The Contract (Third Party Rights) (Scotland) Bill (the Bill) proposes changing the law in Scotland which allows the parties to a contract to create rights for third parties. The aim is to make the law clearer and more usable.


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EXECUTIVE SUMMARY

The Contract (Third Party Rights) (Scotland) Bill (the Bill) was introduced in the Scottish Parliament on 31 January 2017.

It proposes codifying and updating the existing common law on third-party rights – i.e. the rules in case law which allow the parties to a contract to grant rights to third parties.

Third party rights may be used in a variety of situations, for example by companies which want other companies in their group to be covered by a contract, or where someone wants to ensure that the benefits of an insurance contract are payable to another person (e.g. a third-party driver in a motor insurance policy).

The changes proposed are based on recommendations made by the Scottish Law Commission (SLC), which found in 2016 that the existing law is no longer fit for purpose.

The main proposal is the abolition of the existing rule that third-party rights have to be irrevocable to be created – in other words that the parties must intend to give up the right to change their minds about granting the right. According to the SLC, this rule creates a significant barrier to the use of third-party rights as it restricts the freedom of the contracting parties to:

1. set up flexible contracts at the outset; and
2. adjust contracts in response to future events – i.e. by bringing the third-party right to an end, or varying it, before the right holder enforces it.

Other proposals are aimed at clarifying current areas of uncertainty in the common law. The Bill also includes new rules which mean that third-party rights to arbitrate could be created.

The general aim behind the Bill is to provide a new statutory framework with clearer, more usable rules on third-party rights.
INTRODUCTION

Contracts allow people, or other legal entities such as companies, to create rights and duties which can be enforced in court.

In general, these rights and duties are only enforceable between the parties to the contract. The idea is that the contractual relationship is exclusive to the parties (known as ‘privity of contract’).

Although privity of contract is the general principle, almost all legal systems have rules which allow the parties to a contract to grant rights to third parties. This can be useful for various reasons (see below for some examples).

In Scotland, the rules on third-party rights are based on the common law (i.e. case law) and have existed for hundreds of years. They are sometimes known by the Latin term *jus quaesitum tertio* or JQT. Unlike the situation in England, the rules are not codified in statute.

The Scottish Law Commission (SLC), an independent law reform body, examined the Scots law on third-party rights in a March 2014 Discussion Paper (SLC Discussion Paper) and compared it with international benchmarks (SLC 2014).

Following a consultation exercise, and input from an Advisory Group made up of legal practitioners and judges, the SLC published a Report on Third Party Rights (SLC Report) in July 2016 (SLC 2016). This concluded that the existing common law was not fit for purpose and needed to be replaced with new statutory rules. The report included a draft Bill, which has been largely followed by the Bill as introduced. In this regard, the Policy Memorandum (Scotland Parliament 2017, para 3) indicates that the main aim of the Bill is to:

“replace the current common law … which enables parties to a contract to create an enforceable right in favour of a third party with a clearer and more usable statutory version.”

This briefing is aimed at giving a short overview of:

1. How third-party rights are used in practice
2. The current law on third-party rights
3. The problems identified by the SLC with the current law
4. The provisions in the Bill

HOW ARE THIRD-PARTY RIGHTS USED IN PRACTICE?

Third-party rights can be of use in a wide range of personal and commercial situations.

Examples outlined in the SLC documentation and in the Policy Memorandum (Scottish Parliament 2017) include:

- **Insurance contracts** – for example, where life assurance is payable to a third party beneficiary who needs to enforce the terms of the contract in their favour

- **Contracts involving company groups** – for example, if one group company enters into a contract with a service provider, other group companies may need to sue for losses suffered due to breach of the contract
• **Construction contracts** – for example, under the normal rules of contract, if a developer contracts with an architect to design a building, only the developer will have a remedy against the architect for defects in the architect’s work. Without third-party rights (or other contractual remedies – see below) subsequent purchasers will not have a remedy.

• **Pensions** – for example, an employer’s pension scheme might allow a third party to be nominated as the beneficiary (with rights to the pension) if the employee passes away while still employed by the company.

