The Law Reform Commission

AN COIMISIÚN UM ATHCHÓIRIÚ AN DLÍ

CONSULTATION PAPER

PRIVITY OF CONTRACT: THIRD PARTY RIGHTS

(LRC CP 40-2006)

IRELAND

The Law Reform Commission

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THE LAW REFORM COMMISSION

Background

The Law Reform Commission is an independent statutory body whose main aim is to keep the law under review and to make practical proposals for its reform. It was established on 20 October 1975, pursuant to section 3 of the *Law Reform Commission Act 1975.*

The Commission's Second Programme for Law Reform, prepared in consultation with the Attorney General, was approved by the Government and copies were laid before both Houses of the Oireachtas in December 2000. The Commission also works on matters which are referred to it on occasion by the Attorney General under the terms of the Act.

To date the Commission has published 79 Reports containing proposals for reform of the law; 11 Working Papers; 39 Consultation Papers; a number of specialised Papers for limited circulation; An Examination of the Law of Bail; and 26 Annual Reports in accordance with section 6 of the 1975 Act. A full list of its publications is contained on the Commission's website at www.lawreform.ie.

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Full responsibility for the content of this publication, however, lies with the Commission.

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INTRODUCTION

A Background

1. This *Consultation Paper on Privity of Contract: Third Party Rights* forms part of the Commission's Second Programme of Law Reform.[1] The topic was included in the Minister for Justice's Programme of Law Reform in 1962,[2] but this is the first time it has been examined in depth in the State with a view to its reform.

2. A contract is usually described as an agreement between two parties, whether corporate entities or individuals. The agreement is legally enforceable if it is based on genuine consent and involves an exchange of economic value, usually called consideration. For example, if A and B agree that A will paint B's fence and that in return B will pay A €100, both parties have provided consideration and the agreement will be enforced by the courts.

3. Closely related to the requirement of consideration is the concept of privity of contract. In essence, privity means that only the parties to a contract – those "privy" to it – have enforceable rights and obligations under that contract.

4. This Consultation Paper is concerned with identifying the role of privity of contract in the modern law of contract. Its purpose is to analyse whether the needs of those affected by privity would be best served by its reform.

B Outline of the Consultation Paper

5. Chapter 1 examines the historical origins and the development of privity of contract. It discusses the numerous exceptions that have developed in the common law and in legislation. The chapter examines the relationship of privity with other fundamental principles of contract law, for example, the requirement of consideration and freedom of contract. In addition, Chapter 1 highlights the problems that have been encountered in

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1 *Second Programme for Examination of Certain Branches of the Law with a View to their Reform: 2000 – 2007* (PN 9459) (December 2000). Available at www.lawreform.ie

2 *Programme of Law Reform* (The Stationery Office, Dublin, 1962, Pr.6379) paragraph 16(7).

practice as a result of privity. The Commission focuses on a number of key areas, such as construction contracts, shipping contracts, insurance contracts, consumer law and exemption clauses.

6. In Chapter 2 the Commission reviews the options for reform. These include judicial development of privity and possible legislative reform. The advantages and disadvantages of each method are examined, together with a comparative analysis. In addition, the relationship between any proposed reform and the existing exceptions to the rule of privity is examined.

7. Chapter 3 examines the detailed issues that would need to be addressed in any legislation creating enforceable rights for third parties. The Commission discusses the test of enforceability; identification of the third party; the rights of the parties to vary the terms of the contract; and the separate and distinct rights of the parties involved in a contract. At all stages the Commission draws from a comparative analysis of the approaches in different jurisdictions.

8. Chapter 4 contains a summary of the provisional recommendations.

9. As will become clear from the material referred to in this Consultation Paper, the primary and secondary literature in this area is vast. The Commission has benefited in particular from the work of leading writers[3] and from the reform proposals made in many jurisdictions, in particular by comparable law reform bodies.

10. This Consultation Paper is intended to form the basis for discussion and accordingly the recommendations made are provisional in nature. Following further consideration of the issues and consultation with interested parties, the Commission will make its final recommendations. Submissions on the provisional recommendations contained in this Consultation Paper are welcome. In order that the Commission's final Report may be made available as soon as possible, those who wish to do so are requested to send their submissions in writing by post to the Commission or by email to info@lawreform.ie **by 31 March 2007**.

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[3] For example, Clark *Contract Law in Ireland* (5th ed Thomson Round Hall 2004) and McDermott *Contract Law* (Butterworths 2001).

CHAPTER 1 DEVELOPMENT OF PRIVITY OF CONTRACT AND THE NEED FOR REFORM

A Introduction

1.01 The purpose of this chapter is to examine the history and development of privity; the current law in relation to third party rights; the exceptions to the rule of privity; the relationship of the rule of privity with other principles of contract law; and the problems encountered in practice as a result of privity of contract.

B Privity: an overview

1.02 The concept of privity of contract involves two ideas. First, a corporate entity or an individual who is not a party to a contract can not have any burdens from that contract enforced on them. For example, if A and B agree that A is to paint B's fence, and that a third party, C, is to pay A €100, C is not bound by this contract. It would be unfair to force C to pay the €100 as C has not agreed to do so and has not received anything in return. Second, a corporate entity or an individual who is not a party to a contract can not enforce the contract, even if the contract was one which was intentionally made for their benefit. For example, if A and B agree that A will paint the fence of a third party, C, and B will pay A €100, C can not enforce the contract between A and B. C was not privy to the contract between A and B.

1.03 Several reasons have been given for this rule. First, it would clearly be unfair if two parties could impose contractual obligations on a third party without their consent. Second, the courts view contracts as private arrangements. A third party cannot interfere in that contract, or enforce that contract, as it is "none of their business". In particular, parties to a contract are free, if they both clearly so agree, to abandon a contract or vary its terms. For example, A and B may agree that A will paint B's fence red and that B will pay A €100. However, later the parties might agree that in fact A will paint B's fence green. A and B are free to change their minds in this way, and C, a neighbour of B who is particularly fond of the colour red, cannot enforce the contract on its original terms. Finally, privity of contract is closely linked to the traditional rule that a party who wishes to enforce a contract must have provided some consideration. A third party will

not have provided consideration under the contract and so cannot enforce the contract.

1.04 The decisions in which the rule of privity was developed in the 19th century involved relatively simple transactions. The rule was based on the industrial conditions and business arrangements which existed at that time. However, the situations in which the privity rule has an impact in modern Ireland are generally more complex than the example given above in relation to the painting of a fence. Business arrangements will today rarely involve only two parties, and detailed standard form contracts are in common use. Globalisation and the development of international trade have resulted in an increase in transnational contracts. It is important to be aware of the modern context in which the privity rule is applied.

1.05 The adverse impact of the privity rule can be seen in modern construction projects. A large scale construction project, such as the building of a motorway, the construction of a tunnel, or the development of houses, will generally involve many different parties. A main contractor may be appointed with overall responsibility for the project, but various elements of the project, from the supply of concrete to the provision of professional design services and legal advice, will be sub-contracted to other companies, firms and individuals. In this complex and interdependent contractual context, the rule of privity may mean that each of these contracts has, in effect, nothing to do with each other. However, it would be impossible to ensure the completion of such projects unless some mechanism was put in place to ensure that the various contracts were connected in some way. To get around the privity rule, professional bodies (representing architects, engineers, lawyers and others) have developed a complex web of collateral agreements, warranties, and chains of assignment, usually in the form of standard agreements.[1] In major projects the amount of paperwork and the cost of legal services can be quite significant. However, arguably such mechanisms would be less complicated if a modern rule of third party rights was in place, which reflected commercial needs in the 21st century. The Commission accepts that major projects will still require complex contractual arrangements, but notes that some simplification may arise.[2]

1.06 Privity of contract can also cause some strange and unfair results in smaller projects. For example, a person (employer) may contract with a builder for the construction of an extension to their elderly parent's home. The contract is clearly intended to benefit the employer's elderly parent. However, if the builder refuses to complete the building, or provides a

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1 See paragraph 1.72ff, below.

2 See for example the changes to the JCT Standard Form Contract in England after the enactment of the *Contracts (Rights of Third Parties) Act 1999*. See paragraph 1.86, below.

defective service, the parent is not entitled to sue the builder for a breach of contract. The employer may themselves sue, but, under the rules on damages, unless they can prove that they suffered a loss themselves, they will be entitled only to nominal damages. It is also unlikely that the employer could get a court order to compel the builder to finish the job. Courts are unwilling to make such orders when the contract is for the provision of a service. As a result of the privity rule, the parties may be left in a bizarre situation where the person who has suffered loss as a result of the builder's breach of contract cannot enforce the contract.

1.07 Another typical example in which the rule of privity may cause difficulties is where a person agrees to buy an item, for example, a car, through a finance package involving a loan from a finance company. In this context, the finance house is clearly an important party to the agreement. In some instances, the written loan agreement may describe the financial institution as simply the loan provider. But in other agreements it may be described as the seller, because the car dealer will have sold the car to the financial institution, which will then have sold it on to the consumer.

1.08 If the financial institution is merely providing finance, problems can arise if the car turns out to be defective and the car dealer has now gone out of business. Does the buyer have any claim against the financial institution? Under the rule of privity of contract, the answer is clearly no, because the requirement that the car should be fit for the purpose of use is a term of the contract between the seller and the buyer – it has nothing to do with the financial institution. The buyer is left without a remedy.

1.09 If the financial institution is described as the seller and the car turns out to be defective – and the car dealer is still in business – can the buyer go back the garage to have it replaced? The privity of contract rule would indicate no, because the car dealer can say in this instance: "sorry, you did not buy the car from me, get it fixed at the finance company".

1.10 Neither of these outcomes seems satisfactory, and many parliaments have legislated exceptions to the privity rule to provide protection to the buyer in this situation. In Ireland, section 14 of the *Sale of Goods and Supply of Services Act 1980* provides that in this type of scenario a consumer car buyer can choose to enforce his or her rights against either the car dealer or the financial institution.[3]

1.11 Other situations where the privity rule has caused problems have similarly been dealt with by specific legislation. For example, there has been legislative intervention in the areas of insurance and consumer protection.[4] In addition, the courts have used concepts such as trusts, agency

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[3] See paragraph 1.59, below.

[4] See paragraph 1.49ff, below.

and assignment to develop exceptions to the rule.[5] While such exceptions are necessary, they have left the law on third party rights in a complicated state. They are also indicative of a general dissatisfaction with the privity rule.

1.12 Rigid adherence to the rule can give rise to commercial inconvenience and expense, not to mention injustice for the third party with no rights to enforce an agreement made for their benefit. The methods used in attempting to alleviate this unfairness and inconvenience are complicated, and do not cover all situations where privity has an impact. For these reasons, many common law states have reformed the law in relation to third party beneficiaries, and have greatly limited the privity rule. This has happened in New Zealand,[6] Australia,[7] Canada,[8] England and Wales,[9] the United States of America,[10] and Singapore.[11] By reforming the rule it was acknowledged that the situation was unsatisfactory and that if contracting parties intended to benefit and create enforceable rights in a third party, this intention should not be thwarted.[12]

1.13 Nonetheless, the implications of allowing a third party to enforce rights under a contract go to the very core of the common law understanding of contract law and the well settled principle that a gratuitous promise is not enforceable at law. For this reason, the Commission considers that before considering whether the course taken in other jurisdictions should be followed in Ireland, it is necessary to discuss the historical basis for the privity rule and to determine whether it remains valid in the 21st century.

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5 See paragraph 1.27ff, below.

6 *New Zealand Contracts (Privity) Act 1982*.

7 Section 11 *Western Australian Property Law Act 1969*, section 55 *Queensland Property Law Act 1974*, section 56 *Northern Territory Law of Property Act 2000*.

8 *London Drugs v Kuehne & Nagel International Ltd* [1992] 3 SCR 299, *Fraser River Pile & Dredge Ltd v Can-Dive Services Ltd* [1999] 3 SCR 108.

9 *Contracts (Rights of Third Parties) Act 1999*.

10 Section 304 of the *Restatement (Second) of Contracts* states that "intended beneficiaries" have enforceable rights. The Restatements are published by the American Law Institute, a voluntary body of legal practitioners and leading academics. Although they are not binding and do not have legislative status, the various Restatements have been hugely influential in the adoption of statutory reform in many States of the United States of America, and have been cited in cases as persuasive precedents. See paragraph 2.04ff and paragraph 2.82ff, below.

11 *Contracts (Rights of Third Parties) Act 2001*.

12 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 3.28.

C The history of privity of contract

1.14 The 1861 case of *Tweddle v Atkinson*[13] is usually cited as the origin of the rule of privity of contract. In this case a son-in-law failed in his action to recover a sum of money promised to him in a marriage agreement between his father-in-law and his own father, as he was not a party to the original contract. The court decided that "it is now well established that at law no stranger to the consideration can take advantage of the contract though made for his benefit".

1.15 The decision in *Tweddle v Atkinson* was applied by the House of Lords in *Dunlop & Co v Selfridge & Co*.[14] In this case Dunlop had agreed with a wholesaler that the wholesaler would not sell Dunlop tyres below the recommended retail price. The wholesaler sold the tyres on to a retailer, Selfridge, who in turn sold the tyres at a price below that recommended. The House of Lords decided that Dunlop had no case against Selfridge, because Selfridge was not a party to the original agreement.

1.16 Despite this line of authority, prior to *Tweddle v Atkinson* there had been a number of cases which allowed a third party beneficiary to enforce a promise made for their benefit. There was a series of cases prior to 1669 which confirmed the view that a third party could take an action to enforce such a promise.[15] This trend was reversed by the decision in *Bourne v Mason*,[16] in which it was decided that a third party could not recover under a contract as he had provided no consideration, but the matter was by no means settled. The later case of *Dutton v Poole*,[17] for example, was consistent with the recognition of the rights of the beneficiary who has not provided consideration. The case involved an agreement between a father and son, in which the father agreed with his son not to cut down and sell trees on his land. The son would have use of the trees, and would pay his sister a sum of £1000 for her share. The father did not cut down the trees, but the son refused to pay his sister any money. The sister brought an action claiming what was owed to her under the contract between her father and brother. The court decided that there was no need for the sister to provide consideration. The fact that her father had provided the consideration was enough to allow his daughter a right of action. The case is an early example

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13 (1861) 1 B&S 393.

