SUBMISSION OF THE SCOTTISH LAW COMMISSION ON THE CONTRACT (THIRD PARTY RIGHTS) (SCOTLAND) BILL

Introduction

The Scottish Law Commission was established in 1965 to make recommendations to government to simplify, modernise and improve Scots law. Our recommendations are based on analysis of the current law and its operation in practice, comparison with other legal systems, and public consultation on possible changes. The reforms that we recommend are usually accompanied by a draft Bill giving effect to them. It is then for government to decide whether to take up the recommendations, in whole, in part, or not at all. Occasionally, one of our draft Bills may also be taken forward as a member’s Bill.

Since 2009 the Commission has been engaged in a review of contract law. The Contract (Third Party Rights) (Scotland) Bill (“the Bill”) is the second Bill from this project to be introduced in the Parliament. The first was the Legal Writings (Counterparts and Delivery) (Scotland) Bill.

The basic approach of contract law is to give legal effect to arrangements that people intend to make between themselves. The freedom to contract as people wish is quite extensive. Even where contract law lays down rules, contracting parties may usually vary or exclude their application to the contract. The rules in the Bill are generally capable of variation or exclusion by the parties.

Two examples of contractual freedom especially relevant to the Bill are the freedom of contracting parties to agree:

a) what law and jurisdiction govern their contract (e.g. to say that English or another foreign law will apply to the contract and/or that the courts of another system will have exclusive jurisdiction over disputes arising under the contract, although Scots law would have applied by default and the Scottish courts would otherwise have had jurisdiction);

b) that disputes between them will be submitted to arbitration and not be amenable to the jurisdiction of the courts at all.

An important policy driver of the Commission’s contract law project is to reform any features of Scots law that tend to influence parties to opt out of it. We also support the existing policy (reflected in the Arbitration (Scotland) Act 2010) to make arbitration in Scotland and under Scots law as attractive as possible to potential users from elsewhere as well as those already in the jurisdiction.

Exceptions to freedom of contract exist. Contracts that involve criminal activity (e.g. a ‘hitman contract’) or other illegality are not permitted. Consumer and employment contracts are regulated to ensure fairness. Yet others are held to be against public policy (e.g. certain kinds of contingency fee arrangements between solicitor and client). The Bill is not regulatory in this way.

It should be noted, however, that one aspect of the existing law left untouched by the Bill is the rule that does not allow contracting parties to impose duties upon third parties without the latter’s consent.

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1 For example the [Damages (Scotland) Bill](#) introduced by Bill Butler MSP in Session 3.
2 Now the Legal Writings (Counterparts and Delivery) (Scotland) Act 2015.
1. What are the benefits of moving from a common law approach to a statutory footing?

There are two principal benefits of moving from a common law approach to a statutory footing. First, it enables uncertainty in the law to be removed, and secondly it permits reform of aspects of the common law which act as barriers to the use of third-party rights in Scots law.

Although the Scots law of third-party rights in contract has developed over the last five centuries, there are areas where no cases have come before the courts. As judicial decisions are one of the authoritative sources of law, this means that in these areas the law rests on more or less well-informed speculation by writers on the law as to what the courts will decide when the opportunity arises.

While the incremental, problem-solving approach of a case law system can provide useful flexibility in meeting new situations, the result can often be uncertainty until a case emerges for decision. That uncertainty can have significant impact upon the decision to litigate or not, or even to enter a contract or claim a right in the first place.

In third-party rights law, there is at present significant uncertainty as to what the law is in relation to the third party’s remedies, the defences available against the third party, and (to a certain extent) how the third party may renounce or reject its right. Sections 7, 8 and 10 of the Bill set out clear and principled rules on these matters, ending the uncertainty. Section 11 of the Bill also fills a gap left by the Prescription and Limitation (Scotland) Act 1973. In our view, this represents a significant advance in the clarity and accessibility of the law in this area.

By contrast, sections 1 to 6 of the Bill reform the present judge-made law. This is principally because the practical difficulties it creates for parties leads those who are able to do so to make their contracts subject to another system of law altogether – typically English law, which is found in the Contracts (Rights of Third Parties) Act 1999 (“the 1999 Act”).

The major problem with the present state of Scots law stems from a House of Lords judgment in a Scots appeal in 1920. It states that it is not enough for the contracting parties to intend a third party to have a right by saying so in their contract. They must take additional formal steps by which they make this provision irrevocable (incapable of alteration or cancellation). There are various ways of doing this, such as delivery of the written contract to the third party, intimation or notification to the third party, or registration in a public register.

This requirement causes two difficulties in practice. The more important difficulty is the inflexibility it causes. Whereas in general contract law parties can revise or amend their contracts to meet changing circumstances, the effective creation of a third-party right blocks that possibility. This loss of flexibility discourages parties from creating third-party rights.

The second difficulty is that in many cases the intended third party who will have the right is not known or identified (or perhaps not even in existence) at the time the contract is made. So, delivery and intimation are not possible, while registration involves additional formalities in making the contract, incurs additional cost and also puts the contract in the public domain (which may not be desirable for commercial reasons).

