Submission on the Contracts (Rights of Third Parties) Bill by David Christie, Senior Lecturer, Robert Gordon University

This submission looks at the impact of third party rights in the area of construction law.

Before addressing the four questions identified by the Delegated Powers and Law Reform Committee (the “Committee”), this submission identifies some key relevant features of “construction law” as a distinct area within law and the particular relevance of third parties rights in that context. That requires a brief assessment of the role and operation of collateral warranties. That discussion is necessary context for the answers posed by the committee.

What is construction law?

Construction law has been described as

““primordial soup in the “melting pot” of the law — a thick broth consisting of centuries-old legal theories fortified by statutory law and seasoned by contextual legal innovations reflecting the broad factual ‘realities’ of the modern construction process”

Construction law is a sector or discipline specific hybrid drawing on various other classifications from across the various sources of law with a particular focus on particular topics. The cornerstone is contract law and the wider law of obligations, with a particular focus on the legal consequences and analysis of particular issues which frequently arise in construction and engineering projects. Feeding into this is the interpretation of the standard terms of contract which are frequently adopted by parties to the various projects and various statutory innovations which apply specifically to construction law. These specialities combine sufficiently to create a distinct body of rules around the procurement, execution and resolution of construction projects.

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1 I am grateful to students on the masters in construction law and arbitration who answered a question covering some of these issues in their coursework in one of the modules on that Masters programme and whom, in the course of that answer identified a number of the sources which are referred to below. I am also grateful to my colleagues Dr Joseph Mante, Dr Andrey Kotelnikov and Dr Hamish Ross for their comments on an earlier draft of this paper. All views and errors are my own.

These rules operate within the broader legal/cultural context of the construction industry. In terms of the impact of the law which this has; it is said that the approach is marked by general pragmatic and commercial approaches which favour flexibility.³

At its base, therefore, the provision of a clear and coherent option for the use of third party rights in contract is to be broadly welcomed as increasing the options and the flexibility for parties in construction contract.

In terms of third party rights, the full and clear legal analysis produced by the Scottish Law Commission (the “SLC”) would apply to “construction law” as it would to any other area where contract law, and the wider law of civil obligations is used.

**Protection of third party rights in construction law**

In construction law terms, therefore, the key issue which this submission focuses on is the use of “collateral warranties.” Professor MacQueen has already outlined the position in this respect to some extent in his evidence to the committee.

Collateral Warranties were defined in the case of Scottish Widows v Harmon, by Lord Drummond Young as follows:

“A collateral warranty provides, in summary, that the person giving the warranty undertakes various contractual duties to the person who receives the warranty; where the warranty is given by a contractor the obligation is to perform the obligations undertaken in the contract with the employer or, as appropriate, the main or management contractor; and where the warranty is given by a member of the professional team the obligation is to perform the duties undertaken to the employer with due care and diligence.”⁴

As the Committee will be familiar, this mechanism is used because the rights of third parties to claim for losses is restricted in the law of delict (i.e. the law for non-contractual civil obligations) and because of the difficulties with third party rights at common law. In the absence of these mechanisms those parties who might suffer loss have an interest in a route

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⁴ Scottish Widows Services & Anor v Harmon/CRM Facades Ltd [2010] CSOH 4 at para. 1
of recovery created against those who might be at fault. At present – standing the issues with the law of third party rights in Scots law which this Bill aims to address – the principal mechanism to provide this route of recovery is through either a bilateral contract, or potentially a unilateral promise.\(^5\) (For the purposes of the assessment in the present context, there is no need to distinguish between the two approaches beyond saying that (i) there may be some administrative “streamlining” through a ‘promise analysis’ (fewer signatures are required) but that (ii) there may also be significant risks in interpretation and implementation. For present purposes, the vast majority of collateral warranties used with construction contracts will be bilateral (at least) contracts.)

Liam McKenna and Jennifer Charlson have produced some valuable research on this area, including a literature review and some empirical research.\(^6\) This chimes with the author’s own review and understanding of the position. They capture the issue in England as follows:

“Legal experts have endorsed the use of Collateral warranties stating that using the Act is merely “change for changes sake” and “if it ain’t broke, why fix it?” They go onto say that it is likely that the construction market will continue to prefer Collateral Warranties until Third Party Rights are proven to offer equivalent protection and tangible cost savings to all the parties in construction projects”\(^7\)

They term this as a “paradox.”\(^8\) From this, it is clear that what is needed could be termed a virtuous cycle where the use of third party rights instead of collateral warranties increases. That increase becomes more visible and gives parties the confidence to use third party rights. That thereby increases the use of third party rights and so on. The commercial pragmatism of the “ain’t broke...” analysis highlights the importance of general acceptance and conventional wisdom as necessary features in the adoption of new idea. If third party rights are to be successful then they need to be established as an option within the ‘conventional wisdom’ and securing that place is important in counteracting the conservatism of the broader construction law position.