14 [1915] AC 847.

15 Flannigan "Privity of contract – the end of an era (error)" (1987) 103 LQR 564, at 565.

16 (1669) 1 Vent 6.

17 (1677) 3 Keb 786.

of the concept of a "joint promisee".[18] The court held that the justice of the case required that the daughter be allowed to claim as a joint promisee.

1.17 Subsequently there were conflicting statements of the law. In *Crow v Rogers*[19] it was decided that the third party plaintiff could not bring a case. However, in *Martyn v Hind*[20] Lord Mansfield commented on the correctness of the outcome in *Dutton v Poole*, and in *Pigott v Thompson*[21] and *Carnegie v Waugh*[22] it was held that a third party could bring an action on a contract made for his benefit.

1.18 Although it may appear that matters were settled by the decision in *Tweddle v Atkinson* the situation was far from clear-cut. Even after *Tweddle v Atkinson* there was harsh criticism of the effect of privity from some judges in England and Wales. In *Smith and Snipes Hall Farm Ltd v River Douglas Catchment Board*[23] Denning LJ in the English Court of Appeal said that privity of contract was "not nearly as fundamental as it is sometimes supposed to be".[24] He stated that it was more important, and a deeper rooted principle, that a person who makes a deliberate promise which is intended to be binding must keep his promise, and that the court will hold him to it. A third party would be entitled to enforce that promise, provided he was a beneficiary of that promise and had a sufficient interest in it. In *Drive Yourself Hire Co (London) Ltd v Strutt*[25] he repeated these views, and questioned the historical basis of privity. He stated that the rule was based on shaky foundations, and that taking into account the numerous exceptions to it, it had in effect been abolished. In *Woodar Investment Development Ltd v Wimpey Construction UK Ltd*[26] Lord Scarman urged that the rule be reformed, stating that the time for reform of this "unjust rule" was "now, and not 40 years on".[27]

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18 If A makes a promise to both B and C, but only B (and not C) provides consideration for this promise, B and C are "joint promisees". The contract may be enforceable by A, B or C, provided they are all parties to the contract. See *McEvoy v Belfast Banking* [1935] AC 24.

19 (1724) 1 Str 591.

20 (1776) 2 Cowp 437.

21 (1802) 3 Bos & Pul 147.

22 (1823) 2 Dow & Ry KB 277.

23 [1949] 2 KB 500.

24 *Ibid* at 514.

25 [1954] 1 QB 250.

26 [1980] 1 All ER 571.

27 *Ibid* at 590.

1.19 Despite this unease with privity, it was confirmed as part of the law of England and Wales in a number of cases. In *Midland Silicones Ltd v Scruttons Ltd*[28] a third party was not entitled to rely on an exclusion clause, purportedly for his benefit, in a contract. In *Beswick v Beswick*,[29] a coal merchant entered into a contract with his nephew in which he transferred the business to him. In return the nephew was to employ him as a consultant for the rest of his life, and, after his death, was to pay an annuity of £5 a week to his widow. Upon the death of the coal merchant, the nephew paid one instalment of the annuity and refused to pay any more. The widow brought an action for breach of contract, both in her capacity as administratrix of her husband's estate and in her own right as a third party beneficiary. The House of Lords held that she was entitled to enforce the contract as administratrix, but not in her own capacity as she was not privy to the contract. This was re-affirmed in *Woodar Investment Development Ltd v Wimpey Construction UK Ltd*[30] - although not without reluctance, as mentioned above. The House of Lords confirmed the existence of the privity rule in 1993 in *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd*,[31] although in that case one of the many exceptions to the rule was applied.

D The current law in Ireland

1.20 Privity of contract is one of the core principles of contract law in Ireland. The Irish courts applied the rule of privity in 1868 in *Murphy v Bower*.[32] There, a contractor agreed to perform certain work for a railway company. The contractor was to be paid when an engineer certified that the work had been completed. The engineer subsequently refused to certify that the contractor had completed the work. The court decided that the contractor could not bring a case against the engineer in contract, as the engineer was not a party to the contract between the contractor and the railway company.

1.21 There are not many modern decisions of the courts where the privity rule has been applied. This may indicate uneasiness with the rule and the courts' reluctance to apply the privity rule. Alternatively, it may indicate that the rule is circumvented in practice. The Commission now turns to discuss two cases which illustrate the problems which may arise as a result of the privity rule.

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28 [1962] AC 446.

29 [1968] AC 58.

30 [1980] 1 All ER 571.

31 [1994] 1 AC 85.

32 (1868) 2 IRCL 506. See also *McCoubray v Thompson* (1868) 2 IRCL 226, discussed at paragraph 1.134, below.

1.22 A possible instance of judicial reluctance to deal directly with the privity issue in Ireland is *Cadbury (Ireland) Ltd v Kerry Co-Operative Creameries Ltd*.[33] The second defendant, Dairy Disposals Co Ltd, owned by the Minister for Agriculture on behalf of the State, owned a number of creameries which supplied milk to the Cadburys chocolate factory. In 1964, Dairy Disposals undertook to supply Cadburys with milk should they decide to expand their operations. In 1973, Dairy Disposals sold its creameries to Kerry Co-Op. Clause 19 of the sale agreement contained an undertaking from Kerry Co-Op to Dairy Disposals that adequate milk supplies would continue to Cadburys. Cadburys was not a party to this agreement, though they had lobbied the Minister for Agriculture to have the clause included in the contract. No collateral agreement was entered into between Kerry Co-Op and Cadburys.

1.23 Later, as a result of a fall in the total output of milk in the area, Kerry Co-Op wrote to Cadburys suggesting either a reduction of the milk supplies or an increase in price. Cadburys rejected this proposal and sued, claiming that under clause 19 of the sale agreement between Kerry Co-Op and Dairy Disposals it was entitled to adequate milk supplies. Kerry Co-Op argued that, as Cadburys was not a party to that agreement, they had no rights under it, particularly in relation to clause 19.

1.24 Cadburys was clearly not a party to the contract containing the clause and under the rule of privity would not have been entitled to enforce it, even though they were benefiting from it. The High Court could have rejected Cadburys' claim using the privity rule. However, the Court only briefly dealt with the privity issue. Instead, the Court rejected Cadburys' claim by deciding that clause 19 was not sufficiently clear and precise to be legally enforceable. The Commission considers that the failure to deal with the privity issue in a seemingly straightforward case is a possible example of judicial uneasiness to deal with privity directly.

1.25 Another example of the application of the rule of privity is *Glow Heating Ltd v Eastern Health Board*.[34] In this case there was a standard form construction contract between the employer and the main contractor, and another contract between the main contractor and a sub-contractor. The main contractor was in liquidation. The sub-contract contained a clause allowing the sub-contractor to apply to the employer for direct payment in the event that the main contractor could not pay up. The main contract contained a mandatory clause requiring the employer to make the direct payment in the event that the main contractor could not or would not do so. Costello J remarked that "the privity of contract rules should not bar a court

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33 [1982] ILRM 77.

34 [1988] IR 110.

from granting a sub-contractor relief in the circumstances like the present one".[35] He noted that, correctly, in his view, the privity point had not been argued. This shows judicial recognition, at least in certain circumstances, that a third party beneficiary of the terms in the main contract should not be barred from enforcing their rights under the contract.

1.26 The Commission has concluded that the decisions in Ireland indicate some uneasiness with the application of the concept of privity of contract. The Commission considers that it ought to be examined further to determine the need for its continued existence, if any, and ultimately the options for its reform.

E Exceptions to the rule of privity

1.27 The problems associated with the rule of privity have not gone unnoticed. The courts and the legislature have been active in creating instances where third parties can enforce their rights. There are also practical methods for circumventing the rule.

1.28 One of the main arguments for reform of privity of contract is that the current system of third party rights has become far too complex as a result of the many exceptions to the privity rule that have developed over time. These exceptions have their roots both in the common law and in the statute book, and are dealt with below.

(1) Common Law exceptions

(a) Assignment

1.29 A party to a contract is generally free to assign their contractual rights to a third party.[36] The assignment is effected through a contract concluded between the promisee in the original contract (the assignor) and a third party (the assignee). The effect of the assignment of rights is that a third party to the original contract is given rights as though they had been a party to the contract. There is no need for the consent of the promisor in order for there to be a valid assignment, although notice to the promisor is often desirable to prevent the promisor paying the assignor, and to give the assignee priority over other assignees.

1.30 Chains of assignment are often used in the construction industry as an alternative to, or to supplement, a warranty package. Arrangements are often made whereby all the available rights in relation to construction are assigned to a subsequent purchaser.

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35 [1988] IR 110, 117.

36 See McDermott *Contract Law* (Butterworths 2001) at 965-974, Treitel *The Law of Contract* (11th ed Thomson Sweet & Maxwell 2003) Chapter 16.

1.31 However, the rules on assignment are quite complex. For example, in many cases the assignor must be involved in any litigation to enforce the rights, and this can be time consuming and costly. It is not always possible to assign contractual rights. For example, it is not possible to assign rights under a contract that involves a personal confidence.[37] Nor is it possible to assign a contractual obligation, as opposed to a benefit, to a third party without the consent of all parties involved.[38]

1.32 Legislation exists which accommodates the assignment of contractual rights in certain situations.[39]

(b) Trusts

1.33 The law of equity, developed by the courts over many centuries, allows a third party to enforce a contract where it can be shown that a completely constituted trust was created in their favour by the contract.[40] A trust can be defined as an equitable obligation to hold property, be it real property, money, or a chose in action, on behalf of another person. The effect of the trust is that a third party beneficiary may sue for the money or property that the contract party had promised to pay or transfer to him.

1.34 Since *Tomlinson v Gill*,[41] equity has recognised situations in which a trust can be inferred from a contract. In that case, the defendant promised a widow that if he were permitted to administer her deceased husband's estate, he would make up any deficiency in the estate to the creditors. This was sufficient to allow a creditor to sue to enforce this promise, as the court inferred that a trust had been created in favour of the creditors. Likewise in *Drimmie v Davies*[42] a father and son agreed that the son would take over a dental practice on the father's death. The arrangement was subject to annuities payable to the other members of the family. The agreement was held to be enforceable by the father's wife even though she was not a party to the contract. The decision was on the basis that the promise constituted a trust in their favour.

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37 For example, the owner of a house who hires a cleaner cannot assign their contractual rights to another party so that the cleaner must clean for a different owner.

38 This is referred to as "novation". See *O & E Telephones Ltd v Alcatel Business Systems* High Court 17 May 1995.

39 This legislation is discussed in paragraph 1.63, below.

40 See Clark *Contract Law in Ireland* (5th ed Thomson Round Hall 2004) at 475-478, McDermott *Contract Law* (Butterworths 2001) at 925-932, Treitel *The Law of Contract* (11th ed Thomson Sweet & Maxwell 2003) at 646-651.

41 (1756) Amb 330.

42 (1899) 1 IR 176.

1.35 The contractual trust remains part of the common law, but the courts are reluctant to infer a trust where it has not been expressly provided for in the agreement. For example, in *Cadbury (Ireland) Ltd v Kerry Co-op Creameries Ltd*[43] Barrington J held that in order for there to be a contractual trust, the parties must have had the intention to create a trust. He concluded that in this case Dairy Disposal and Kerry Co-op had no intention to create a trust in favour of Cadburys.[44] Thus, Cadbury's could not make use of this exception to the privity rule.

1.36 There are several reasons for the courts' reluctance to use the contractual trust.[45] Using the contractual trust as a means of granting third parties rights was described by Lord Wright as a "cumbrous fiction".[46] If the parties have not intentionally created a trust, it is not the place of the courts to infer that they have. If the courts imply trusts in this manner, it could cause much uncertainty. It could lead to the unfair situation whereby third party beneficiaries obtain equitable rights that the parties may not have intended they should have. The parties may become burdened with the responsibilities arising from a trust. For example, the contractual parties would not be able to vary or cancel the terms of the contract without the consent of the beneficiary.[47]

1.37 The Commission considers that the caselaw relating to the contractual trust demonstrates the problems that can be created by the rule of privity. Judges have attempted to achieve a balance between the interests of the parties to a contract and those of the third party. In doing so, the courts have recognised that there are situations where the third party beneficiary should have enforceable rights. But granting an equitable trust through the courts is an uncertain, not to mention cumbersome, method of doing this that may not result in fairness for all the parties.

(c) Agency

1.38 Agency describes the relationship that exists when one person (the agent) is appointed by another person (the principal) to act as their representative. The agent is authorised to make a contract between the principal and a third party.

1.39 When the agent acts on behalf of the principal, any transactions within the scope of the agent's authority will be legally binding on the

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43 [1982] ILRM 77. See paragraph 1.21ff above.

44 [1982] ILRM 77, 80–81.

45 See Clark *Contract Law in Ireland* (5th ed Thomson Roundhall 2004) at 477–478.

46 *Williston on Contracts* (1939) 55 LQR 189, at 208.

47 *Re Schebsman* [1944] Ch 83.

principal. Thus, the principal acquires rights and liabilities under contracts made between the agent and a third party: the principal can sue, and be sued by, the third party.

1.40 In some cases the principal may not be known to the third party, who may assume that the agent is contracting on its own behalf. Such a principal is known as an undisclosed principal. The principal will still acquire rights and liabilities under the contract between the agent and a third party. The privity rule is particularly evident in contracts entered into in this manner. The principal obtains rights of enforcement under the contract that was made for his/her benefit. The third party may enforce the contract against the undisclosed principal in the same manner as if they had negotiated the contract with them. However, in most cases involving agency, the link between the agent and the principal will be apparent or established through a long line of custom and usage.

1.41 The law of agency is a commercially convenient way of conducting business, particularly where the principal is unable to attend the negotiation and conclusion of contracts entered into in the course of their business. Given that the privity of contract rule provides that only those party to the contract have enforceable rights under the contract, the law of agency was a necessary development in the context of modern commercial transactions.