For further details see paras 10-12 of the Policy Memorandum, Chapter 3 of the SLC’s Discussion Paper and paras 1.13–1.35 of the SLC’s Report.

**HOW DOES THE CURRENT LAW WORK?**

The current law is complex. However, in very simple terms the following elements are necessary to create third-party rights in Scots law:

1. **There needs to be a contract**

2. **The contract has to identify the third party in some way** – i.e. by express reference to a particular individual or class of persons, or, less commonly, by implication (the third party need not be in existence at the time of the contract)

3. **The intention of the contract has to be to confer a right on a third party** – this intention can be implied, or derived from an express provision in the contract.

4. **The third-party right needs to be “irrevocable”** – in other words it needs to be clear to the third party, from such circumstances as delivery or intimation\(^1\) or equivalent, that the parties intended to give up the right to change their minds about granting the third-party right (for details see the “Problems” section below)

Two additional points are worth noting:

• There is no need for the third party to accept the right before it comes into existence

• The contracting parties can only confer rights on third parties and not duties. Duties can only be imposed if a third party consents.

For more details on the current law see the SLC Discussion Paper (paras 2.23–2.89) and paras 24-47 of the Policy Memorandum.

**PROBLEMS IN THE CURRENT LAW**

The SLC’s Discussion Paper and Report outline in depth the range of legal and practical problems stemming from the current law on third-party rights. A brief summary follows of some of the main ones (more details can be found in the Policy Memorandum).

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\(^1\) Intimation is the formal method of completing an assignation, normally required for a personal right to be transferred to a different creditor (see SLC Report, para 2.22). For a discussion of the meaning of “delivery” see paras 2.11–2.12 of the SLC Discussion Paper.
LEGAL UNCERTAINTY

A key problem highlighted by the SLC is that the ad hoc development of case law has led to uncertainty about the scope of some of the rules on third-party rights.

The SLC notes that reducing uncertainty is a key reason for updating the law, arguing that:

“The strongest positive aspect will be the removal of uncertainty in the law which could otherwise only be resolved by judicial decision obtained at the expense of litigating parties.” (SLC Discussion Paper para 1.28)

One area of uncertainty is linked to the remedies which are available to third parties whose third-party rights are breached. For example, it is not clear whether third parties have a right to claim damages for breach of a third-party right. The Discussion Paper refers to this as, “the most significant uncertainty in the current Scots law of third party rights” (para 7.12) whereas the Report indicates that, “the overall position on damages … remains in a state of some uncertainty” (para 2.49)

There is also uncertainty surrounding the rules (known as “defences”) which give contracting parties the right not to carry out their obligations towards third parties. The SLC Discussion Paper indicates that:

“In the absence of much authority on the matter, it is thought that in Scots law a defect in the contract's formation rendering it invalid (whether void or voidable) – i.e. error, misrepresentation, fraud, force and fear, facility and circumvention and undue influence - will also make the third party’s right invalid … It is not entirely clear whether, if part of a contract is illegal but the part containing the third party's right is legal, the latter is enforceable … There is almost no authority on the effect upon a third party right of the contract’s frustration by supervening events.” (para 7.15)

It is also not clear how the rules on the time limits for bringing claims – known as “prescription” – apply to third-party rights (see Brodies 2015). These rules are contained in the Prescription and Limitation (Scotland) Act 1973 (1973 Act). The general rule is that most claims can no longer be made five years after the day on which loss, injury or damage first occurred. However, the 1973 Act does not mention third-party rights and so it is not clear how the rules apply to them (see SLC Report, paras 6.38–6.39).

IRREVOCABILITY RULE IS TOO INFLEXIBLE

Problems identified by the SLC

Third-party rights have to be irrevocable under Scots law. There is uncertainty as to precisely what this means. However, based on the leading case (a House of Lords judgment from the 1920s²) the ways in which a contract can be made irrevocable would seem to include:

1. delivery or intimation of the contract to the third party
2. registration of the contract, for example in the Books of Council and Session (a register of deeds maintained by Registers of Scotland)
3. the third party’s reliance upon the contract term in its favour
4. the third party’s knowledge of the contract term in its favour

² Carmichael v Carmichael's Executrix 1920 SC (HL) 195
The basic idea is that the contracting parties intend not only to confer a benefit upon a third party but also to give up the freedom to change their minds (SLC Report, paras 2.18–2.24).