These problems do not arise in other legal systems which the Commission has examined in the course of its researches on this topic. In particular, there is no requirement of prior irrevocability in the 1999 Act. The workaround developed by many Scottish practitioners is accordingly to make any third-party right provision in their clients’ contracts subject to English law.
The difficulties with Scots law could in theory be removed by judicial reconsideration of the matter. But that would require litigation squarely raising the point to go all the way to the UK Supreme Court. Even if that happened, there can be no certainty that the Supreme Court would resolve the present difficulties. In 1971, the House of Lords sitting as a final appellate court had such an opportunity but passed it by because the court was able to deal with the case before it in a satisfactory way on another legal ground.

The Bill is the result of the Commission’s considered view that legislation is the only practical way by which the difficulties caused by the present common law can be removed in the near future.

A further benefit is that the law on third-party rights will become more accessible than at present. Whereas now the person who wants to know what the law is will have to read many cases and legal textbooks, if the Bill is enacted the law will be clearly set out in primary legislation.

2. What impact will this Bill have on third party rights?

(i) **Ease of creation**

The most important effect of the Bill will be to make it easier for contracting parties who wish to create third-party rights to do so within their contract. They will no longer have to use alternative methods to get round the requirement of irrevocability.

This ease of creation is especially important when at the time of contracting the parties to the contract do not know who exactly the third party will be. This may be because the third party does not yet exist. Examples of non-existent parties include unborn children and companies within a group structure which have not yet been formed at the time of creation of the third-party right.

**Example 1: third party non-existent at the time of contracting**

A company which is a member of a group of companies is negotiating a contract with an IT supplier and wishes the rights it will have under the contract to be available to the other companies in the group, including those companies that will be formed in the group in the future. The Bill makes this straightforward from a legal point of view. The third-party rights of the existing companies come into existence when the contract is concluded. Those of subsequently created companies come into existence with the companies themselves.

Alternatively, it may be that at the contracting stage the third party can only be identified by way of some generic description in the contract. The contracting parties know they want to make provision for a third-party but they don’t yet know who precisely that third party will be.

**Example 2: third party identified later**

A professional association is formed by contract. The contract provides that the association will provide benefits to the families of members who become unable to work through death or illness. At the time of contracting, the third parties can only be identified generically – “members’ families”. When a particular member dies or falls ill, it becomes possible to identify the persons forming that member’s family who are thus entitled to claim the benefits.
(ii) Ease of exclusion

A further benefit of the Bill from the point of view of contracting parties is that it is also easy to exclude third-party rights should they wish to do so. All they need to do is include in their contract a simple provision that the Bill does not apply to that contract.

(iii) Clarity on enforcement

Third parties benefit from the Bill in that it becomes clear how a third party may enforce its right. In particular, it may sue for damages in its own right (a point not certain in the present law).

Example 3: third party’s independent claim

A mother books a holiday for her spouse and their children. The holiday fails to deliver on various undertakings made in the contract, and the whole family is very disappointed. The mother can claim damages for her disappointment, while her spouse and each child can, as third parties with rights under the contract, also to claim damages in respect of their particular disappointments.

(iv) Clarity on defences against the third party

Section 8 of the Bill also makes clear that any defences the contracting parties have against the third party must be specifically relevant against the third party. In the actual case on which Example 2 above is modelled, the rules of the association were unenforceable between the members because the association was unlawful. But the undertaking in favour of members’ families was not caught by that illegality, and their rights were therefore enforceable against the association’s funds.

(v) Third-party participation in arbitration

Section 9 of the Bill provides for the possibility of third parties being entitled to participate in arbitrations under arbitration agreements made by other parties. The 1999 Act makes similar provision, but the Arbitration (Scotland) Act 2010 did not recognise this possibility. The Bill therefore increases third parties’ access to arbitration.

The main benefit of this lies in enabling all disputes arising under a particular contract to be decided in one forum, rather than the third party having to litigate while the contracting parties are separately arbitrating. Section 9 envisages two cases:

a) where the contracting parties provide that the third-party right is conditional upon enforcement by way of arbitration (in which case it would hardly be fair if the contracting parties could then turn round and deny the third party access to an arbitration on the basis of the provisions in the 2010 Act);

Example 4: third-party right conditional on arbitral enforcement

Contracts for the hire of ships to carry goods provide for payment of commission to named third-party brokers who negotiated the contracts. The contracts also include general arbitration clauses which however make no specific reference to the brokers, instead mentioning “all disputes arising from this [contract]”. As a claim arising from the contract, the brokers’ third-party-right claim to commission must be made through the arbitral process.
b) where an arbitration agreement is capable of covering a dispute between one or more of the parties and a third party, whether that dispute arises under contract or otherwise.

**Example 5: third-party right to participate in arbitration**

Cohabitants M and F buy a house together with the help of funding from F’s Aunt C. The pre-purchase agreement between M and F provides for arbitration of “all disputes arising from the agreement or in connection with it”. Aunt C is not a party to the pre-purchase agreement but in order to secure her position takes a share of the title to the house along with M and F.