1.42 The agency exception has been used by third parties seeking to rely upon exclusion clauses in a contract. This application of the exception is discussed below.[48]

(d) Collateral contracts

1.43 The privity of contract rule has been circumvented in certain instances by the use of collateral contracts. As with all contracts there must be consideration between the parties to the contract and the parties must intend to be contractually bound. Collateral contracts were relied upon to avoid the privity rule in *Shanklin Pier Ltd v Detel Products Ltd*.[49] There, contractors were employed by Shanklin Pier to paint a pier. Detel Products, who were suppliers of paint, assured Shanklin Pier of the quality and duration of their paint. On foot of this assurance, Shanklin Pier instructed the contractors to buy and use this paint. In fact, the paint only lasted 3 months and Shanklin Pier brought an action for breach of contract against Detel Products. The problem was that the paint was bought under a contract of sale between Detel Products and the contractors. The plaintiffs were not a party to this contract. However, the court decided that there was a collateral

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48 See paragraph 1.91ff, below.

49 [1959] 2 KB 854.

contract between the Shanklin Pier and Detel Products, under which Detel Products had promised that the paint would last 7 years. Shanklin Pier had provided consideration for this promise by instructing the contractors to buy the paint.

1.44 This decision was followed in Ireland in *McCullough Sales Ltd v Chetham Timber Co Ltd*.[50] As will be discussed later on, collateral contracts and warranties are used extensively in the construction industry as a way of avoiding the effects of the rule of privity.[51]

(e) Covenants running with land

1.45 Conveyancing law in Ireland, as it currently stands, provides that covenants that "touch and concern" real property may be enforced against persons that were not a party to the original transaction.[52] This rule, known as the rule in *Tulk v Moxhay*,[53] states that a negative covenant will run with the land to which it relates.[54] It can thus be enforced against subsequent owners of the land, except a *bona fide* third party purchaser without notice of the covenant. In this way, a third party gains rights and responsibilities under the original covenant.

1.46 The Commission has recommended the abolition of the rule in *Tulk v Moxhay* by way of legislative intervention.[55] The *Land and Conveyancing Law Reform Bill 2006*,[56] which is currently before the Oireachtas, would implement this recommendation. Section 47 would abolish the rule in *Tulk v Moxhay* and instead make freehold covenants fully enforceable by and against successors in title. The central principle, that a third party will be affected by covenants that run with the land, would be given a statutory basis.

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50 High Court 1 February 1983.

51 See paragraph 1.72, below.

52 See Wylie *Irish Land Law* (3rd ed Butterworths 1997) Chapter 19; Lyall *Land Law in Ireland* (2nd ed Round Hall Sweet & Maxwell 2000) Chapter 21.

53 (1848) 2 Ph 774.

54 A positive covenant, for example, a covenant to carry out repairs is not enforceable against successors in title under the rule in *Tulk v Moxhay*.

55 See *Report on the Reform and Modernisation of Land Law and Conveyancing Law* (LRC 74-2005) pp154 – 157 and *Report on Land Law and Conveyancing Law: (7) Positive Covenants over Freehold Land and other Proposals* (LRC 70-2003) paragraph 1.20.

56 Bill No. 31 of 2006. Available at www.oireachtas.ie

(f) Tort of negligence

1.47 Since the decision in *Donoghue v Stevenson*,[57] if a person suffers a loss as a result of another person's negligence, that person is entitled to sue for damages, regardless of whether or not there was a contract between the two parties. It can thus be seen as a rather large exception to the privity rule. However, in order to recover under the law of torts, negligence must be established. It is not enough to show merely that a promise was broken, which would be the case in an action under contract law.

1.48 In addition to the common law development of the law of tort, the *Liability for Defective Products Act 1991* gives statutory rights to buyers of products, and gives third parties rights of action in tort.

(2) Statutory exceptions to the privity of contract rule

1.49 There are a number of statutory provisions in Ireland designed to circumvent the privity of contract rule in specific situations where it was obviously causing injustice. The main statutory provisions are outlined below.

(a) Married Women's Status Act 1957

1.50 Section 7 of the *Married Women's Status Act 1957* gives the surviving spouse and children of a deceased person the right to sue upon a policy of life insurance or an endowment policy which had been entered into by that person. Under the common law rule of privity, the spouse and children would not have been able to sue on the policy, even if the policy was designed to benefit them.

1.51 Section 8 of the *Married Women's Status Act 1957* provides that any contract entered into by a married person that confers a benefit on their spouse and/or their children shall be enforceable by the spouse and/or the children. Section 8 permits the contract to be rescinded by the contracting parties at any time before the beneficiary adopts it and the third party is bound by any defences the defendant may have against the other contracting party.

1.52 The exception in Section 8 of the *Married Women's Status Act 1957* is quite wide, in that it applies to every day contracts and not just life insurance or endowment policies. However, it only confers third party rights on the spouse and children of the contracting party, and not, for example, on other cohabitants or relatives, and it only does so where the contract expressly confers a benefit on the spouse or children. For example, the exception did not apply in *Burke (a minor) v Dublin Corporation*.[58] There, a

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57 [1932] AC 62.

58 [1991] 1 IR 341.

minor's asthma condition was aggravated due to his unfit living conditions, and he attempted to sue for breach of the tenancy agreement entered into between his parents and Dublin Corporation. The minor claimed that because the rent was calculated by reference to the number of children living in the premises, the contract was expressed to be for the benefit of those children. The Supreme Court rejected this argument, and decided that the minor could not rely on section 8 of the *Married Women's Status Act 1957* as the contract did not expressly confer a benefit on the minor. The case was thus decided on the basis of housing legislation and negligence principles, rather than on contract.

(b) Insurance

1.53 Section 76(1) of the *Road Traffic Act 1961* provides that a person who is claiming against an insured motorist will have certain remedies against the motorist's insurer.

1.54 Section 62 of the Civil Liability Act 1961 provides that if a person has effected a policy of insurance in respect of liability for a wrong, and that insured person becomes bankrupt, dies, or in the case of a company, is wound up, the moneys payable to an insured person or company under the policy are only applicable in discharging valid claims against the insured. No part of the moneys is considered an asset of the insured or applicable to the payment of debts of the insured in the bankruptcy, administration of the estate, or the winding-up or dissolution. The Act thus recognises the rights of third parties who have valid claims against the insured in those specific situations. The section is simply indicative of a policy decision not to allow insurance pay-outs to be used by the liquidator in an insolvency situation.

1.55 Section 62 does not expressly confer a positive right of action on those entitled to the award of damages against the insured. However, in *Dunne v PJ White*[59] it was held that there was an entitlement on the part of an injured party to sue the insurers of a bankrupt party to ensure compliance with Section 62 of the Civil Liability Act 1962. This decision therefore arguably goes some way toward providing a third party with rights against the insurer.

(c) Consumer Protection

1.56 Section 13(2) of the *Sale of Goods and Supply of Services Act 1980* contains an implied condition in the sale of a motor vehicle that at the time of delivery the vehicle is free from any defect that would render it a danger to the public and to people travelling in the vehicle. Section 13(7) of the 1980 Act goes further by providing that if a person using the vehicle with the consent of the buyer suffers a loss because of a breach of section 13(2),

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[59] [1989] ILRM 803

they may maintain an action for damages against the seller as if they were the buyer. Section 82 of the *Consumer Credit Act 1995* extends the condition contained in section 13(2) of the 1980 Act to hire purchase agreements.

1.57 Section 2 of the *Package Holiday and Travel Trade Act 1995* defines a consumer as including any person on whose behalf the principal contractor agrees to purchase the package, or any person to whom the principal contractor (the buyer) or another beneficiary transfers the package.

(d) Consumer protection in Credit and Finance Arrangements

1.58 Section 80 of the *Consumer Credit Act 1995* provides that where a consumer[60] enters into a hire purchase agreement, the consumer has a remedy against both the seller and the hire purchase company in the event of a breach of the hire purchase agreement or a misrepresentation made by either the seller or the hire purchase company. At common law, the consumer could not have sued the seller of goods for any breach or misrepresentation, as the consumer's contract was with the hire purchase company and not the seller of the goods.[61]

1.59 Section 14 of the *Sale of Goods and Supply of Services Act 1980*, mentioned above,[62] similarly provides that where goods are sold to a consumer under an arrangement with a finance house, the finance house shall be deemed to be a party to the sale of goods to a consumer. The finance house and the seller are jointly answerable to the buyer for breach of the contract of sale and for any misrepresentations made by the seller with respect to the goods.

(e) Negotiable instruments

1.60 Cheques, bills of exchange and promissory notes are examples of negotiable instruments. Cheques and bills of exchange order the payment of money, whereas promissory notes contain a promise to pay money. Ownership of the rights and obligations contained in the instrument can be transferred to and enforced by a third party, referred to as the "holder in due course". This makes negotiable instruments an important exception to the privity of contract rule. Section 38(2) of the *Bills of Exchange Act 1882* provides that the holder in due course may take an action against not only

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60 Section 2 of the *Consumer Credit Act 1995* defines a consumer as "a natural person acting outside his trade, business or profession". However, section 33 of the *Central Bank and Financial Authority of Ireland Act 2004* provides that the Minister for Finance can declare any specified person or specified class of persons to be a consumer for the purposes of the 1995 Act.

61 *Dunphy v Blackhall Motors* (1953) 87 ILTR 128.

62 See paragraph 1.07ff above.

the original debtor on the instrument if he fails to pay, but also against any other previous signatories of the instrument who have had the debt negotiated to them.

(f) Shipping Contracts

1.61 Section 1 of the *Bills of Lading Act 1855* provides that every consigner of goods named in a bill of lading, and every endorsee of it to whom the ownership of the goods described in it shall pass, will have transferred to them all rights of action, and be subject to the same liabilities, in respect of such goods as if the contract contained in the bill of lading had been made with them.

(g) Company law

1.62 Section 25 of the *Companies Act 1963* provides that the memorandum and articles of association form a contract between the company and its shareholders and also between the individual shareholders. As a result, one shareholder can sue another shareholder on the basis of, for example, the articles of association.

(h) Assignment

1.63 It could be argued that the legislative provisions which provide that an assignee of a contractual right can bring an action in their own name are indirect circumventions of the privity rule. These legislative provisions include the following:

i) Section 28(6) of the *Supreme Court of Judicature (Ireland) Act 1877* provides that any debt or legal chose in action can be assigned, provided certain conditions are fulfilled. The section did not abolish the equitable rules on assignment, which can still be used if the conditions for a statutory assignment are not met.

ii) The *Policies of Assurance Act 1867* allows for the voluntary assignment of life policies. It allows the assignees to sue in their own name without the need to join the assignor as a party in the action.

iii) Sections 79 to 86 of the *Companies Act 1963* set out the procedure to be followed for formally transferring shares.

iv) Section 50 of the *Marine Insurance Act 1906* provides that a marine insurance policy is assignable unless it contains a term expressly prohibiting assignment. Generally, marine policies covering cargo are freely assignable. Section 50(2) empowers the assignee to sue in their own name. It preserves any defences that the insurer might have against the original assured. Section 14 of the 1906 Act permits any person having an interest in the subject

matter insured to insure on behalf of and for the benefit of other persons interested as well as for their own benefit.

(i) Employment Contracts

1.64 Several European Directives[63] which have been implemented in Irish law provide that where an employer transfers his undertaking, the firm taking over the business enters into all the employment contracts subsisting at the time of the takeover.

(3) Discussion

1.65 The Commission considers that the current law on third party rights is unnecessarily complex. The common law exceptions may also cause uncertainty, as it is not always clear when the courts will apply the privity rule and when they will apply an exception to the rule. Attempting to avoid the rule, for example by drafting the contract so that it comes under an exception to the rule, creates extra expense and paperwork that could be avoided.

1.66 The Commission considers that the numerous exceptions to the privity rule are indicative of an underlying unease with the rule itself. There are sound policy reasons for reforming the rule of privity in order to give a third party enforceable rights.

1.67 The Commission has therefore concluded that justice and commercial necessity dictate that the privity rule would benefit from reform.

F The problems encountered in practice as a result of the rule of privity

1.68 In the course of the Commission's preliminary discussions with legal practitioners, representative organisations and other experts, a number of areas were identified that are particularly affected by privity of contract. It became clear to the Commission that reform of the privity rule would have a real effect on how transactions are concluded in the ordinary course of business. It also became evident that there were definite benefits to be obtained from allowing third parties to enforce rights under contracts, once appropriate safeguards were in place. The main areas identified are dealt with below.

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63 See, for example, Directive 2001/23/EC *Transfer of Undertakings and the Safeguarding of Employees' Rights*, implemented by the *European Communities (Protection of Employees on Transfer of Undertakings) Regulations 2003* (SI No 131 of 2003).

(1) Construction contracts

(a) Introduction

1.69 The construction industry in Ireland is, by any standards, enormous. In 2005 construction output was over 22% of the Gross National Product, amounting to an estimated €30 billion. The housing output in 2005 reached a new record level of over 80,000 units, almost four times higher than the average in Western Europe. There has also been significant growth in the civil engineering sector, where the overall output for 2005 in productive infrastructure (such as roads, energy, water services, airports and transport) and social infrastructure (including education, health and public buildings) amounted to an estimated €7.3 billion.[64]

1.70 Over the past 20 years there has been a change in how the construction industry is structured. Instead of large companies with direct employees, there has been a shift towards contract managers, with the bulk of the work being carried out by sub-contractors. A large proportion of the work carried out in the construction sector is now done by smaller firms, with 5 or fewer employees, and sole traders. However, large firms are still important: a 2002 census of private sector construction firms with 20 or more employees showed that these firms had a total turnover of almost €9 billion.

1.71 In the construction sector the privity rule comes into play in quite different ways, depending on whether the project is large or small.