According to the SLC, this need for irrevocability is one of the main problems with the current law. It argues that the problem is not the recognition of third-party rights as such:

“but the requirements for their creation laid down by the House of Lords in …1920, namely that the contract in question must be irrevocable by the contracting parties before the third-party right can exist, with the corollary that the third-party right cannot be altered or cancelled in response to changing circumstances.” (SLC Report para 1.6)

The SLC indicates (SLC Report paras 5.1–5.3) that the irrevocability rule creates, “significant barriers to the use of third-party rights” as it restricts the freedom of the contracting parties:

1. **to set up flexible contracts at the outset;** and

2. **to adjust contracts in response to future events** – i.e. by bringing the third-party right to an end, or varying it, before enforcement by the right holder is sought.

The SLC contrasts the requirement for irrevocability with the English Contracts (Rights of Third Parties) Act 1999 (1999 Act) which allows the contracting parties to write in an express term enabling them to terminate or vary the contract without the consent of the third party (see SLC Discussion Paper at para 3.5 and page 76).

Basing its view on comments from law firms, the SLC further explains that irrevocability has a number of negative practical consequences, including:

- **Lawyers applying English law to Scottish contracts** so that they benefit from the rules in the 1999 Act

- **Reduced protection for company groups** since irrevocability makes it more complex to extend third-party rights to companies within a group or to cover future changes in the structure of companies in a group (see SLC Discussion Paper, paras 3.4–3.19)

- **The need for less efficient legal ‘workarounds’** for example “collateral warranties” which are used in construction contracts to ensure that third parties (for example the purchaser/tenant of a new building) have legal remedies against others with whom they have no contract (for example the architects, engineers or surveyors who advised the building’s developer) (SLC Report paras 1.26–1.30)

**SLC recommendations**

Given these problems, the SLC Report came to the conclusion that Scots law should be changed so that third-party rights can be created, even if not irrevocable – for example where they are subject to cancellation or modification (para 5.5).

The Report also considered whether the ability to modify or cancel a third-party right should be an absolute one or whether it should be limited in some way.

In a detailed analysis of the issues (see SLC Report paras 5.6–5.51), the SLC took the view that, although the contracting parties should be free to agree otherwise, they should lose the ability to cancel or modify a third-party right if:

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3 In general contracts can be drafted to include clauses applying the law of a different country/legal jurisdiction to the agreement/part of the agreement – see SPICe 2014
1. a condition that has to be fulfilled before the right can be enforced has been fulfilled; or
2. they have given the third party notice of the right; or
3. the contracting parties knew, or could have foreseen that the third party might rely on the third-party right and cancellation/modification of that right would adversely affect the third party to a material extent.

The Policy Memorandum includes a useful summary of the SLC’s recommendations on the abolition and cancellation of third-party rights (paras 38–41).

ARBITRATION

Arbitration is a way in which legal disputes can be resolved outside the courts. It is frequently used in commercial settings and involves a contractual term (the “arbitration agreement”) requiring disputes to be referred to persons known as “arbitrators”, or a specified arbitration body, who consider the dispute and make a decision (the “arbitration award”). Normally, the parties agree to be bound by this award and options for appealing to the courts are limited.

The problem identified by the SLC is that the Scottish arbitration legislation (the Arbitration (Scotland) Act 2010) does not deal expressly with third-party rights.