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\(^5\) See discussion in Hogg “Promises to Lend, Collateral Warranties and Red Herrings” (2015) Edin LR 384

\(^6\) McKenna and Charlson The Contract (Rights of Third Parties) Act 1999 versus collateral warranties in the UK construction industry 2015 Const LJ 320

\(^7\) Ibid. at 321.

\(^8\) Ibid.
For perhaps obvious reasons, risk adverse parties do not wish to experiment with the mechanism which they use to make recovery. If that is true in England, where third party rights have been codified since 1999, then it must also be true in Scotland where the position is far less clear.

Nevertheless, while McKenna and Charlson’s research suggests ongoing ambivalence about third party rights in England and Wales, it does seem that there is at least acceptance of their merits. Third Party Rights also have commercial support from the publishers of the two most commonly used suites of standard form building contracts in England and Wales, the Joint Contracts Tribunal and the NEC 3, who provide detailed schedules of third party rights which parties can adopt if they choose to agree them as part of their suite of contracts.

While practice still seems to favour collateral warranties in England and Wales, they are recognised as a sub-optimal solution in many ways. There are three possible grounds for attack on this front (as the committee may have already heard). These are linked and can be summarised as follows.

1. The logistical difficulties. These are well known and have been discussed in other evidence before the Committee. Put simply, even assuming that the terms of the warranties are uncontroversial and all parties are willing to grant and execute the documentation, there is still a very significant amount of time, effort and legal expense required in creating and then securing the appropriate suite of collateral warranties.

2. Following on from the first point, the protection of third parties requires the procurement of the collateral warranties and this can be very difficult to achieve. As highlighted in Kier Construction Limited v WM Saunders Partnership LLP, the courts are willing to order parties to comply with the obligations to produce collateral warranties. That requires such obligations to be written and enforceable through the supply chain to provide the full blanket of protection – and then for these obligations to be enforced. Unless the contracts of the whole supply chain facilitate it, there can be difficulty. Walker and D’Aeth have

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9 As captured, for example, by Professor Beale in A review of the Contracts (Rights of Third Parties) Act 1999 in A S Burrows and Edwin Peel, Contract Formation and Parties (2010) OUP
10 NBS National Construction Contracts and Law Survey 2015
11 [2016] CSOH 17
identified the prominence given to this problem in collateral warranties in the *Liberty Mercian* cases\(^\text{12}\) in England as being something which suggests that “*following a prolonged battle for respectability, [third party rights’] time has finally arrived.*” \(^\text{13}\)

3. In an article in 2007, a discussion on collateral warranties started on the footing (presented as portraying something like the ‘conventional wisdom’) that “*collateral warranties don’t matter very much because they are never used in anger.*” \(^\text{14}\) The article disputed this (terming it a “popular myth”\(^\text{15}\)) – by reference to case law. However, if the view is that collateral warranties are harmless while offering security, then that view can be shaken by the increasing number of decisions around the terms and operation of warranties. Moreover, the capacity for surprising decisions which might pose questions as to the operation of collateral warranties can also shake the conventional view of them as a secure and certain mechanism for the protection of rights.

The main case which highlights this issue is the decision in *Parkwood v Laing O’Rourke*\(^\text{16}\), which held that it was possible, depending on the precise interpretation of the terms of the contract, for a collateral warranty to be considered a “construction contract” (depending on its precise terms) and thereby it was possible for certain terms to be implied into the contract – including the mechanism for construction adjudication as a means of dispute resolution. One law firm briefing on the case concluded: “*the ‘better the devil you know approach to favouring collateral warranties over third parties rights is not longer viable: this is because, as it turns out, no-one actually knew what they were dealing with when it came to collateral warranties.*” \(^\text{17}\) That is perhaps overstating it but does

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\(^\text{12}\) [2013] EWHC 2688
\(^\text{14}\) Question and Answer *Collateral Warranties and net contribution clauses* (2007) Construction Newsletter 31
\(^\text{15}\) Ibid.
\(^\text{16}\) [2013] EWHC 2665 (TCC)
represent the vulnerability of collateral warranties to unusual circumstances and
decisions.

So it may be that the increasing acceptance of third party rights in England and Wales is
occurring at a point when some of the benefits of collateral warranties is being undermined.
The extent to which collateral warranties are the principal pragmatic choice in all cases is in
question and the flexibility of an alternative approach seems to be being realised. The virtuous
cycle may be beginning to move.