(i) Larger construction projects

1.72 It is rare in the larger construction projects for one construction company to undertake all the work from design to completion. Many smaller firms will become involved as contractors, sub-contractors, individual specialists and advisors. As a result of the privity rule, these different contributors are not contractually bound to each other, or to subsequent owners and tenants. This is despite the fact that all actors are contributing towards the same project and the end result will be a culmination of all of their expertise. Completion would be impossible if the actors were not connected to each other in some way. As a result, complex legal techniques have developed to deal with the privity rule. These include:

- collateral contracts and direct agreements;
- guarantees and warranties;
- chains of assignment and trusts;

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64 Statistics from *Review of the Construction Industry 2004 and Outlook 2005-2007* (Department of Environment, Heritage and Local Government, and DKM Economic Consultants, September 2005). Available at www.environ.ie

- nomination of sub-contractors;
- direct payment provisions;
- name-borrowing provisions, under which the main contractor allows the sub-contractor to use its name in proceedings against its employer/commissioning client;
- retention trusts.

1.73 These techniques have been formalised in the standard form contracts developed for the construction sector. Many of these contracts are drafted in the context of major public procurement and public infrastructure projects commissioned by a client such as a Government Department, though others are drafted between private undertakings in the context of property development. Traditionally, these contracts were based on a project commissioned and designed by the client – commonly referred to as the "employer" – and the work was then carried out by a main contractor, and numerous sub-contractors, on the basis of this design. More recently, the standard contracts involve "design and build", in which the commissioning client will request the main contractor to develop the design and also execute the work – again, using many sub-contractors in the process.

1.74 The standard form contracts currently in use can be traced to those used at the end of the 19th Century by representative bodies such as the Royal Institute of British Architects (RIBA).[65] In the context of building contracts, the RIBA Form of Contract was later developed by the Joint Contracts Tribunal (JCT) into the JCT Form of Contract. In most instances, the traditional RIBA and JCT Forms of Contract involved building contracts under the overall supervision of an architect. The RIBA Form was followed in Ireland by the Royal Institute of Architects in Ireland (RIAI) in its Articles of Agreement and Schedule of Building Conditions. In the wider context of civil engineering contracts, the ICE Form of Contract was developed after World War II by the Institute of Civil Engineers and the Federation of Civil Engineering Contractors. In Ireland, this was adapted as the IEI Form, developed by the Institute of Engineers in Ireland.[66] The original ICE/IEI Forms of Contract involved civil engineering contracts under the overall supervision of an engineer. In that respect, they mirrored the RIBA and JCT Forms of Contract. In the 1990s, the British Institution of Civil Engineers developed a new civil engineering contract, the New Engineering Contract, the NEC Contract, later renamed the Engineering Construction Contract, the ECC Contract.[67]

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65 See generally, Bunni *The FIDIC Forms of Contract* (Blackwell 2005).

66 The IEI is now known as Engineers Ireland.

67 For more recent developments, see paragraphs 1.86ff, below

1.75 Ultimately, these national contracts have formed the basis for transnational standard contracts. Thus, for building contracts between UK based building companies and companies based outside the UK, the ICE Form was adapted to become the ACE Form, agreed by the Institute of Civil Engineers, the Association of Consulting Engineers and the Export Group for the Construction Industries. For major infrastructure contracts, the FIDIC Form (the "Red Book") was developed by FIDIC, the International Federation of Consulting Engineers.

1.76 It is important to note that, in Ireland, a large proportion of construction contracts, including civil engineering and infrastructure projects, are funded by central and local government. It is not surprising, therefore, that the Government has developed variations of the standard contracts already mentioned. Much of this has, in recent years, been done under the aegis of the Government Contracts Committee (GCC) in the Department of Finance.[68] Until very recently, building contracts funded by government have been subject to Conditions of Contract for Government Departments and Local Government (GDLA). Civil engineering contracts, including infrastructure contracts, have been based largely on the IEI and ECC Forms, subject to amendments approved by the Department of Finance. In recent years, some major public infrastructure projects have been subjected to criticism for not being completed on time and within original budgets. As a result, a move towards fixed price contracts - usually based on "design and build" - has occurred in recent years. In this context, the Government Contracts Committee (GCC) has been involved in the development of new standard form contracts, which appear to represent a significant shift from the previous GDLA and IEI contracts already mentioned, in particular by transferring the cost risk from the client to the contractors.[69] These new contracts will also constitute the "framework agreements" for the purposes of the *European Communities (Award of Public Authorities Contracts) Regulations 2006*,[70] which implemented the most recent 2004 EC Public Contracts Directive.[71]

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68 See generally www.finance.gov.ie.

69 The precise form of these contracts has been the subject of intense discussion between the GCC and relevant stakeholders. In April 2006, the most recent drafts of the proposed new forms were circulated to interested parties. It is understood that the new contracts deal with: Building Works with Employer Design; Building Works with Contractor Design; Engineering Works with Employer Design; and Engineering Works with Contractor Design. Other associated contracts deal with design consultancies and sub-contract works. The Commission understands that the new standard form contracts may be finalised in late 2006 or early 2007.

70 SI No 329 of 2006.

71 Directive 2004/18/EC, which replaced a number of previous Directives in this area.

1.77 It is thus clear that standard form contracts are constantly being developed and revised to accommodate changes in the law and in the way business is regulated.

1.78 The detailed terms associated with these standard form contracts extend to issues well beyond the scope of this Consultation Paper. Nonetheless, many terms can be traced directly to the privity rule, notably, the development of complex collateral contracts, guarantees and warranties, chains of assignment, the nomination of sub-contractors and name borrowing provisions. If the privity rule was reformed, it is possible that these standard form contracts could be less complex and the rights of all parties concerned clearly outlined.

(ii) Smaller scale projects

1.79 The privity rule also applies, though quite differently, in smaller construction projects, for example the construction of a single dwelling or the extension of a house. Although less complex, potentially unjust situations can arise, such as the example given of the extension built for an elderly relative.[72]

1.80 Problems can also arise when there is no such obvious third party, for example, where a contractor is employed by a landowner to carry out certain building works and the contractor in turns hires a sub-contractor to carry out a specific part of the work. Although the sub-contractor is liable to the main contractor for any defect or breach, the rule of privity means the sub-contractor is not directly liable to the landowner. In the course of discussions in the preparation of this Consultation Paper, it became clear to the Commission that, although this situation is favourable to the sub-contractor, it may be in the interests of justice that the landowner should have direct access to the sub-contractor in these circumstances. This is particularly the case where the main contractor is unable or unwilling to pursue that sub-contractor.

1.81 Any agreements between builders and consumers would be subject to the *European Communities (Unfair Terms in Consumer Contracts) Regulations 1995*.[73] The 1995 Regulations take into account the fact that a contract is not always a stand-alone instrument, but instead will often be entered into in the context of other contracts or agreements. Regulation 3(2) provides that for the purpose of the Regulations a contractual term is unfair if

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[72] See paragraph 1.06, above.

[73] SI No.27 of 1995, which implemented the 1993 EC *Directive on Unfair Contracts Terms*, 93/13/EEC.

> "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer, taking into account the nature of the goods or services for which the contract was concluded and all circumstances attending the conclusion of the contract and all other terms of the contract *or of another contract on which it is dependent*."[74]

The italicised words are of particular relevance to the privity rule and third party rights.

1.82 Standard form contracts have been developed in the context of the consumer building contract, between a builder and a purchaser. Notably, a standard Building Agreement was negotiated by representatives of the Law Society of Ireland and the Construction Industry Federation (CIF), which both bodies recommended to their respective members as the basis for individual contracts between builders and purchasers. When both bodies became aware in the late 1990s that a number of building agreements were departing from the standard Building Agreement – to the disadvantage of purchasers – they approached the Director of Consumer Affairs with a view to initiating declaratory proceedings seeking to have a sample of 15 specific examples of these departures declared in breach of the 1995 Regulations. In *In re Application by the Director of Consumer Affairs*,[75] Kearns J in the High Court declared the 15 sample terms in breach of the 1995 Regulations.[76]

1.83 Some of the terms which were declared invalid by Kearns J involved privity and third party rights. For example, Term 1 was an "entire agreement" clause, which attempted to limit the possibility of any preliminary representation made by the builder or his agents to the consumer from being taken into account. This term was held to be invalid under the Regulations. Hence, it is not now possible for the builder to avoid liability for statements made by his agents by use of an "entire agreement" clause. Term 10 provided that the consumer could not assign the benefit of the agreement without the previous consent of the contractor, but that the contractor could do so. This was said to be unfair in that it created an imbalance in the agreement. It would however most likely be enforceable if

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74 Emphasis added.

75 High Court 5 December 2001.

76 See Dorgan "Safe as Houses?" (2002) *Law Society of Ireland Gazette* January 2002, 12. The details of the case are also available on the website of the Director of Consumer Affairs, www.odca.ie. The proposed National Consumer Agency, to be established under the *Consumer Protection (National Consumer Agency) Bill* (a draft of which was published by the Department of Enterprise, Trade and Employment in 2006: see www.entemp.ie), will incorporate the functions of the Director of Consumer Affairs.

it provided that neither party could assign benefits in the contract without the prior written consent of the other party.

(b) The experience in England and Wales

1.84 In its 1996 Report on privity of contract, the Law Commission for England and Wales identified the construction industry as benefiting from reform of the rule of privity.[77] They described as an "unfortunate result" that parties in the main contract could not simply extend the benefits of, for example, the architects' and engineers' duties of care and skill in the main contract to subsequent purchasers or tenants. The Law Commission viewed as unfortunate the amount of legal documentation needed, and the potential lack of accountability if this legal documentation was not in place. The enactment of the *Contracts (Rights of Third Parties) Act 1999*, on foot of the Law Commission Report, potentially meant that contracting parties would have no need for collateral warranties. Third party rights could be laid out in the main contract.

1.85 Naturally with a change as fundamental as the one proposed in the 1999 Act, there was a certain amount of scepticism and a general reluctance to alter commercial practices in the few years after the Act came into force. In many contracts, particularly the larger construction contracts, the Act was excluded from operating in particular transactions.

1.86 However, it would appear that the tide is now turning, with some of the standard form contracts used in multi-party transactions being altered to include the 1999 Act. In general these contracts have provided for the optional incorporation of the 1999 Act in construction contracts. In 2003, the Joint Contracts Tribunal (JCT) produced a Major Project Form (MPF), based on the NEC/ECC form of contract, with a view to dealing with the specific demands of commissioning clients/employers who have in-house contractual procedures and regularly undertake major projects.[78] One of the most notable aspects of this new standard form contract is that it uses the 1999 Act as a means of avoiding an abundance of separate warranties and other collateral agreements between the contractor and any funder or purchaser.

1.87 Likewise, in 2005 the British Property Federation issued its own standard form Consultancy Agreement, which is also based on the JCT Major Project Form 2003. The agreement encompasses all the main disciplines – architects, structural engineers, building services engineers, quantity surveyors and planning supervisors – in the same document. The form enables specified categories of third parties to enforce the terms set out in a third party rights schedule for their benefit, in accordance with the 1999

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77 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996).

78 On the JCT and NEC/ECC Contracts, see paragraph 1.74, above.

Act. It has been welcomed by some who see the standard form agreement as achieving the same result as collateral warranties but without the need for a multitude of separate agreements.[79]

(c) Discussion

1.88 The Commission considers that there are good reasons for reform of the privity rule to the extent that it has had an effect in the construction sector. For all those involved, the rule of privity is likely to slow down and complicate transactions. From this perspective, it would be hugely beneficial to have a single contractual arrangement in place, rather than a network of different agreements (sometimes numbering in the hundreds for the larger transactions) specific to each contractor and sub-contractor. The main contract would set out all the rights and responsibilities of the actors in the transaction, and state when and by whom the rights would be enforceable. This type of "convention-style" document allows a contractor or sub-contractor who signs up to a transaction to take on the central terms and conditions, but the Commission acknowledges that, in the current state of the law, it is the exception rather than the norm. Legislative reform of the privity doctrine could make the completion of these types of transactions a lot easier. It could reduce the significant costs arising from the volume of documents currently in use.

1.89 Reform of the rule of privity could mean that sub-contractors and the commissioning client / employer could sue each other directly without having to involve the main contractor. This has its obvious advantages both in the context of the smaller and larger scale projects. The commissioning client would especially benefit in cases where the sub-contractor has only partly completed the work, and the builder has become insolvent, or cannot be found. Ordinarily the rule of privity means that the commissioning client will have no direct contractual rights against the sub-contractor. Likewise, the sub-contractor would be able to sue on the main contract for direct payment from the commissioning client in situations where the main contractor is unwilling or unable to do so.

1.90 The Commission is mindful that, given current practice, it is unlikely that a commissioning client will leave themselves so open to direct liability from the main contract. Nevertheless, it is the view of the Commission that if the privity rule was reformed, a central regime could be put in place in which the rights and obligations of the parties and third parties are clearly set out. This would result in clarity, less complexity, and ultimately less expense.

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[79] See Erwin "An Ambitious Attempt" *Estates Gazette* October 2005, 131.

(2) Exemption clauses

(a) Introduction and current law

1.91 An exemption clause seeks to exclude or limit the liability of the parties to a contract. This can include liability for breach of contract as well as liability in tort or under statute. The rule of privity becomes relevant when a party to the contract seeks to extend the benefit of an exemption clause to a third party, typically employees, sub-contractors, or their agents. However, under the normal rules of privity, these third parties are not entitled to rely on these exemption clauses, as they were not party to the contract in which they are contained.[80] The Commission notes that these cases arise primarily as tort actions. Such cases illustrate the overlap between privity of contract and the law of tort.[81]

1.92 In the course of negotiating contracts parties are concerned with the allocation of risks. For example, a developer may assume the risk of a premises being damaged by fire, or the main contractor may assume responsibility for defects in the work caused by negligence. By assuming these risks the contractors will ensure that they have an appropriate insurance policy that will indemnify them should the event occur. The cost of taking out this insurance policy will be reflected in the cost of the contract.

