

## CITY OF LONDON LAW SOCIETY -

### JOINT PAPER OF THE CONSTRUCTION COMMITTEE AND LAND COMMITTEE

#### THIRD PARTY RIGHTS INITIATIVE

##### BACKGROUND

Those involved in UK real estate developments are familiar with the role of collateral warranties and the importance of the availability and terms of those documents to the marketability of developments. A collateral warranty provides, amongst other things, a contractual undertaking from a contractor or consultant to a funder, purchaser or tenant that it has properly carried out its works or services in connection with a development. Such undertakings provide a right to recover loss or damage suffered as a result of, say, a defect where otherwise, no right would exist.

While collateral warranties are generally quite short and often very similar in content, negotiating their terms and then physically obtaining them can be disproportionately complex, tedious and expensive. Many therefore welcomed the introduction of the Contracts (Rights of Third Parties) Act 1999 (the "**Act**") as it provides a means of giving a third party to a contract a right to enforce the terms of that contract without the necessity of procuring collateral warranties. Given the material benefits to all involved in real estate developments of procuring Third Party Rights over collateral warranties, the take up of Third Party Rights in UK real estate developments has been disappointing. In this [note/article] we review the process for implementing Third Party Rights and the real benefits that their used can provide.

##### NEGOTIATION PROCESS

As regards the process for negotiation of Third Party Rights, there is no difference in approach to that presently adopted for securing the grant of collateral warranties. A developer would seek to negotiate Third Party Rights as part of its discussion on the terms of the building contract or appointment. The terms on which they will be granted will normally be identified in schedules to the building contract or appointment documents and, on the whole, will be in identical terms to the collateral warranties that would otherwise be agreed by contractors and consultants. For example the Third Party Rights Schedules included within the JCT standard contract forms reproduce the terms of the equivalent standard form collateral warranties produced by the JCT.

Of course, any funders, purchaser and tenants which are known at the outset (as the main funder and anchor tenants often are) will be able to comment on the terms of the Third Party Rights whilst the construction documents are being negotiated, just as they are able to currently when collateral warranties are used. Whilst the level of negotiation of Third Party Rights with contractors and consultants may in some cases match those of collateral warranties, they certainly won't exceed them.

##### IMPROVED ADMINISTRATION AND CONSEQUENT REDUCED COST

Once schedules of Third Party Rights have been agreed however, their real advantage over collateral warranties is seen. Where collateral warranties are to be obtained, significant costs can be incurred by each of the employer, contractors, consultants, sub-contractors and third parties, usually comprising a combination of the following:

- generating draft warranties for comment by several parties;
- preparing multiple engrossments of each warranty;

- postal and legal costs associated with circulating warranties amongst several parties for signing, which can be even greater where signatories are located abroad;
- legal and management costs arising from chasing the execution of the engrossed warranties;
- legal costs of drafting and reviewing powers of attorney for signatories and checking that signatories have necessary authority to sign;
- re-engrossments and/or amendments requiring approval where signature blocks require amendment; and
- as noted above, attempts by some parties to amend warranties when they are circulated for signing (which requires approvals and consents to be sought from other parties).

Where multi-let developments are concerned, these costs can be replicated many times.

In contrast, Third Party Rights take effect by the employer simply serving a notice on the contractor or consultant identifying the third party entitled to the rights by name. Hence the employer has complete control over the grant of the rights and the contractor and the consultants know who they are liable to. The funder, purchaser or tenant can be provided with a certified copy of the notice and the relevant contract.

Many are familiar with the attritional process faced by those trying to sell or let a completed development in attempting to get collateral warranties in favour of actual purchasers and tenants. It can be difficult to get a contractor or consultant to focus on executing these documents in a timely manner after the work has completed and all fees have been paid. It is particularly acute where there is an ongoing dispute with a member of the construction team who is required to give a collateral warranty. There have been attempts in the past to get around the problem for example requiring contractors or consultants to agree to powers of attorney or arranging for warranties to be executed with beneficiaries names left blank. However such solutions can potentially give rise to their own problems and as such they have not found wide favour in the market as a whole.

The cost and time savings that can be made because of the ease of administering third party rights have already been recognised by many major developers building multi-let, flagship schemes in the UK's urban centres. Many of the landmark tower schemes in London have adopted Third Party Rights in place of collateral warranties. Contractors and consultants have received comfort on such schemes by the potential number of Third Party Rights on multi-let buildings being capped, either by an overall number, a maximum number of Third Party Rights per floor or by Rights only being available to tenants taking a lease above a certain area set out in the construction contract.

#### **PERCEIVED DRAWBACKS ON USE OF THIRD PARTY RIGHTS**

The only technical difficulty with Third Party Rights that is occasionally identified relates to the fact that the Act speaks of third parties obtaining the benefit of **rights** under contracts to which they are not a party, but not imposing **obligations**. This has led some funders (and forward-purchasers) to argue that step-in rights included in Third Party Rights, which impose on funders an obligation to pay and perform, will not be triggered by the employer serving a notice, thus rendering one of a funder's key protections ineffective. We believe these concerns are misplaced. As long as the relevant step in rights are expressed to be conditional on the payment of outstanding sums then it is when the funder issues its step in notice that it assumes the obligation to pay, not when the Third Party Rights are granted. In any event, this should not be seen as a reason for rejecting Third Party Rights wholesale. Rather, where this issue remains a

significant concern then, as a fallback, the ability to call on a direct agreement in favour of the funder either containing step-in provisions alone or all rights normally granted, could be retained.

## **THE FUTURE**

It is the joint view of the Real Estate and Construction Committees of the CLLS that, because of inherent benefits identified above, commercial parties' interests are best served by the use of Third Party Rights in place of collateral warranties. Consequently, the industry should now be making concerted efforts to move to Third Party Rights as being the norm. As part of this, legal and other professional advisers should explore the use of Third Party Rights for all new development projects and should be advising prospective funders, purchasers and tenants that Third Party Rights provide equivalent protection to collateral warranties. The contribution that advisers can make to this paradigm shift cannot be underestimated.