The relationship between M and F breaks down in acrimonious circumstances and an arbitration commences between them over the distribution of the jointly-owned assets including the house. Aunt C is aligned with her niece F, and both are at loggerheads on all issues with M. He accordingly refuses to admit Aunt C as a party to the arbitration, standing upon the latter’s lack of that status under the 2010 Act.

Aunt C could sue to enforce her property right in the house and thereby secure her share of the proceeds of any sale. But this would be expensive for Aunt C, who is not entitled to civil legal aid. It would in any event be preferable to have all the issues addressed within the one set of proceedings, avoiding the risk of inconsistent outcomes between the M and F arbitration and Aunt C’s litigation. If the language of the arbitration clause is wide enough, Aunt C can under section 9(3) be admitted to the M and F arbitration for her interest.

In both **Example 4** and **Example 5**, the difficulty is the very general language of the arbitration clause, which does not mention the third party specifically. That difficulty may be avoided if the arbitration clause does mention third-party disputes and expressly enable the third party to participate in the arbitration.

**(vi) Protecting the third party against cancellation or adverse modification**

A change in the law made by the Bill that could be seen to impact negatively upon third parties is that, even after the contracting parties have concluded a contract with a third-party right provision in it, they may change the content of that provision or cancel it altogether (see section 3). While of course a change might be made favouring the third party (e.g. increasing the amount payable to it), more typically the change will be detrimental in reducing or removing completely the benefit for that party. This however is the price of giving greater flexibility to the contracting parties (who have, after all, set up the possibility of a third-party right in the first place).

It is important first to note that any cancellation or modification of the third-party right requires to be agreed by all the contracting parties. That provides some protection for third parties against arbitrary changes to their position.
The Bill does however provide a considerable amount of further protection for third parties against unfair cancellation or modification of their right in certain circumstances. These are:

a) where the contracting parties give a binding commitment in the contract that they will not cancel or modify the third-party right (section 3(2)));

b) where the third-party right becomes enforceable only after the occurrence of some event (it is a conditional right), and that event then happens (section 4);

c) where the third party is notified of the right by a contracting party and the parties subsequently cancel or modify the right (section 5);

d) where the third party acts in detrimental reliance on the existence of the right, with the knowledge and acquiescence of the contracting parties, or such activity could have been foreseen by them, and the cancellation or modification of the right would have further adverse effects on the third party (section 6).

Example 6: third-party reliance

Tara is the daughter of one of the partners in the firm of Jones & Quinn. She intends to go to university in the USA. The partners agree that, subject to the profits of the business achieving a given level in any year, the firm will pay her tuition fees for the next 3 years.

Tara begins her course and the firm pays the fees for Year 1. In Year 2, the firm’s profits do not reach the specified level. Unaware of this, Tara incurs expense in travelling to the USA and recommencing her studies.

If it can be shown that the partners knew of and acquiesced in Tara’s detrimental reliance, or ought to have foreseen it, and that cancellation or modification of the right would have further adverse consequences (i.e. she would be unable to complete her degree course), then she may be able to hold them to paying her fees for Year 2 and perhaps Year 3 as well.

The interaction of these protections can be seen in Figure 1 at the end of this paper.

3. Do you think the Bill will increase the use of Scots law?

As we note above, one of our major policy objectives in preparing the Bill was to remove barriers in Scots law which might cause parties to make their contracts subject to another law. We think that the removal of these barriers has some potential to increase the use of Scots law.

The Bill’s provisions on arbitration may attract business to Scotland. They bring Scots law into line with the position under the 1999 Act in England and Wales, and with the position in

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3 Parties may also do so at any time by way of an independent promise to that effect.
4 In Example 1, this occurs when a new company is formed in the company group. In Example 2, it occurs when an association member dies or becomes ill.
5 In Example 1, all the companies existing in the group at the time of the IT contract’s formation are notified of its conclusion and content.
6 For example, where a third-party right is still conditional upon the occurrence of an event, the third party spends money on the basis that it will eventually get the benefit of the right, and cancellation or modification of the right would have further adverse effects for the third party.
those other jurisdictions around the world which have imitated the English legislation. We also understand that the possibility of third-party rights to arbitrate is in line with developing practice in international commercial arbitration practice.

4. Do you have any concerns about the approach taken in the Bill?

No. The Bill reflects the recommendations that we made in our 2016 Report, which was based on extensive consultation with interested parties. We are confident that the Bill provides robust solutions to the various difficulties we identified.

5. What are the financial implications of the Bill?

We have set out our detailed views on the Bill’s financial implications in the Business and Regulatory Impact Assessment published alongside our Report.

In brief, we think that the Bill provides a facility which people may choose to use or not, as they see fit. It imposes no costs on parties beyond those who choose to use it. We also give examples in the Business and Regulatory Impact Assessment of potential savings, for example if third-party rights are used instead of collateral warranties.

Scottish Law Commission
8 March 2017
Figure 1: This diagram illustrates when third party rights become incapable of cancellation or alteration by the contracting parties under the Bill.