1.93 In most cases it will be intended that a large proportion of the work being carried out under the main contract will be done by sub-contractors or employees. Because of the rule of privity, the sub-contractor or employee will have no direct contractual relationship with the promisor in the main contract, be it a developer in the context of a building project, or a shipowner in the case of a contract for the carriage of goods. As such, any exemption from liability that the main contractor had included in the main contract will not apply to them. Nor will the assumption of the risks of the employer contained in the main contract apply to the sub-contractors.

1.94 The situation becomes more pressing because of the right of subrogation which allows the insurer to exercise the rights of the insured once they have been fully indemnified. An insurer can step into the shoes of the insured after paying out under the insurance policy and sue the negligent wrongdoer in tort.[82] This means that sub-contractors or employees who were not party to the main contract, and thus do not benefit from the exemption

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80 See generally Merkin "Third Party Immunity Granted Under Contract" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000).

81 See paragraph 1.47ff, above, and paragraph 1.118ff, below.

82 See O'Regan Cazabon *Insurance Law in Ireland* (Round Hall Sweet & Maxwell) 1999) at 20-24.

clause, are open to being sued by the insurance company, even though the main contractor had assumed the responsibility and been compensated.

1.95 As a result of the rule of privity, each sub-contractor will be forced to insure themselves against liability for breach of contract, in tort or under statute. This too will be reflected in the cost of their services. In many cases, sub-contractors and employees will not be in the financial position to insure against risks such as this, particularly when the value of the transactions is in the millions.

1.96 Further anomalies that result from the application of privity in this context are illustrated by two English cases. In the first of these, *Adler v Dickson*,[83] a cruise ship passenger was injured when a gangway fell. The passenger ticket contained a clause exempting the cruise ship company from liability in negligence. Because of this the claimant chose not to sue the ship company but the master of the ship and the boatswain directly. The master of the ship and the boatswain chose to rely on the exemption clause in the main contract.

1.97 The English Court of Appeal decided that the exemption clause was not available to an employee of the shipping company as they were not within its scope either expressly or impliedly. The reasons given by the judges in the Court varied, however. Jenkins LJ decided the case on the ground that the employees were not privy to the contract, and said that even if the words contained in the exclusion clause had been more explicit they would still not have been allowed to rely on the clause. Morris LJ concluded that, if it could have been demonstrated that the shipowners had been acting as agents for its employees, they would have been entitled to rely on the clause. Denning LJ decided that if the correct stipulation was made in favour of the employees that they would be able to rely on the exclusion clause, but that on the facts of the case, the clause was not sufficient to afford the immunity from suit.

1.98 In *Midlands Silicones Ltd v Scruttons Ltd*[84] the same conclusion was reached. There, in a contract between the owner of goods and the carriers of goods, the carriers limited their liability for damage to the goods transported by them. The goods were damaged by stevedores[85] engaged by them, and the owner of the goods sued the stevedores. The stevedores were not entitled to rely on an exemption clause contained in the contract between the owner of the cargo and the carrier. The English House of Lords decided that there was nothing in the contract that stated or even implied that the limitation of liability was to extend to the stevedores.

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83 [1955] 1 QB 158.

84 [1962] AC 446.

85 A stevedore loads goods on and off a ship.

1.99 As the cruise ship in *Adler v Dickson* was called "The Himalaya" any exemption clause which was used to exclude or limit the liability of third parties later became known as a "Himalaya Clause". Drafters of shipping contracts began to include specially formulated "Himalaya Clauses" that would expressly benefit stevedores and others in bills of lading. These clauses were upheld in subsequent cases, such as *New Zealand Shipping Co. Ltd v A M Satterthwaite & Co Ltd: The Eurymedon*[86] in which it was decided that if the exemption clause is appropriately worded and both parties to the contract intended that it was to benefit the stevedores, the third party was entitled to rely upon it.

1.100 In that case Lord Wilberforce recognised that this decision was based on general policy reasons and reflected commercial realities:

> "[T]o give the [stevedores] the benefit of the exemptions and limitations contained in the bill of lading is to give effect to the clear intentions of a commercial document, and can be given within existing principles. … It should not be overlooked that the effect of denying validity to the clause would be to encourage actions against servants, agents and independent contractors in order to get round exemptions (which are almost invariable and often compulsory) accepted by shippers against carriers, the existence, and presumed efficacy, of which is reflected in the rates of freight."[87]

1.101 The Supreme Court of Canada has allowed third parties to rely on exemption clauses even when the clause was not a "Himalaya clause" which expressly benefited the third party. It has developed what has become known as the "principled exception" to privity in Canadian law. In *London Drugs v Kuehne & Nagel International Ltd*[88] the plaintiff delivered a transformer to a warehouse company for storage under a contract which limited the company's liability to $40. The company's employees negligently caused extensive damage to the transformer when they tried to move it with forklifts. The Supreme Court of Canada allowed the employees to rely on the exemption clause, even though they were not parties to the contract and the clause did not expressly benefit the employees.

1.102 In *Fraser River Pile & Dredge Ltd v Can-Dive Services Ltd*[89] the Supreme Court of Canada allowed a third party to rely on an exclusion clause where the third party was not an employee of one of the contractual

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86 [1975] AC 154.

87 [1975] AC 154 at 169.

88 [1992] 3 SCR 299.

89 [1999] 3 SCR 108. This decision is discussed in paragraph 2.13, below.

parties. A shipowner took out a marine insurance policy, which included a waiver of the insurer's right of subrogation against any charterer. It was decided that the charterer could rely on this term of the insurance contract, even though it was not a party to the contract, as the term was clearly intended to benefit the charterer. The Supreme Court of Canada evidently considered that a third party's right to enforce an exemption clause was, on balance, preferable to the application of the conventional privity rule.

1.103 In England and Wales, the *Contracts (Rights of Third Parties) Act 1999* allows third parties to enforce rights under contract where such was the intentions of the contracting parties. This Act applies equally to provisions in contracts that seek to exclude liability of a third party as it does to provisions that confer a specific benefit. This is clear from section 1(6), which provides that:

> "Where a term of contract excludes or limits liability in relation to any matters, references in this Act to the third party enforcing the term shall be construed as references to his availing himself of the exclusion or limitation."

(b) Discussion

1.104 The Commission notes that the courts have allowed third parties to enforce exemption clauses contained in main contracts. It is clear that this case law has developed to reflect commercial realities. However, the circumstances in which a third party may enforce these clauses are far from clear-cut. "Himalaya clauses" have been described "an ingenious, short-term solution to a difficult problem", but they may raise more problems than they solve.[90] In the Commission's view, third party reliance on exemption and limitation clauses need not be this complicated. The Commission therefore considers that the privity rule should be reformed to allow third parties to rely on exemption and limitation clauses included in a contract for their benefit.

(3) Insurance law

(a) Introduction

1.105 There are a number of ways in which a third party can be affected by a contract of insurance. The Commission has already noted how the legislature has intervened in some of these situations in order to grant a third party enforceable rights. For example, section 7 of the *Married Women's Status Act 1957* provides that the spouse and children of an assured person can enforce a life assurance policy made for their benefit. Similarly, section 76 of the *Road Traffic Act 1961* provides that persons claiming against an insured motorist can obtain certain remedies from the insurer, even though

[90] Tetley "The Himalaya Clause – revisited" (2003) 9 JIML 40.

they are not a party to the insurance contract between the motorist and the insurance company.

1.106 However, there are still a number of situations where the privity rule can operate so as to prevent a third party from enforcing an insurance contract. For example, the *Married Women's Status Act 1957* does not deal with the rights of a cohabitant, or another relative under a contract of insurance. In this section the Commission examines some of the instances of insurance which are adversely affected by the rule of privity.

(i) Insurance for employees

1.107 It is not uncommon for an employer to take out an insurance policy on behalf of its employees, to cover the employees in case of a workplace accident. This kind of scheme can become problematic particularly where the employer becomes insolvent or is unable or unwilling to claim under the insurance contract on behalf of the injured employee. Generally, the employee has no right to claim the insurance money directly from the insurance company as they are not a party to the insurance contract.[91] This can cause unfair results, as shown in the High Court decision of *McManus v Cable Management (Ireland) Ltd & Ors*.[92] There, owing to an accident at work caused by the negligence of his employer, an employee was injured. The insurance company refused to indemnify the employer in the case, and the employee sought a declaration that such refusal was unlawful. The Court decided that the plaintiff could not bring this case as he was not a party to the insurance contract.

(ii) Contracts for the sale of property

1.108 Another problem occurs in contracts for the sale of property, when damage is done to a property after the contract of sale, but before the land is conveyed to the purchaser. The purchaser will not be covered by the vendor's insurance, as they are not a party to the insurance contract.[93] In its 1981 Report on the privity rule, the Contracts and Commercial Law Reform Committee of New Zealand noted that even if the insurance contract does extend the benefit of its terms to the purchaser, the privity rule will defeat the purchaser's expectation if they are not a party to the insurance.[94] It is therefore imperative that a purchaser obtains their own insurance from the moment the contract is completed, even though they may not have taken possession of the property. Reform of privity of contract would enable

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91 See *Green v Russell* [1959] 2 QB 226.

92 High Court 8 July 1994.

93 *Rayner v Preston* [1879] 18 Ch 1.

94 New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981) at 17.

insurers to give effective cover to purchasers while the property is still in the possession of the vendor, and would avoid the current situation where property may be insured by both the vendor and the purchaser.

(iii) Leased premises: insurance arrangements for landlords and tenants

1.109 Landlords and tenants have to be particularly careful that they are both covered adequately by an insurance policy. Both parties have an insurable interest in the property, but it is normal for one of the parties, usually the landlord, to take out a policy of insurance for the property. A difficulty may arise for the tenant if the landlord's insurance company exercises its right of subrogation, which allows it to take over all the rights of the landlord with regard to the claim. Thus, the insurance company might bring an action against the tenant if, for example, the damage to the property was caused by the tenant's negligence, or the tenant had not maintained the property in the manner envisaged by a repair and maintenance covenant in the lease. To avoid this situation, the landlord could include the tenant's name in the insurance policy, so that the tenant becomes "the insured", or the insurance company could release its rights of subrogation in the policy. Failing agreement on these issues, the tenant may choose to take out their own policy of insurance.[95]

1.110 The situation would not arise if the privity rule were reformed so as to allow the tenant to enforce their rights under the policy between the landlord and the insurance company.

(b) Discussion

1.111 The difficulties created by privity of contract in insurance situations are not limited to the examples above. For example, problems can arise in situations where a retailer insures against liability to consumers. Should the customer injure themselves on the premises, they have no basis for an action against the insurance company to indemnify the shop owner.

1.112 It is the view of the Commission that appropriate and careful reform of privity of contract could create a situation whereby the parties to an insurance contract could decide who they wanted to benefit from its terms and who ought to be able to enforce the contract. A third party would not be denied rights in situations where it was clear that the contractual parties intended that they should be able to enforce them.

(4) Shipping contracts

1.113 The operation of the rule of privity in shipping contracts has led to the creation of a number of devices designed to give third parties enforceable

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95 See Wylie *Landlord and Tenant* (2nd ed Butterworths 1998) at 349-362.

rights.[96] The Commission has already outlined the introduction and upholding of "Himalaya clauses" in the context of exemption clauses designed to be enforceable by third parties.[97]

1.114 There are a number of other instances in shipping contracts where the privity rule has caused inconvenience. For example, a difficulty arises in relation to the commission payable to shipbrokers.[98] A shipbroker operates as the personal representative of the shipowner when negotiating things such as ship management, liner and port agency and the chartering or selling of sea vessels. They operate on a commission basis, and many standard form charterparties contain a clause providing for the payment of this commission.[99] The operation of the rule of privity means that the shipbroker has had to use complicated methods to enforce this clause providing for payment. In appropriate cases, the shipbroker can invoke agency principles based on their relationship with the paying party in order to enforce the clause. It was decided in *Robertson v Wait*[100] that the charterers themselves could recover as a trustee on behalf of the shipbrokers.

1.115 It is the Commission's view that these solutions are not commercially convenient. In order to enforce the commission clause, the broker must involve the charterer in the action. The charterer may be unwilling to be involved for whatever reason, and in such a case the broker must join the charterer as a second defendant for failure to enforce the trust.

1.116 The England and Wales *Contracts (Rights of Third Parties) Act 1999* has been tested in the courts in relation to shipping contracts. *Nisshin Shipping Co Ltd v Cleaves & Co Ltd and Others*[101] involved the refusal of the charterer to pay commission to the shipbroker, Cleaves, on the grounds that Cleaves was in repudiatory breach of the agency agreement between them. Cleaves relied on the 1999 Act and claimed that it was entitled to be paid its commission under the terms of the charterparty. In the English High Court, Coleman J decided that, as the charterparty was neutral as to whether the broker could enforce the term, it was to be assumed that the parties had intended that the term would be enforceable by him. The decision is significant, as prior to the 1999 Act coming into force Cleaves would have

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96 See generally Jamieson "Shipping Contracts" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000).

97 See paragraph 1.96ff, above.

98 See Jamieson "Shipping Contracts" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 144 - 148.

99 For example, the Gencon, Baltime and NYPE (New York Produce Exchange) standard forms contracts all contain such clauses.

100 (1853) 2 Ex 299.

101 [2004] 1 All ER (Comm) 481.

had to have joined the principals as trustees and /or co-claimants in order to recover its commission.

1.117 Reform of the rule of privity would remove the need for the brokers to invoke equitable remedies. Instead, the brokers could maintain an action in their own names, under the charterparty provisions themselves. This method of enforcing terms in a contract designed to benefit a third party is much more commercially convenient.

(5) Professional negligence

1.118 There are a number of ways in which a third party may be affected by a contract entered into with a professional. A person may retain a solicitor to draft a will in order to benefit third parties. A construction professional, such as an architect or engineer, can undertake contractual duties to a person other than their immediate client. For example, a warranty against defective work may be intended to benefit subsequent purchasers. Financial practitioners, such as auditors, engaged to report on the accounts of a client company may in certain circumstances affect third parties who rely on the information provided.