The SLC explains that:

“The issue with which we are concerned … is where a contract contains a clause under which future disputes are to be submitted to arbitration should they arise. The question then is whether a third party who by definition is not a party to the contract or the arbitration agreement which it contains can nonetheless subsequently invoke the latter….

if the contracting parties are content that the matter … should be determined by arbitration, there is no problem. But if at the time the third party makes the move it is opposed by one or more of the contracting parties, then it will be confronted with the currently insuperable difficulty that it is not party to the arbitration agreement and so has no entitlement (under the default Rule 1 of the Scottish Arbitration Rules) to submit a dispute to arbitration.” (SLC Report 7.29)

The SLC contrasts this with the position in England and Wales, and certain other countries, where third parties can, under certain circumstances, be treated as a party to the arbitration agreement, with the result that disputes on third-party rights can be dealt with by arbitration (see SLC Report para 7.5–7.22).

The SLC Report, therefore, recommends that Scots law should be brought in line with other jurisdictions and should:

“recognise that contracting parties may provide for disputes with third parties on whom they intend to confer an enforceable benefit (a third-party right) to be also subject to arbitration (and thereby, for the most part, exclude the courts).” (para. 7.33)

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4 Section 8 of the 1999 Act
WHAT DOES THE BILL DO?

The Bill implements the SLC’s recommendations and reforms the common law on third-party rights, replacing it with a statutory version. The main provisions in the Bill are outlined below. For more details see the Explanatory Notes to the Bill and the Policy Memorandum.

Section 1 – Essentials for the creation or a third-party right

This section sets out the essentials for the creation of a third-party right, including the need for:

- A contract which intends to grant a right to a third party (section 1(2))
- A third party identifiable in the contract (section 1(3))

It also confirms that third-party rights may come into existence at a future date. The Explanatory Notes to the Bill explain that this can be used to give rights to parties of a particular description who have yet to come into existence, for example future group companies (see para. 11).

The Explanatory Notes explain that section 1 has to be read with the general rules of contract. Therefore, with the exception of certain specified situations, there is no requirement for the contract setting up the third-party right to be in writing (for the exceptions see SPICe 2014, page 5).

Section 2 – Further details on the creation of a third-party right

This section includes further details on the creation of a third-party right. It provides that:

- The third-party right can be conditional and so can start or be brought to an end if the condition in question is met (section 2(2))
- There is no requirement that the intention to create a third-party right be express. It can also arise by implication under the usual rules of contractual interpretation (section 2(3))

It also confirms that a third-party right does not need to be un cancellable or unmodifiable, thus abolishing the irrevocability requirement mentioned above (section 2(4)(a)). Section 2(4)(b) also removes the need for there to be “delivery, intimation or communication” of the existence of the right to the third party. The Explanatory Notes indicate that:

“Delivery, intimation or communication will be strong indicators of the contracting parties’ intention to create a right in a person’s favour, but they are not a necessary step.” (para 18)

Section 3 – Abolition of the irrevocability rule

This section builds on section 2(4)(a), which removes the current bar on creating a third-party right unless it is irrevocable.

Section 3(1) expressly allows contracting parties to modify or cancel an existing third-party right unless the exceptions in sections 4–6 apply. However, section 3(2) allows contracting parties to make a right irrevocable if they wish by providing that they remain free to declare that a third-party right cannot be modified or cancelled.

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5 See the Requirements of Writing (Scotland) Act 1995
Sections 4–6 – exceptions to the rule allowing cancellation/modification of a third-party right

Sections 4 to 6 include exceptions to the general rule in section 3(1) which allows the contracting parties to modify or cancel a third-party right. These exceptions follow the SLC’s recommendations mentioned above.

Section 4(1) provides that a right may not be modified or cancelled once any conditions to which its enforcement was subject have been fulfilled. However, section 4(2) allows this rule to be overridden if the contract provides that the right may be modified or cancelled with retroactive effect, i.e. after the right has come into being as a result of the condition being fulfilled.

Section 5 provides that no account is to be taken of the modification or cancellation of a third-party right if it has been notified to the third party by a contracting party. This rule is, however, subject to its own exceptions. It does not apply where at the point of notification, the right is conditional (section 5(3)). It will also not apply where the third party was told by the contracting party, at notification, that the cancellation or modification may still be made, or where the third party agreed to the modification or cancellation (section 5(4)).

