, Robert Gordon University**

Contracts create binding legal relationships between the parties to that contract. In Scotland and England, those who are not parties to a contract – “third parties” - only gain rights in restricted circumstances. The existing historic common law rules of third party rights in Scotland, known as *jus quaesitum tertio*, lie adrift of commercial practice through lack of use and uncertainty as to their application in reality.<sup>1</sup> Lack of clarity means that there is what the present writer has termed a ‘death spiral’:<sup>2</sup> lack of use has meant that there is no opportunity for the case law to be clarified and certainty brought to the law; lack of certainty in the law means that the rights are not used. Indeed, they are often expressly excluded, to avoid the risk of their inadvertent creation – and unexpected claims from unexpected quarters.

A particular issue in the law, as it applies in the construction sector, has come about because, with the restrictive approach to recovery for pure economic loss in delict,<sup>3</sup> those who come to own or use a building can find it difficult to recover for losses arising from defective building work. One solution which the construction industry has developed is the use of “collateral warranties” to create a contractual route to recovery.<sup>4</sup> This is recognised as creating, at the least, significant amounts of paperwork and administrative effort. A more commercially certain set of rules around third party rights has the potential to improve this aspect of construction law practice.

Although they have fallen out of commercial use, third party rights are not without their uses. They are widely recognised in the civil law jurisdictions on Continental Europe, in the Draft Common Frame of Reference<sup>5</sup> and in England and Wales where

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<sup>1</sup> The current discussion flows from the work of the Scottish Law Commission and their work on third party rights in Scots law. See Scottish Law Commission *Review of Contract Law: Discussion paper on Third Party Rights in Contract* (DP No. 157) (March 2014) and Scottish Law Commission *Review of Contract Law: Report on Third Party Rights in Contract* (No. 245) (July 2016) for exhaustive discussion of the issues. For a summary of the current position see e.g. William McBryde *The Law of Contract in Scotland* (3<sup>rd</sup> Ed, 2007 (W Green)) at Chapter 10

<sup>2</sup> Evidence to the committee by the author, 16 March 2017 at page 6 available at <[http://www.parliament.scot/S5\\_Delegated\\_Powers/David\\_ChristieRGU.pdf](http://www.parliament.scot/S5_Delegated_Powers/David_ChristieRGU.pdf)> .[accessed 7 July 2017] This phrase was taken up by Members in the Stage 1 debate see Official Report for 25 May 2017 (the “Stage 1 debate”) at columns. 49, 64 68 and 76.

<sup>3</sup> Following the decision in *Murphy v Brentwood District Council*, [1991] 1 AC 398 (and notwithstanding the difference in approach in Scotland, in *Junior Books Ltd v Veitchi Co Ltd* [1983] 1 AC 520

<sup>4</sup> There is a full discussion of the problem and this solution by Lord Drummond Young in *Scottish Widows Services Ltd v Harmon/CRM Facades Ltd and others* [2010] CSOH 42 per Lord Drummond Young at [1]

<sup>5</sup> C von Bar and E Clive (eds), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference* (2010) (“DCFR”) in II.–9:301

the ability for the parties to a contract to give third parties rights was created by legislation in 1999.<sup>6</sup>

With the difficulties highlighted – and others – in mind, third party rights are an area which has been identified as ripe for reform in Scots law and legislative reform – in the form of the Contract (Third Party Rights) (Scotland) Bill<sup>7</sup> – is underway. The Bill passed Stage 1 (agreement in principle) on 25 May 2017 and stage 2 on 27 June 2017. The extent to which the current proposals fit within the particular construction law context is examined here.

### **Construction Law and third party rights**

Construction law is characterised as the group of rules and legal categories which arise from construction work. Much of this centres on the – often complex – interaction of the various contracts by the various specialisms involved in the construction project and the wider context of multiple statutory and regulatory regimes which govern specific aspects of construction work of particular importance, such as the payment regime, dispute resolution and health and safety.