1.119 To date, the duty owed by professionals to third party beneficiaries has been governed by the tort of negligence.[102] In *Wall v Hegarty*[103] the High Court found that a person expecting a legacy in a will that turned out to be invalid could sue the solicitor who negligently drew up the will. In *White v Jones*[104] the English House of Lords decided that a solicitor who failed to draft a new will within a reasonable period, despite being instructed to do so by his client, was liable to his client's daughters who missed out on £9,000 inheritance as a result of his failure. In *Ward v McMaster*[105] the High Court held that a builder was liable in negligence to subsequent owners of a house for defective premises.[106]

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102 See generally, McMahon & Binchy *Law of Torts* (3rd ed Butterworths 2000) Chapter 13, Jackson & Powell *Professional Negligence* (5th ed Sweet & Maxwell 2002).

103 [1989] ILRM 124.

104 [1995] 2 AC 207.

105 [1985] IR 29.

106 In its *Report on Defective Premises* (LRC 3–1982) the Commission recommended a statutory regime of liability for defective premises comparable to the England and Wales *Defective Premises Act 1972.* To date, this Report has not been implemented, but a non-statutory scheme, Home Bond, is operated by the Construction Industry Federation, the Irish Home Builders Association and the Department of the Environment, Heritage and Local Government.

1.120 The law in relation to professional negligence has been described as "complex, fluid and at times unpredictable".[107] Depending on the profession and the nature of the engagement, different outcomes are likely.

1.121 Reform of the privity rule so that a third party could claim under a contract made for their benefit could potentially alter the manner in which these cases are dealt with. A third party could bring an action in contract, rather than in tort. There are differences between liability in contract and liability in tort, and these would be of relevance if the liability of professionals to a third party was contractual rather than tortious.[108] For example, if an action is taken in contract, a professional person will be liable if they breach a term of the contract. In contrast, in tort it is necessary to show that the professional was under a duty of care and that they were negligent. Also, if a professional person is liable in contract, they will be liable in damages for any pure economic loss of the third party, whereas in tort, recovery for pure economic loss is limited.[109] The issue of contractual liability to non-clients would become a very live one for both litigators and draftsmen.[110]

1.122 The Commission recognises that there are arguments for and against using contractual rather than tortious liability in order to resolve the problems that can arise when a third party is affected by a contract entered into with a professional and a client. One major advantage with taking the contractual route is certainty. Each of the contractual parties is aware from the outset of their rights and responsibilities under the contract. The Commission considers that if the privity rule was reformed in a structured manner giving a third party enforceable rights based on the intention of the contracting parties, the unpredictable nature of the law of professional negligence could possibly be avoided. It is of course possible that professional persons will exclude such contractual liability to third parties, but at least then, too, the situation may be clearer than it is at present.

1.123 It is notable that the Law Commission for England and Wales concluded that cases such as *White v Jones*[111] did not come within the sphere of their proposed legislation because a contract between a testator and his

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107 Tettenborn "Professional Negligence" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 164.

108 See generally, Jackson & Powell *Professional Negligence* (5th ed Sweet & Maxwell 2002) paragraph 2-007ff.

109 See *Glencar Explorations plc v Mayo Co Co (No2)* [2002] 1 IR 84.

110 See Tettenborn "Professional Negligence" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 163.

111 [1995] 2 AC 207. See paragraph 1.119, above.

solicitor does not confer a benefit on a third party as such.[112] The solicitor's obligation is to exercise reasonable care and skill in the drafting of the will to enable the testator to confer the benefit.

1.124 The Commission considers that the opposite conclusion could also be reached. Indeed, the Law Commission for England and Wales accepted that, at one level, they preferred the view that the right of the prospective beneficiaries belonged within the realm of contract rather than tort law.[113] Since both parties are contracting in order that the beneficiaries under the will would be provided for in the event of the testator's death, it could be argued that the contract is entered into to benefit these third parties. The third party beneficiaries are undoubtedly affected by it.

1.125 The Commission notes that the timing of the Law Commission's 1996 Report on privity of contract is relevant, as the decision of the House of Lords in *White v Jones* was still very fresh. The Law Commission was happy to let issues concerning negligent will drafting remain for determination within the context of the tort of negligence. In *White v Jones* Lord Goff noted that the problems created by consideration and privity of contract led the House of Lords to seek solutions in the law of torts. However, it is arguable that there would not be the same need to resort to the law of tort if the restrictions of the privity rule no longer applied.

1.126 The Commission is of the opinion that it is at least arguable that reform of privity of contract could be applied to cases involving the drafting of wills and analogous situations, if this was the intention of the contracting parties. The Commission recognises however, that such reform would need to take an appropriate form so that third parties could only claim under the contract if that was the intention of the original contracting parties.

(6) Consumer law issues

1.127 In consumer contracts, the Commission notes that there were two main scenarios causing possible injustice. The first was where a consumer bought faulty goods from a retailer. If the privity rule applied, the consumer had no redress against the manufacturer, because they would not have a contract with the manufacturer. The second situation would arise where a person bought goods for someone else. This person receiving the gift would be unable to sue the seller if they were not satisfied with its quality, as they were not a party to the contract. These kinds of situation have been resolved in most cases by the enactment of consumer protection legislation. These include the *Sale of Goods and Supply of Services Act 1980*, the *Liability for Defective Products Act 1991*, the *Consumer Credit Act 1995*, the *European*

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112 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraphs 7.19ff.

113 *Ibid* at paragraph 7.27.

Communities (Unfair Terms in Consumer Contracts) Regulations 1995 and the *Package Holiday and Travel Trade Act 1995.* Many of these involved the implementation of EC consumer protection Directives, and the EC continues to play an important role in consumer protection.

1.128 In addition to the legislative intervention in the area, the Commission is conscious that, in the majority of cases, traders generally operate good customer services standards in Ireland. It is often the case that consumers returning goods will be reimbursed, or given some kind of store credit, without too much concern about who the original parties to the contract were.

1.129 Nevertheless, it is the Commission's view that any potential reform of privity will have implications for the consumer. If reforms allow third parties to bring an action in contract, this could supplement the existing scheme of consumer protection legislation. For example, reforms might deal with whether a third party falls under the definition of a consumer for the purposes of protection.[114]

1.130 The Commission is conscious that any reforms in this area must take account of the increasing protection afforded consumers by existing legislative measures, many of which are influenced by EC Directives. The Commission is also conscious that this is an area in which national legislative activity is set to increase, with the publication of the draft *Consumer Protection (National Consumer Agency) Bill 2006.*[115]

1.131 The Commission considers that any reform granting third parties enforceable rights under a contract made for their benefit would only have a positive impact on the rights of the consumer. The Commission is concerned with the conferring of benefits, not burdens on the third party, and it is therefore not likely that the consumer will be placed at a disadvantage.

G The relationship of privity with existing fundamental principles of contract law

1.132 There are certain fundamental principles of the law of contract which are inherently linked with the rule of privity. The rule is associated with the requirement of consideration and concepts such as freedom of contract, and mutuality and reciprocity between contracting parties.

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114 See Bird "Dealing as Consumer" (1999) 6 CLP 10.

115 The Draft Bill proposes to establish a Consumer Protection Agency to replace the Office of the Director of Consumer Affairs. It also proposes to implement the EC *Directive on Unfair Commercial Practices*, 2005/29/EC. The Draft Bill is available at www.entemp.ie.

1.133 The Commission considers it appropriate to examine these fundamental concepts with a view to assessing how they could affect, or be affected by, reform of the rule of privity.

(1) Consideration and the Privity Rule

(a) The Requirement of Consideration

1.134 The general rule of consideration is that a party wishing to enforce a promise must have provided some benefit or incurred some detriment. In other words, the consideration must "move from the promisee". The leading Irish case on the point is *McCoubray v Thompson*.[116] There, a contract provided that a farm would be transferred to Thompson if he agreed to pay half the value of the farm to McCoubray (a third party). After the land was transferred to Thompson, he refused to pay the amount promised in the contract to McCoubray. The court decided that as McCoubray had not provided any consideration he could not recover the amount owed to him.

1.135 Third parties are not entitled to enforce rights under a contract because they have not provided any consideration for that promise. The rule of privity of contract and the requirement of consideration are so entwined that some commentators have argued that they are two different ways of saying the same thing.[117]

1.136 The Commission is therefore of the view that any reform of privity of contract, giving third parties rights of enforcement, would undoubtedly have an effect on the rule of consideration.

1.137 In its 1996 Report on privity of contract,[118] the Law Commission for England and Wales noted that any reform of the privity rule was necessarily going to involve a departure from the rule that the consideration must come from the promisee. The Law Commission recommended that its proposed legislation should ensure that the rule that consideration must move from the promisee be reformed to the extent necessary to avoid nullifying their proposed reform of the rule of privity.[119]

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116 (1868) 2 IRCL 226.

117 See for example: Furmston "Return to Dunlop v Selfridge" (1960) 23 MLR 373; Flannigan "Privity – end of an era (error)" (1987) 103 LQR 564, at 568. However, Clark has stated that "the weight of authority is in favour of regarding the law as having two distinct rules": Clark *Contract Law in Ireland* (5th ed Thomson Round Hall 2004) p.473.

118 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996)

119 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraphs 6.3-6.7.

1.138 The Commission considers that the argument could be made that as long as a valid contract has been entered into and consideration for the performance of the contract has been provided, there are good reasons why a third party, whom the contractual parties intended should benefit, should be entitled to enforce the contracts. This reasoning is resonant of the pre-*Tweddle v Atkinson* decisions, particularly *Dutton v Poole*.[120]

1.139 While rights for third party beneficiaries may be acknowledged by reform of the rule of privity, consideration will still be required in order to make an agreement legally binding. The only change to the rule of consideration would be that the consideration need not have moved from the promisee. The Commission considers that to facilitate reform of the rule of privity, it may be advantageous to clarify that the absence of consideration moving from the third party would not prevent the third party from enforcing the contract.

(b) Bargain theory and the Enforceability of Promises

1.140 Contract law is concerned with the question of what type of promise should be enforced by the courts. As mentioned already, the requirement of consideration places some legal limits on the enforceability of promises. It is premised on the idea of reciprocity or exchange: a person who has made a promise to provide goods or services should be bound by that promise if they have received, or have been promised, valuable compensation in return for that promise. The parties have the right to sue for breach, but can also be sued themselves if they do not uphold their part of the bargain. This is sometimes referred to as the "bargain theory" of contract.[121]

1.141 It could be argued that any reform of the privity rule would infringe this basic principle of contract law. A third party could sue on the contract, even though they have not provided anything in exchange and cannot themselves be sued under the contract. The third party would acquire all of the benefits and none of the burdens in the contract.

1.142 However, the Commission considers that the law has developed, and the bargain theory of contract is not the only theory used to enforce promises. Traditionally, contracts would be enforced where the promise was written in a deed under seal. The courts have developed concepts such as unjust enrichment, detrimental reliance and legitimate expectations, and have used these concepts to enforce promises even where the parties do not have a traditional two-sided bargain or exchange of promises. Public policy

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120 (1677) 3 Keb 786.

121 See Clark *Contract Law in Ireland* (5th Ed Thomson Round Hall 2004) p.47 – 51.

has an important role to play in determining when a promise can be enforced and by whom it can be enforced. [122]

1.143 It is the Commission's view that public policy may favour the enforcement of third party rights, even though it could be argued that enforcement of such rights is not possible under traditional contract law rules. If the parties to a contract intend to benefit a third party, the third party may reasonably rely on that intention and may suffer a detriment if there is a breach of contract. Public policy may dictate that the third party should not be without a remedy in this situation.

(2) Freedom of Contract and the Privity Rule

1.144 The idea of freedom of contract means that the parties are free to enter into whatever kind of contract they like, provided it is legal. The courts will not interfere with the bargains that have been struck between the parties. If the parties freely and voluntarily entered into a contract, the courts' only function is to enforce that contract. Thus, the courts will not add to any agreement, or imply terms merely because it is reasonable to do so.

1.145 One aspect of freedom of contract is that the parties should be free to agree to vary or cancel an arrangement into which they have entered. It could be argued that giving third parties rights of enforcement infringes the contracting parties' freedom to contract.

1.146 However, the Commission considers that granting a third party enforceable rights need not infringe the parties' freedom of contract. It is possible to contemplate reforms which allow a third party to enforce their rights whilst protecting the right of the contracting parties to vary or cancel their agreement.

1.147 The Commission assumes that contracting parties who have intentionally entered into an agreement to confer a benefit on a third party have in mind that the contract will be carried out, and that the third party will benefit. If the rule of privity operated so that this intention could not be seen through to completion, the parties' intentions would be thwarted and the contract's purpose would be nullified. It could be argued that the concept of freedom of contract supports the enforcement of third party rights in this situation, and that the contractual intention of the parties should be enforced in the most effective way possible by the courts.

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[122] See Kincaid "Privity Reform in England" (2000) 114 LQR 43.

H Comparative analysis

(a) Civil Law Systems and Third Party Rights

1.148 The concepts of consideration and privity of contract are unique to common law legal systems, that is, the Anglophone legal systems. One of the arguments for reform of privity of contract is that it would bring Irish contract law more in line with the Civil Law systems of most European countries. This becomes increasingly important with the globalisation of international trade, and the increase in cross-border transactions. For the sake of commercial convenience and clarity it makes sense that the same fundamental principles should underpin contracts. It has already been mentioned that many of the other common law countries have reformed the rule of privity, and the specifics of these reforms will be examined in detail later.[123]

1.149 The following sections outline the approach taken in civil law jurisdictions to third party beneficiaries.[124]

(i) France

1.150 In France there is no requirement of consideration as such, but in order for a contract to be valid it must have a lawful "*cause*". In essence, this means that a contract must contain reciprocal obligations between the parties in order to be legally binding. The *cause* need not be valuable consideration in the sense of the common law interpretation of this, but instead can be the overall benefit that the promisor receives by entering into the contract.