Section 6 includes rules which stop the contracting parties modifying or cancelling a third-party right when it has been relied on by the third party. Section 6(2) provides that no modification or cancellation is possible when a person has a third-party right and:

1. the person either does something, or refrains from doing something, relying on the right; and
2. as a result, the person suffers a material adverse effect; and
3. the contracting parties either acquiesced in the person's action (or inaction) or it was reasonably foreseeable that the person would act (or not act) in that way.

These rules do not, however, apply where:

1. the third party knew or ought to have known before acting that the contracting parties were entitled, under their contract, to modify or cancel the right despite the third party relying on it; and
2. the third party has agreed to the modification or cancellation. (sections 6(3) and (4))

Section 7 – Remedies available to a third party

Section 7(2) clarifies that a third party is entitled to any remedy to which a contracting party would be entitled. Amongst other things, this removes the doubt mentioned above as to whether third parties have the right to claim damages. Section 7(3) allows the contracting parties to contract out of this provision, which means that, if they wish, they can exclude, restrict, or even extend the available remedies.

Section 8 – Defences available against a third party

This section clarifies that contracting parties are normally entitled to assert any defences against third parties which would be available against other contracting parties. They must, however, be specifically relevant to the third-party right and not just the contract in general. The aim is to remove the current uncertainty on defences mentioned above.

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6 The Bill does not define “notification”, but according to the Explanatory Notes it is to be assessed objectively.
Section 9 – Arbitration

Section 9 provides a mechanism so that an arbitration agreement between the contracting parties can operate in respect of third-party rights.

It provides that a third party will become a party to an arbitration agreement in two situations:

1. Section 9(2) – Where there is a dispute about a substantive third-party right and the main contract requires contractual disputes, including disputes about the right in the third party’s favour, to be submitted to arbitration. According to the Explanatory Notes (para. 37) this will be the main case and will cover, for example, situations where the third party has a right to be indemnified by a contracting party against claims for which the third party is found liable. In such circumstances the third party must submit the dispute to arbitration if it wishes to pursue it. Alternatively, if a contracting party raises a court action against the third party in respect of such a dispute, the latter may seek a suspension of the legal proceedings (known as a ‘sist’ in Scots law) allowing the arbitration to take place.

2. Section 9(3) – Where the dispute is not about a third-party right arising from the contract, but rather about an independent right such as a non-contractual claim based on delict brought by or against a party to an arbitration agreement which can also apply to the dispute with the third party. In such circumstances the third party has the option (but not the obligation) of submitting the dispute to arbitration or seeking a sist in respect of a court action raised against it.

Section 10 – Renunciation of third-party right

This section allows a person with a third-party right to give it up (i.e. renounce it). Renunciation can occur expressly or by implication. However, the power to renounce the right cannot be excluded by contract as, otherwise, a person could be forced to accept a benefit which they may not want.

The Explanatory Notes indicate that a right of renunciation is needed as there is no requirement on a third party to accept a right. There therefore needs to be a clear way to allow the recipients of third-party rights to reject them.

Section 11 – Prescription

This section clarifies that the standard rules on prescription (the right to make a claim) in the 1973 Act also apply to third-party rights. This means that third-party rights normally prescribe after a period of period of 5 years.

Sections 12–13 – Abolition of common-law rule and existing rights

Section 12 abolishes the common law rules on third-party rights (the jus quaesitum tertio). On commencement of the Act existing common law third-party rights will continue in force, unless otherwise provided in contract (section 13). However, it will not be possible to create new common law rights. Instead third-party rights as defined in section 1 may be created.

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7 I.e. a deliberate or negligent breach of a legal duty
**Section 14 – Commencement**

Section 14 provides that it and section 13 and 15 come into force on the day after Royal Assent. The other provisions come into force on a day or days specified by the Scottish Ministers in regulations.

**Section 15 – Short Title**

This section sets out the short title of the Bill.
SOURCES


SPICe 2014. Legal Writings (Counterparts and Delivery) (Scotland) Bill. Available at: http://www.parliament.scot/ResearchBriefingsAndFactsheets/S4/SB_14-64.pdf
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