More broadly, construction law has been characterised as being very “commercial” in its focus and with that has come the idea that flexibility is a virtue.<sup>8</sup> Flexibility, of course, requires a framework in which the parties can operate and that requires certainty and clarity around the parameters of operation. The legal commentator Tony Bingham has recently pithily commented on reports by Arcadis (a construction consultancy) who have identified the causes of disputes internationally as including

*“Failure to understand and/or comply with contractual obligations by the employer/contractor/subcontractor...These contractual rules are unfathomable to the lads<sup>9</sup> doing the actual building work”<sup>10</sup>*

Of course, legal flexibility and this sort of clarity are not always able to coexist and a degree of “open textured” language is often needed.<sup>11</sup> This tension is found not only

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<sup>6</sup> Contracts (Rights of Third Parties) Act 1999 (the “English Act”)

<sup>7</sup> Contract (Third Party Rights) (Scotland) Bill as introduced on 31 January 2017 (the “Bill”)

<sup>8</sup> See discussion by Matthew Bell *Contract Theorists: What did they ever do for us in construction law?* May 2016, D189 available on [www.scl.org.uk/papers](http://www.scl.org.uk/papers) ([accessed 7 July 2017]) especially at p.6 and it is notable that the Draft Common Frame of Reference Principles which gives contracts for construction services as an example of one where the need for flexibility trumps the usual requirement for certainty and security in construction contracts (see p. 47)

<sup>9</sup> Statistics suggest that “lads” unfortunately reflects the vast majority of those involved on site work see Lucy Alderson *“Where are all the women in construction?”* 6 March 2017 at <https://www.constructionnews.co.uk/best-practice/skills/where-are-all-the-women-in-construction/10017903.article> [accessed 7 July 2017].

<sup>10</sup> Tony Bingham *Still beating the drum* Building Magazine 21 April 2017 at p. 39.

<sup>11</sup> See discussion on this – as it applies to drafting legislation in Farrar “Law Reform and the Law Commission” (1974) (Sweet and Maxwell) pp.44 – 45.

in construction law but it is often tested in that sector, especially where there are complex, multi-party contractual set ups.

In the context of third party rights in construction, the lack of certainty and the need to have some flexibility over the provision of routes of recovery has meant that collateral warranties have been used instead. Agreeing and executing a full suite of warranties for a project can be time consuming and a difficult task to prosecute in the face of contractor intransigence. This difficulty was widely recognised in the discussions in the Scottish Law Commission<sup>12</sup> and on the floor of Parliament.<sup>13</sup>

Third party rights could help with these logistical issues – although there are other benefits from the creation of contractual relationships which cross through the contractual nexus of a project – such as the provision of step-in rights which allow some parties to take over management of the project in the event that one of the existing parties with responsibility becomes insolvent. Clarifying third party rights could remove some of the more routine work from collateral warranties and leave them to focus on these more technically challenging issues.

In order to achieve this, it is necessary for the law to be certain enough that parties will have confidence in it. The question then is the extent to which the current Bill meets those needs.

## **The Bill**

The draft Bill before the Scottish Parliament is largely the same as that which was produced by the SLC following consultation.<sup>14</sup> The principal thrust of the Bill is to reform and replace the common law – largely modelling it on a combination of the DCFR and the English Act, as well as the broad understanding of what the historic Scottish position had been.

The evidence submitted to the Delegated Powers and Law Reform Committee and the oral evidence heard by that committee have broadly welcomed this approach and the Bill is considered necessary.<sup>15</sup> The Bill's broad principles were agreed at Stage 1 of the legislative process. Minor amendments were proposed by the Minister responsible and agreed to by the DPLR Committee, completing stage 2.

The Bill attempts to codify and improve upon the existing common law and bring certainty to what was previously uncertain. The Bill prospectively abolishes the common law rules of *jus quaesitum tertio* and makes provision for the creation of third party rights (or, rather, the acquisition of rights by third parties – which is a

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<sup>12</sup> See e.g. the author's summary at p.11 of the Scottish Law Commission Report on Third Party Rights No. 245, July 2016.

<sup>13</sup> Stage 1 Debate (n. 4) at column 63.

<sup>14</sup> See references to Scottish Law Commission material at n.1

<sup>15</sup> Oral evidence has been heard on 7, 14, 21 and 28 March 2017, and on 18 and 21 April 2017.

slightly different emphasis, if largely immaterial). The Bill then provides for a series of rules which control the extent to which third party rights can be changed by the parties, after creation, as well as their renunciation and prescription. In addition, there is provision for the use of third party rights in arbitration.