1.151 As regards third party rights, Article 1165 of the Civil Code provides that contracts only affect the parties to it. However, Article 1121 qualifies this by providing that a person can contract for the benefit of a third party (*stipulation pour autrui*) and such a contract is directly enforceable by that third party. The Civil Code does lay down the further requirements that such a contract is only valid if the promisee made a gift to the promisor, or requested some performance to themselves. However, the *Cour de Cassation* has ignored these requirements finding that it is enough that the promisee gains some kind of moral profit from the arrangement. The result

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123 See Chapters 2 and 3 below.

124 See generally: Whincup *Contract Law and Practice: The English System and Continental Comparisons* (4th ed Kluwer Law International 2001) Chapter 3; Kötz & Flessner *European Contract Law, Volume One: Formation, Validity, and Content of Contracts; Contracts and Third Parties* (Clarendon Press Oxford 1997) Chapter 13; Zweigert & Kötz *An Introduction to Comparative Law* 3rd Ed (Clarendon Press Oxford 1998) at 456 – 469.

is that any contract which is intended to benefit a third party is enforceable by that third party.

(ii) Germany

1.152 There is no rule of consideration in German contract law. A contract is valid and enforceable as soon as the parties to the contract agree on all the provisions that they wish to have included. Furthermore, Article 328 of the Civil Code provides that contracts may be made for the benefit of third parties so that the third party has the right to demand performance of that contract. However, contracts concluded to the detriment of third parties are not enforceable against them.

(iii) Denmark

1.153 In Denmark there is no requirement of consideration and contracts made for the benefit of third parties are readily enforceable by those third parties. The parties' freedom of contract is preserved by allowing contracting parties to vary and cancel the terms of the contract at any time, except where the promise is made directly to the third party and where it would be unjust to do so.

(iv) The Netherlands

1.154 There is no requirement of consideration in Dutch law. Articles 6.253-4 of the Civil Code expressly recognise contracts for the benefit of third parties, and allow the third party to enforce the terms of those contracts. These contracts are recognised as soon as the third party beneficiary has accepted the terms.

(v) Principles of European Contract Law

1.155 Article 6:110 of the Principles of European Contract Law deals with a stipulation in favour of a third party. It provides that a third party may require performance of a contractual obligation when such a right has been expressly agreed upon between the contracting parties, or when such agreement is to be inferred from the purpose of the contract or the circumstances of the case. The promisee may by notice deprive the third party of the right to performance unless the third party gives notice that they have accepted that right or the third party receives notice from the promisee that the right has been made irrevocable.

1.156 The Principles of European Contract Law do not have the status of law and are not binding. Should contracting parties adopt the Principles, they would operate only as terms of the contract, not an effective choice of law. However, the Principles are designed to reflect basic principles of contract law across the European Community (EC) and thus may provide the foundation for measures taken in the future by institutions in the EC and for the harmonisation of contract law across Europe. Importantly, the Principles

indicate that the favoured approach in EC Member States is to enforce the rights of third parties to a contract.

(vi) UNIDROIT Principles of International Commercial Contracts

1.157 Articles 5.2.1 – 5.2.6 of the UNIDROIT Principles of International Commercial Contracts deal with third party rights. They provide that parties can confer enforceable rights on a third party beneficiary either expressly or by implication, provided the beneficiary is identifiable with adequate certainty. The third party's rights are determined by the agreement of the parties and are subject to any conditions or other limitations under the agreement.

1.158 The UNIDROIT Principles were formulated as a Restatement of the law on international commercial contracts. It should be noted that, like the Principles of European Contract Law, the UNIDROIT Principles are neither a complete legal system nor a Convention to which Ireland is a party. As a result, should the parties adopt the Principles, they would operate only as terms of the contract, not an effective choice of law. But the Commission is of the view that they are a further indication that in international commercial transactions there is a trend towards facilitating the enforceability of third party rights where to do so will give effect to the clear intentions of the contracting parties.

(b) Discussion

1.159 The fact that the majority of other EU Member States recognise that contracts for the benefit of third parties should be enforceable by those third parties offers a compelling reason for the Commission to examine the fundamental reasons why the rule of privity has such a strong foothold in Irish law. It is clear from the above discussion that there are forceful public policy reasons which favour its reform.

1.160 However, the Commission acknowledges that the argument is not as straightforward as it would seem. The absence of rules relating to privity and consideration in the civil law systems is not the only difference between them and the common law systems. For example, the civil law system has a general principle of good faith, which is absent from the traditional common law of contract.

1.161 In some instances, the divergence in the approach to third party rights arises because the common law has developed techniques that are not recognised in civil law countries.[125] For example, in France and Germany, liability for injury caused to third parties by defective products has been imposed through contract, whereas in Ireland it is dealt with through the law of tort. Similarly, in France and Germany losses to third parties caused by

[125] See Stevens "The Contracts (Rights of Third Parties) Act 1999" (2004) 120 LQR 292.

negligent misstatements are brought in contract, when these would be brought in tort here. Civil law does not allow an undisclosed principal to acquire rights in a contract entered into by an agent, whereas this is possible in the Irish law of agency. Nor do the Civil law legal systems make similar use of the concept of the trust. It is clear that different legal systems can attempt to achieve the same result in different ways.

1.162 The Commission recognises that, given the fundamental differences between common law and civil law in this area, direct "cutting and pasting" of ideas from civil law into common law is a complicated venture, and not necessarily appropriate. The harmonisation of international contract law rules is not a simple process and is not always a welcome one. However, the difference in approach shows that the rule of privity of contract is not universal and indicates that it may be appropriate to review the continued existence of the rule in Irish law.

I The need for reform of the rule of privity of contract: provisional recommendations

1.163 In this Chapter, the Commission has examined the evolution of the privity rule and found that its roots are not as deeply entrenched as might have been assumed. Before the rule was recognised in *Tweddle v Atkinson*, there were significant contradictory judgments which point to the recognition of third party rights.

1.164 The Commission outlined the current impact of privity of contract. The examples given concerning construction contracts, exemption clauses, insurance law, shipping contracts, professional negligence and consumer law have highlighted the negative impact that the privity rule can have in practice.

1.165 The Commission highlighted the various methods used to circumvent the rule. These included statutory exceptions, exceptions developed by the courts, and methods used by drafters and practitioners to allow third parties to enforce rights under a contract for their benefit.

1.166 The Commission detailed how the legislature has intervened to protect third parties. The approach of the legislature to date has been to identify problems occurring in specific instances and deal with them directly.

1.167 The privity rule has clearly been recognised as a problem in contractual arrangements for quite some time. As far as is practicable, the problems that are encountered in practice have been dealt with in a piecemeal way. It is clear that the rule of privity has not prevented parties from entering into contractual arrangements. A brief glance at the current economic climate in Ireland would indicate that this is certainly not the case. Nevertheless, the procedural difficulties and the expense of these

transactions are heightened by the privity rule. These, coupled with the confusion and complexity that can surround even the simplest of transactions, make a strong argument for reform of the privity rule.

1.168 The complex and varying methods used to grant rights to third parties are confusing and unnecessary. Reform of the privity rule, and the creation of a general right of enforcement for third parties, would ensure that there is clarity in contractual relations involving third parties. This will in turn prevent injustice arising in cases where the parties to a contract and the third party have relied on the benefit that the third party is to have from a particular transaction.

1.169 The Commission is of the opinion that the current methods of granting rights to third parties are not sufficient to deal with the problems created by the privity rule. There is still potential for injustice, inconvenience, and expense.

1.170 The Commission also recognises that the privity rule has been reformed in many other common law jurisdictions, and does not exist in many civil law countries. Ireland has the advantage of being able to learn from the experiences of these other jurisdictions in drafting the most appropriate and effective manner of reform.

1.171 The Commission therefore provisionally recommends that the privity of contract rule should be reformed to allow third parties to enforce rights under contracts made for their benefit.

1.172 *The Commission provisionally recommends that the privity of contract rule should be reformed to allow third parties to enforce rights under contracts made for their benefit.*

CHAPTER 2 OPTIONS FOR REFORM

A Introduction

2.01 In Chapter 1, the Commission outlined the main reasons why the rule of privity should be reformed. It is the aim of this chapter to analyse how best this reform might be achieved. The ultimate object is to find a suitable method of reforming the rule of privity so that the problems outlined in Chapter 1 can be resolved. It is important in this respect to consider how any proposed reform would impact on existing methods of allowing third party rights.

B Judicial development of the rule of privity

(1) Introduction

2.02 In this section the Commission places in context the role of the courts in the development of third party rights. It has already been noted that the courts have developed methods to grant rights to third parties. Concepts such as trusts, the law of agency, assignment, collateral warranties and the circumstances in which an exemption clause in shipping contracts can be enforced, have all originated from situations in which the courts recognised an injustice and sought to remedy the wrong.

2.03 However, it is important to note that the role of the courts is limited to deciding cases on the facts presented before them. It is rare that well established principles such as the privity rule would be abolished outright through judicial decisions. An analysis of the approach in other jurisdictions is useful as it can be seen that in some jurisdictions the privity rule has been limited in a number of important respects through judicial decision making. In the majority of cases, however, reform has taken the legislative route.

(2) Comparative analysis

(a) United States of America

2.04 In the United States of America third parties have been able to enforce contracts made for their benefit since the mid-19th century. All States have accepted this third party beneficiary rule, with the last of these, Massachusetts, finally adopting it as a general rule, rather than an exception,

in 1979.[1] The *Restatement (Second) of Contracts* now contains a statement of the third party beneficiary rule as it stands. Section 304 states:

> "A promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may enforce the duty"

2.05 It has been said that one of the reasons the privity rule was limited in the United States is that the judges seemed to be primarily concerned with promoting certain social standards rather than strict legal formalism.[2]

2.06 The most important decision in the area is *Lawrence v Fox*.[3] There the New York Court of Appeals decided that Lawrence could recover as a third party beneficiary because any other result would go against "manifest justice". The theoretical basis for this decision was that there was a moral obligation to fulfil a promise which benefited a third party.

2.07 In *Choate, Hall & Stewart v SCA Services Inc*[4] the Supreme Judicial Court of Massachusetts adopted the general rule of allowing third parties to recover under contracts concluded for their benefit. The Court referred to the existing system of law whereby the privity rule was limited and circumvented by many exceptions, and stated that:

> "The rather confusing patchwork should be supplanted by the general rule now prevalent, which avoids circuity of action and is calculated to accord with the probable intentions of the contracting parties and to respond to the reasonable reliance of the third-party creditor."[5]

The Court stated that the rule of privity was a reflection of "simple, neighbourly society",[6] in which people were concerned not to involve a contracting party in litigation with a third party. The Court considered that such an approach was not reflective of modern standards.

2.08 The general principle that third party beneficiaries are entitled to enforce their rights under contract has been refined since the mid-19th century. The finer details of the rule were left to be teased out in subsequent cases. Questions worked out over time included: when a third party was

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1 *Choate, Hall & Stewart v SCA Services Inc* (1979) 378 Mass 535.

2 De Cruz "Privity in America: A study in judicial and statutory innovation" (1985) 14 Anglo-American L Rev 265, at 266.

3 (1859) 20 NY 268.

4 (1979) 378 Mass 535.

5 (1979) 378 Mass 535 at 545.

6 (1979) 378 Mass 535 at 543.

entitled to benefit; the kinds of contracts covered by the rule; the position of the parties in relation to varying or cancelling the terms of the contract. Although this had the effect that specific injustices were tested before the courts and appropriate solutions reached, it is also clear that this method takes time.

2.09 It is for this reason that although judicial reform of the rule worked well in the United States, the Commission considers that it may not be the most appropriate method of reform in the Irish context.

(b) Canada

2.10 The Canadian courts have also been very pro-active in the creation of enforceable rights for third parties. Although reform by way of legislative intervention was advocated by some of the Canadian Law Reform Commissions,[7] the courts established a general exception to the rule of privity that allows a third party beneficiary to bring an action in contract.

2.11 In *London Drugs v Kuehne & Nagel International Ltd*,[8] the plaintiff stored an electrical transformer with the defendant. The contract contained a clause that limited the liability of the defendant to $40 in the event that the transformer was damaged. The transformer was damaged through the negligence of the defendant's employees as they were carrying out their duties. The plaintiff sued the defendant and the individual employees involved. The Supreme Court decided that under the circumstances it was intended by both the plaintiff and the defendant that the contractual allocation of risk would extend to the employees in the performance of their duties. The employees could rely on the exclusion clause in the contract, even though they were not party to the contract.

2.12 Iacobucci J delivered the main judgment in the case, and the language used indicated that the consequences of the decision of the Court would be far reaching. He elected to "deal head-on with the rule of privity and to relax its ambit" and stated that:

> "Except for a rigid adherence to the rule of privity of contract, I do not see any compelling reason based on principle, authority or policy demonstrating that this Court, or any other, must embark upon a complex and somewhat uncertain "tort analysis" in order to allow third parties such as the respondents to obtain the benefit of a contractual limitation of liability clause, once it has been

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7 For example, the Ontario Law Reform Commission *Report on the Amendment of the Law of Contract 1987*; the Law Reform Commission of Nova Scotia *Final Report on Privity of Contract (Third Party Rights)* August 2004, the Manitoba Law Reform Commission *Report on Privity of Contract* Report No 80 October 1993.

8 [1992] 3 SCR 299, discussed in paragraph 1.101, below.

established that they breached a recognized duty of care. In my view, apart from privity of contract, it is contrary to neither principle nor authority to allow such a party, in appropriate circumstances, to obtain the benefit directly from the contract (i.e. in the same manner as would the contracting party) by resorting to what may be referred to as a 'contract analysis'."[9]

2.13 The Supreme Court of Canada chose to modify the rule of privity of contract so as to reflect commercial reality and common sense. This became known as the "principled exception" to the rule of privity.[10]

2.14 The Supreme Court of Canada decision in *Fraser River Pile & Dredge Ltd v Can Dive Services Ltd*[11] gave the exception to the privity rule a coherent definition. It was held that third party rights are dependent on the intention of the parties to the contract. In this regard, the intention of the parties is determined by reference to a two prong test:

i) The parties to the contract must intend to extend the activities performed by the third party seeking to rely on the contractual provision and

ii) The activities performed by the third party seeking to rely on the contractual provision must be the very activities contemplated as coming within the scope of the contract, as determined by reference to the intention of the parties.[12]

2.15 It is evident from the experience in Canada that the courts were willing to develop substantial exceptions to the privity rule. However, in the *Fraser River* case, Iacobucci J had the following to say on judicial reform of the privity rule:

> "Privity of contract is an established rule of contract law, and should not be lightly discarded through the process of judicial decree. Wholesale abolition of the rule would result in complex repercussions that exceed the ability of the courts to anticipate and address. It is by now a well-established principle that courts will not undertake judicial reform of this magnitude, recognizing instead that the legislature is better placed to appreciate and accommodate the economic and policy issues involved in introducing sweeping legal reforms.