At the same time, collateral warranties continue to exist – and may be particularly useful
where a more complex relationship with third parties is required. In particular, where there
is a need for the third party to take on obligations as well as benefits, collateral warranties
will be important. That however ought not apply to all third parties. Moreover, for those
where it does, the additional complexity required in setting up such an arrangement justifies
the time and effort spent in agreeing the collateral warranties. Providing what is hopefully a
more straightforward option for the more straightforward cases ought to free up some of the
time spent to devote to the more complex situations.

Turning then to the issues for the committee, then, the following observations might be
made.

**What are the benefits of moving from a common law approach to a statutory footing?**

From a construction law point of view, it is clear from the discussion above that the collateral
warranty is a sub-optimal solution to the problem. However, if the response in England and
Wales is to hope for a virtuous cycle which promotes third party rights as a genuine and
accepted alternative to this solution, this option is not currently available in practice in
Scotland.

Indeed, rather than a virtuous cycle, the position of third party rights in Scotland – which have
existed for centuries – could be seen as a “death spiral”. While the principle of third party
rights is recognised in Scotland, it does not provide commercial parties in the construction
industry or elsewhere with sufficient certainty as to their position. As the RIAS have pointed
out in their written evidence to the Committee, the common law needs cases to come before the courts to allow questions to be decided upon and the law developed. That hopefully increases certainty. Unfortunately, the lack of certainty around third party rights has led to an apparent lack of use of third party rights by the sort of parties who might otherwise have the resources to take cases before the courts. So, the ‘death spiral’ of third party rights has occurred where the lack of certainty prevents use, that lack of use leads to a lack of case law, which in turn prevents the law from being developed, and that continues the uncertainty.

Moreover, there are indications that – even if tentatively – the industry may be becoming more receptive to third party rights as a whole in England and Wales and that increased interest and enthusiasm could be harnessed in Scotland.

Certainly, there is scope for offering construction companies the option of an improved way to protect third parties from losses – outside of the traditional contract approach. That would increase the flexibility of their approach in this area.

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

This is linked with the answer to question 1. For the reasons set out above, it would seem that there was a reasonable prospect that use of third party rights in Scotland would be increased and that the position of third parties would be improved, to at least some extent, by these developments.

Collateral Warranties will remain in use, of course and there may be situations where that is particularly useful – such as when the third party needs to bear obligations as well as benefits. The Bill will enhance flexibility in the approach.

2. Do you think the Bill will increase the use of Scots Law?

The slow progress made by third party rights in England and Wales shows the difficulties with the take up of legal innovations. There seems to be a need, on occasion, to capture the “zeitgeist”. To some extent this is organic.

The use of English law in many construction contracts is for a number of reasons and the improvement of the third party rights position is probably unlikely to do a great deal to alter the position on its own. For example, the most commonly used standard forms use English law (although the Scottish Building Contracts Committee have a Scots law version of the JCT).

There is a wider point in the sense that the change may give parties more confidence to use Scottish law than they had – and it may make the position clearer for those that do.

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

Collateral warranties remain in place as an option so if the construction industry does not like the Bill, it has an option. For the reasons set out above, it is not considered that the status quo is the best option and so the Bill is a useful addition.

The construction law approach is to seek flexibility. Clearly that needs to occur within a framework of reasonable certainty and the systematic approach of the SLC, benchmarked against practice and law elsewhere seems to do that.

From a construction law perspective, the issues which seem to be raised most frequently in terms of the operation of the 1999 Act in England and Wales relate to the use of ‘net contribution clauses’ (where parties try and limit the extent of their liability where they share the fault for a loss with others) and ‘step in’ rights (where parties give others the opportunity to enter into the contract and discharge the obligations under it. Principally, in this context, funders who step into the shoes of the employer and thereby gain the rights of the employer against the granter of the collateral warranty).
It is understood that these issues can, however, be resolved by contractual drafting and, in particular in the case of step in rights, are only likely to be of use in situations where parties have the resources to engage in complex legal advice and drafting processes.

5. **What are the financial implications of the Bill?**

Any legislative change brings a degree of cost in terms of (i) education of the professions involved in it and (ii) potentially in terms of requiring further work to ensure the clarity of the interpretation of the legislation. That is why “change for changes sake” ought not to be pursued. That is not what these proposals suggest however.

Furthermore, some of the start up cost at least in the construction sense might be mitigated because the basic approach of using third party rights is one which is recognised and understood by the industry, following the growing use of third party rights in England and Wales.

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19 See e.g. Richard Pike *Collateral Warranties and third party rights* (2012) Construction Newsletter 6 at p. 7