In construction law terms, then, there is a simplification of the complex rules around irrevocability and an attempt to increase certainty by codifying the rules – while also building in a degree of transparency: which helps certainty. All of that is aimed at creating a viable system of third party rights – which adds flexibility for commercial parties in terms of how they protect their rights – alongside the certainty which comes from clarification of the law.<sup>16</sup>

In terms of striking the balance between certainty and clarity, some difficulties remain.

### **Drafting difficulties**

Such controversy as exists centres on some particular points of the drafting. The Bill was described by one witness (off the cuff) as being “probably quite well designed to create a lot of disputes”<sup>17</sup> and generally by the Faculty of Advocates as being overly cumbersome and which could be cut down into a much neater provision.<sup>18</sup> Drafting issues were also raised in the course of the stage 1 debate.<sup>19</sup>

These issues focus on sections 4 - 6 of the Bill which deal with the extent to which parties can change the third party right once it has been constituted. The effect of these provisions is that parties have the freedom to set up rights for third parties in their contract. These rights are limited to the extent that they are not easy to change once the third party might have relied upon them (which is necessary in order to give them value for the third parties). The contracting parties do, however, have freedom to alter or agree not to alter the rights until they become fixed. The flexibility of the parties’ intention is not sacrificed by providing a backstop which ensures long term certainty.

That the Bill takes three sections to express this is partly a reflection of the need to ensure that the uncertainty of the past is expunged but the danger is that the more words which are used, the greater the confusion they could cause. It is striking that the Faculty have suggested replacing the broad thrust of the intention in the Bill with

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<sup>16</sup> See also Tikus Little *The Contract (Third Party Rights) (Scotland) Bill: resetting the law* in this volume.

<sup>17</sup> Official Report of Delegated Powers and Law Reform Committee on 28 March 2017, by Craig Connal QC, Pinsent Masons LLP at .p22 (Mr Connal QC gave evidence alongside the author).

<sup>18</sup> R G Anderson, *Supplementary Evidence of the Faculty of Advocates* 23 March 2017 available at <[http://www.parliament.scot/S5\\_Delegated\\_Powers/Ross\\_Anderson\\_-\\_Supplementary.pdf](http://www.parliament.scot/S5_Delegated_Powers/Ross_Anderson_-_Supplementary.pdf)> (“Faculty Supplementary Evidence”) [accessed 7 July 2017]

<sup>19</sup> See for example Gordon Lindhurst MSP’s comments in columns 72 and 73 of the Official Report on the Stage 1 debate.

a single section of less than four lines.<sup>20</sup> Drawing on the language in the Principles of International Commercial Contracts, the Faculty suggest that the provision is simply:

*"The [contracting] parties may modify or [cancel] the rights conferred by the contract on the [third party] until the [third party] has accepted them or reasonably acted in reliance on them"*<sup>21</sup>

That approach – of brevity – is appealing. This is balanced by the Scottish Government's desire that

*"The provisions at sections 4 to 6 need to be capable of dealing with a wide and sometimes complicated range of circumstances, and must be fit for all purposes. We are concerned that, in paring down the provisions to make them more streamlined, we might lose that capability, which would be highly undesirable"*<sup>22</sup>

Although the Minister did undertake to reflect further on this point,<sup>23</sup> no amendments were brought forward on this point in Stage 2: the Minister was not keen to go beyond the Bill and principles which had been the subject of Scottish Law Commission consultation.<sup>2425</sup>

From the construction law point of view, it is not clear that more words necessarily means more clarity. There is merit in simplifying the position. That litigation lawyers consider that the framework provided might not be clear is a cause of concern. It is perhaps unfortunate that there does not seem to be further consideration of the issue on the cards.<sup>26</sup> Since clarification is one of the goals of the process, not achieving it will undermine the reform.

A further source of discussion has been the use of "undertaking" within the legislation to reflect the source of the third party rights (as opposed to the "contract" or a "promise" or actual source).<sup>27</sup> As the Faculty point out, this runs counter to the other

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<sup>20</sup> Ibid at. p. 5

<sup>21</sup> Faculty Supplementary Evidence at para. 15

<sup>22</sup> Annabelle Ewing, Minister for for Community Safety and Legal Affairs during the debate on Stage 1 of the Bill at column 48

<sup>23</sup> Ibid at column 83 of the Official Report in the Stage 1 debate.

<sup>24</sup> See Official Report of the Delegated Powers and Law Reform Committee for 27 June 2017 at column 2. This might reflect that, since this Bill has come from a Scottish Law Commission exercise and achieved broad consensus, the parliamentary procedure is abbreviated.

<sup>25</sup> See Scottish Parliament *Guidance on Public Bills* (Session 5 Edition, Version 1 June 2016) at paras 3.49 – 3.54)

<sup>26</sup> A view echoed by John Scott convenor of the Delegated Powers and Law Reform Committee in the Stage 1 debate at column 51.

<sup>27</sup> A third party right is defined in section 1 of the Bill as being something which is acquired where "the contract contains an undertaking that one of more of the contracting parties will do, or not do something, for the person's benefit" and this undertaking is referred to subsequently throughout the Bill.

instruments which contain third party rights<sup>28</sup>. Professor Adam Tomkins MSP suggests that this would be “ripe for wholly unnecessary litigation.”<sup>29</sup> The source of the wording is discussed by the SLC<sup>30</sup> where they say “The word undertaking...avoids direct characterisation of the third-party right as a promise”<sup>31</sup> and seems to draw on a desire that third party rights can not only be created expressly but can arise by implication.<sup>32</sup>

The Faculty rely on the interpretation of the right itself, while the SLC’s drafting separates the right itself from the source or factual basis of the right. An alternative would be to refer to the parties’ “contract or agreement” but that may become confusing when referring to third party rights which are specifically distinct from their contractual rights (having not been agreed to) and which do not include obligations (there is only benefit given to third parties – no burdens).

The construction law preference in this situation is unclear. The urge for certainty suggests that there is benefit in only allowing creation by express terms – especially when there is a risk that implied creation of third party rights would not only give rise to new terms but to new parties to any claim. However, that would cut back flexibility when compared with contract law and would risk introducing broader uncertainty by creating a separate branch of “interpretation” law around third parties when compared with contracts: express creation would create certain formulas of language to conjure up a third party right – as opposed to giving parties more freedom to decide. The approach of seeking flexibility is best served by allowing the widest possible range of rights to be created in the widest possible way and allowing the parties to decide how to restrict these; rather than imposing external constraints.

## **Dispute resolution**

The construction sector is very familiar with disputes – and indeed has its own statutorily mandated form of dispute resolution: construction adjudication.<sup>33</sup> In this vein it is relevant that the other source of possible controversy is section 9 of the Bill which makes provision for the enforcement of third party rights and their operation in other circumstances, in the course of arbitration. This section was a late addition to the SLC’s report and draft Bill and came about upon consideration of the equivalent

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<sup>28</sup> Faculty Supplementary Evidence at para. 9

<sup>29</sup> See column 80 of the Official Report.

<sup>30</sup> SLC Report paras. 3.17 – 3.20

<sup>31</sup> Ibid at para. 3.20

<sup>32</sup> Ibid paras 3.17 – 3.20 and also in paras. 5.18 and 5.19 of the Scottish Law Commission’s preceding discussion paper on the subject *Review of Contract Law: Discussion Paper on Third Party Rights in Contract* DP No. 157, March 2014 (the “Report”) and discussed by Craig Connal QC and the author in columns 21 to 24 of the evidence to the committee. The point taken by the Minister – see column 47 of the Official Report of the Stage 1 debate.

<sup>33</sup> Section 108 of the Housing Grants, Construction and Regeneration Act 1996 mandates that all “construction contracts” as defined in the Act must provide that parties can refer an disputes to adjudication “at any time”.

provision in the 1999 Act (which seems to have been, itself, a late addition to the draft Bill for that Act).<sup>34</sup>

It was correctly considered worthwhile to align Scottish and English treatment in this area. Two broad sets of rules are introduced to deal with this point, namely:

- To allow third parties to enforce their rights by arbitration and
- To allow third parties to join in an arbitration – where that right is given by the parties to a contract – even if they have no other substantive third party rights.

The promotion of arbitration, and alignment of the legislation in this way is to be welcomed and it has been further clarified by the Stage 2 amendments.<sup>35</sup> There are however some technical difficulties. The rationale of allowing third parties to be involved in dispute resolution proceedings between parties to the underlying contract (where appropriate) would apply to other forms of alternative dispute resolution too.<sup>36</sup> The discussions in committee focused on construction adjudication as the alternative<sup>37</sup> and the view that was taken was that it would add additional complexity.<sup>38</sup>

Construction adjudication is to be completed within 28 days, once the adjudicator is appointed (with limited scope for extensions). There are therefore good policy reasons to justify a difference in approach between arbitration and construction adjudication in terms of third party rights. That does not, however, deal with the other issues and forms of dispute resolution. The distinction between arbitration and other forms of non-court dispute resolution is not altogether clear. The mere naming of something as arbitration may not be enough – and that would leave the position of third parties unclear: not least in terms of excluding them from the process.<sup>39</sup> It might be that the particularly distinct nature of arbitration, which has a role for the state in what is otherwise a private matter, justifies the segregation – as other forms of dispute resolution are more purely consensual.<sup>40</sup> The benefits in those situations would therefore be transferable in the same way as other third party rights.

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<sup>34</sup> The history of this is set out in paras. 7.3 to 7.17 of the Report

<sup>35</sup> Again, most clearly explained in the Official Report of the Delegated Powers and Law Reform Committee on 27 June 2017 (“Stage 2 Official Report”) at columns 2 and 3

<sup>36</sup> A point raised by the Author and Craig Connal QC in their respective oral evidence to the Scottish Parliament Law Reform and Delegated Powers Committee on 28 March. Official Report at columns 34 - 39. See also comment made by David Wedderburn on the same day in respect of the interaction with construction adjudication at p.18

<sup>37</sup> The viewpoints summarised at paras. 97 and 98 of the Delegated Powers and Law Reform Committee report on the Bill.

<sup>38</sup> The view endorsed by the Minister – column 83 of the Official Report in the Stage 1 Debate.

<sup>39</sup> See discussion in David Christie *The Elephant in the Dispute Resolution Room* (2016) JR 27

<sup>40</sup> See discussion in Davidson *Arbitration* (2012) paras. 2.11 to 2.16 for the various models of arbitration.



Resolving particular conflicts between the Third Party Rights Bill and the Arbitration (Scotland) Act 2010 seems to be a particular focus for the Scottish Government, as the Minister pointed out at Stage 2:

*"without further provision a third party would be unable to enforce that [third party] right because, under the Arbitration (Scotland) Act 2010, only a person who is a party to an arbitration agreement can go to arbitration. Section 9 is a technical fix to overcome that obstacle."*<sup>41</sup>

That answer provides the narrow rationale – on its own – for the provision. Moreover, in the event that other forms of contractual dispute resolution sought to allow third parties to be brought in and could do so in clear terms, it might well be that an overall purposive interpretation of the legislation could allow that. While construction adjudication may be excluded – given its peculiarities, this may not be a particularly significant issue.

## **Conclusion**

In England, some commentators have suggested that – over 15 years since third party rights were introduced there - there may be something of a zeitgeist developing to help push third party rights as a genuine alternative to the use of collateral warranties in the construction industry.<sup>42</sup> Even if questions remain around some of the proposed statutory language, overall the reform to clarify and improve the position in Scots law is well timed to meet this zeitgeist and give parties to construction contracts more options and flexibility in terms of how they set up their contractual arrangements.

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<sup>41</sup> See Stage 2 Official report at n. 35 at column2 – 3.

<sup>42</sup> See discussion in the author's submission (n. 4) at pp. 4 - 5 and in particular Stephen Walker QC and John Hughes - D'Aeth *Giving Rights to Third Parties: Topical Issues*. A paper based on a talk given to the Society of Construction Law at a meeting in London on 10 February 2015. SCL paper 198, May 2016 available on <<http://www.scl.org.uk/papers>> [accessed 7 July 2017]