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9 [1992] 3 SCR 299 at 413-414.

10 See Brock "A 'principled' exception to Privity of Contract: *Fraser River Pile & Dredge Ltd v Can-Dive Services Ltd*" (2000) 58 UT Fac L Rev 53.

11 [1999] 3 SCR 108.

12 [1999] 3 SCR 108 at 126.

> That being said, the corollary principle is equally compelling, which is that in appropriate circumstances, courts must not abdicate their judicial duty to decide on incremental changes to the common law necessary to address emerging needs and values in society."[13]

2.16 It is clear that judicial reform of the privity rule has its merits. However, as Iacobucci J noted, judicial reform is necessarily limited. It is often the case that the legislature is better placed to gauge the precise needs and values of a changing society. Legislation can be drafted to include many of the potential nuances that reform of the rule of privity can present. Hence, the majority of common law jurisdictions have altered the privity rule by means of legislation. Even within Canada, the Law Reform Commission of Nova Scotia, despite the decisions in *London Drugs v Kuehne & Nagel International Ltd* and *Fraser River Pile & Dredge Ltd v Can Dive Services Ltd*, recommended that the privity rule should be relaxed by legislation to allow a third party beneficiary to enforce rights under a contract.[14] It was their view, as suggested by Iacobucci J in the *Fraser River* case, that a total abolition of the privity rule was a matter for the legislature.[15] In New Brunswick, legislation has been enacted with the effect that a third party can enforce a claim under a contract made for their benefit. Section 47 of the *Law Reform Act 1993* provides that:

> "a person who is not a party to a contract but who is identified by or under the contract as being intended to receive some performance or forbearance under it may, unless the contract provides otherwise, enforce that performance or forbearance by a claim for damages or otherwise."

2.17 There is also a revised provision in the Québec Civil Code along the lines of the French *stipulation pour autrui* which "entitles the third person beneficiary the right to exact performance of the promised obligation directly from the promisor".[16]

(c) England and Wales

2.18 In its 1996 Report on privity of contract, the Law Commission for England and Wales considered that the role of the judiciary in the

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13 [1999] 3 SCR 108 at 131-132.

14 Law Reform Commission of Nova Scotia *Final Report on Privity of Contract (Third Party Rights)* 2004.

15 *Ibid* at 7.

16 Article 1444 of the Québec Civil Code (1991, c. 64, a. 1444).

development of third party rights was important.[17] It was acknowledged, however, that the House of Lords had been given a number of opportunities to reconsider the third party rule, and had declined to do so. The Law Commission was particularly aware that the House of Lords may have to wait a long time before another suitable case reached them. The Law Commission concluded that legislation was the best option and had the advantage that many of the difficulties of which they had become aware through their consultation could be addressed. It was their opinion, however, that any proposed legislation ought not to hamper judicial development of the law in specific instances.

2.19 The details of the Law Commission's 1996 Report and the subsequent 1999 Act will be examined in further detail in Chapter 3.

(3) Discussion

2.20 Judicial development of the law can be a slow process. The common law system of precedent generally requires the courts to follow previous decisions of the higher courts. For the rule of privity to be reformed in a general way, the higher courts would need to be presented with a case which highlights the injustices of the rule. It is by no means certain that an appropriate case will come before the Supreme Court any time in the near future and there is no guarantee that the judges sitting would choose to pronounce on the soundness of the rule. The Commission has already noted the reluctance of Irish judges to deal directly with the privity rule.[18]

2.21 Judicial development is an uncertain route to take, because it is dependent on the "pendulum of judicial opinion".[19] Judicial opinion can fluctuate over time, leaving those that are affected by the rule of privity unsure of where they stand in relation to their rights under a contract. Positive legislative intervention is often necessary in order to address all of the salient issues and problems.

2.22 As already mentioned, in the *Fraser River* case, Iacobucci J noted that it is not the place of the courts to carry out major reforms of the law, but that rather this is a matter for the legislature. As Dawson J in *Trident General Insurance Co Ltd v McNeice Bros Pty Ltd*[20] stated, the court "is neither a legislature nor a law reform agency. It would do more harm than

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17 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraphs 5.8 – 5.10.

18 See paragraph 1.20ff, above.

19 Per Lord Goff in *The Mahkutai* [1996] AC 650 at 658.

20 [1988] 80 ALR 574.

good to attempt to reach a right result by a wrong means."[21] It was his view that the role of the court was limited to the adaptation of existing principles rather than the creation of new ones.

2.23 The Commission nonetheless considers that the role of the judiciary will be vital when it comes to determining the application of any proposed legislation. In particular, no legislation could hope to cover every conceivable problem that might be faced. The judiciary will have an essential role to play in any further development of third party rights beyond the scope of the proposed legislation.

2.24 *The Commission provisionally recommends that the development of third party contractual rights should take the form of legislation, which is most suited to address the injustices and inconveniences associated with the current privity of contract rule. The Commission also provisionally recommends that legislative reform of the privity rule should not constrain judicial development of third party rights.*

C Reform of the promisee's remedies in order to give more protection to a third party

(1) Introduction

2.25 One of the reasons advanced for reform of the privity rule is that the promisee, who is a party to the contract, cannot obtain adequate redress for the loss of a third party beneficiary. For example, in an action for damages, a party is only entitled an award which reflects their own personal loss as a result of the other party's breach. The courts will only award a nominal amount to a promisee who has not borne the loss themselves.[22]

2.26 There are exceptions to this rule of damages. For example, in the context of the carriage of goods by sea, the goods may be lost in transit after ownership in the goods has passed from the seller of the goods to the buyer. The buyer of the goods is not a party to the contract for the carriage of the goods and cannot sue on it. The seller of the goods is a party to the contract for the carriage of goods, but if they sue on this contract they cannot prove that they have suffered a loss. In this situation, the courts have developed an exception to the normal rule of damages so that the seller of the goods can recover substantial damages.[23]

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21 [1988] 80 ALR 574 at para 14.

22 See the comments of Finlay CJ in *Burke (a minor) v Dublin Corporation* [1991] 1 IR 341 at 353 in this regard.

23 *Dunlop v Lambert* (1839) 6 Cl & F 600; *The Albazero* [1977] AC 774.

2.27 Another exception may exist in the context of certain everyday transactions, for example, contracts for family holidays, ordering meals in restaurants or hiring a taxi for a group. In the Supreme Court, Finlay CJ has stated that these cases may call for "special treatment" in relation to the measure of damages.[24]

2.28 In certain instances, where the award of damages does not offer adequate compensation, the promisee may seek an order of specific performance.[25] In such a case, the promisor will be compelled to perform their end of the bargain. If the object of the contract was to confer a benefit on a third party, then specific performance will be of use to the third party. However, an order for specific performance is at the discretion of the court, and will not always be available. For example, an order for specific performance will not be given to compel the performance of personal services.

2.29 It is the Commission's view that the extension of the promisee's remedies would not be sufficient to cure the problems associated with the rule of privity. It would not assist the third party if the promisee is unable or unwilling to sue on the contract. Nor would it cover the situation where a third party is seeking to rely on an exemption clause contained in a contract to which they are not a party.

2.30 In its 1996 Report on the privity rule, the Law Commission for England and Wales accepted that the advantage of this method of law reform was that it avoided the need to address several difficult questions which arise if third parties are given enforceable rights, such as the test for enforceability for a third party.[26] However, the Law Commission concluded that reform of the remedies of the promisee would not be an adequate method of reform, because the promisee may be unwilling or unable to enforce a contract made for a third party. In this situation, the third party is still without a remedy. The Law Commission also recommended that the general issue of remedies available to the promisee in a contract enforceable by a third party should be left to the common law.[27]

2.31 In 1993, the Manitoba Law Reform Commission recognised that reform of the promisee's remedies was attractive for a number of reasons. It

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24 *Burke v Dublin Corporation* [1991] 1 IR 341, 353. This case is discussed in paragraph 1.52, above.

25 Such an order was granted in this context in *Beswick v Beswick* [1968] AC 58. The Court in that case said that if nominal damages were the only remedy available it would be "grossly unjust": per Lord Reid [1968] AC 58 at 73.

26 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 5.4.

27 *Ibid* at paragraph 5.17.

involves very little dislocation of basic contractual principles and avoids the necessity of resolving the numerous issues that arise in drafting a detailed legislative scheme.[28] However ultimately they chose not to recommend this method as to do so would be an incomplete solution to the problem of third party rights. It is entirely dependent on the situation of the promisee and the third party would still have no remedy if the promisee was unable or unwilling to sue on the contract.

(2) Discussion

2.32 The Commission notes that none of the jurisdictions that have reformed the privity rule have done so by reforming the remedies available to the promisee. The Commission agrees that this method of reform does not address the real issues that are presented by the privity rule.

2.33 Nevertheless, some argue that the most appropriate and legally acceptable method of reforming the rule of privity is to focus on the promisee's remedies.[29] As to the potential unwillingness or the lack of ability of the promisee to sue, it is argued that this is the nature of litigation, and that it is just as likely that the third party beneficiary will be unable or unwilling to sue.

2.34 The Commission is not convinced by such arguments as they fail to address the injustice and the commercial inconvenience that the rule of privity can cause. Reform of the promisee's remedies will only assist in a limited number of cases and could not possibly hope to achieve all of the aims of this reform.

2.35 However, the Commission acknowledges that reform of the rule of privity should not in any way hamper judicial development of principles relating to the award of damages.

2.36 *The Commission provisionally recommends that reform of the promisee's remedies should not form part of the proposals to reform the privity rule.*

D General Legislation entitling third parties to enforce contracts for their benefit

(1) Introduction

2.37 One of the possible means of legislative reform would be to introduce a general all-encompassing legislative provision creating

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[28] Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80) October 1993 at 56.

[29] Stevens "The Contracts (Rights of Third Parties) Act 1999" (2004) 120 LQR 292 at 293.

enforceable rights for third party beneficiaries. This method has the advantage of simplicity. Many of the civil jurisdictions examined in Chapter 1 take this general approach. There are inherent difficulties, however, in applying this to a common law jurisdiction which has developed a myriad of complicated exceptions to the privity rule. Without further legislative guidance these issues would be left to be teased out by the judiciary and indeed in general practice. While this has the advantage of keeping in line with modern commercial practice and retaining a degree of flexibility, it may lead to further complexity and confusion as to third party rights.

(2) Comparative analysis

(a) Ontario

2.38 The Law Reform Commission of Ontario examined the merits of reform of the privity rule by means of a general enabling provision in legislation. It was their opinion that a general clause would have the effect of permitting the courts to enforce third party rights where the justice of the case so required. There would be an element of flexibility and the judiciary would still have an important role to play. Such a clause would simply abolish the impediment to a third party enforcing rights under a contract, leaving the courts free to fashion principles in favour of the third party.[30]

2.39 The Law Reform Commission of Ontario considered that an attempt at a detailed legislative scheme was far too complex and difficult a task. It expressed concern about the legislature's ability to classify the kinds of third party beneficiary and the types of agreement that would be covered by any legislation. It concluded that no legislature could possibly foresee all of the potential problems that might arise in the future. It would therefore be futile to attempt such an endeavour.

2.40 Ultimately, the Law Reform Commission of Ontario recommended that:

> "There should be enacted a legislative provision to the effect that contracts for the benefit of third parties should not be unenforceable for the lack of consideration or want of privity".[31]

2.41 The recommendations of the Law Reform Commission of Ontario have not as yet been implemented. This is probably because the Supreme Court of Canada has already intervened in cases such as *London Drugs* and *Fraser Pile Dredge Co*.[32] The result is that a third party may generally

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30 Ontario Law Reform Commission *Report on the Amendment of the Law of Contract* (1987) at 69.

31 *Ibid* at 71.

32 See paragraph 2.10ff, above.

enforce terms in a contract made for their benefit. As there is now no bar to the enforcement of third party rights in Canada, perhaps the need for legislative intervention is lessened, particularly when the form of legislation contemplated was general.

(b) England and Wales

2.42 In its 1996 Report on privity of contract, the Law Commission for England and Wales examined the approach advocated by the Ontario Law Reform Commission and rejected it for a number of reasons.[33] Although the Law Commission recognised that it had the advantage of making the change of principle a legislative matter, while leaving it to the courts to handle subsequent developments, it was ultimately of the opinion that the problems associated with the rule of privity were far too complex to be dealt with in an incremental way. It was the Law Commission's view that to introduce a general clause abolishing the need for privity certainly achieved flexibility, but that it does so at the expense of clarity and certainty. The Law Commission was also of the view that to leave such issues to the courts without any legislative guidance would be an abdication of responsibility. This was particularly so when it is known that these difficult issues will have to be faced at some stage if the reform is to have any meaningful effect.

(c) Hong Kong

2.43 The Law Reform Commission of Hong Kong also examined reform by means of a general enabling clause.[34] It was felt that while this kind of "broad brush" method had the advantage of being simple to implement, it would be difficult to apply. While such a clause would ensure the removal of the general bar to a third party enforcing rights under a contract, lawyers would still find it very difficult to advise a client on their position until all of the other problems were teased out in the courts. It concluded that such a general approach was not appropriate when dealing with issues as complex as those presented by privity of contract.

(3) Discussion

2.44 All common law jurisdictions that have implemented legislation to create third party rights have opted for a more detailed approach to reform. There is a concern that while a general clause might be easier to enact initially, it does not properly address the complex issues that arise in

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33 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 5.6.

34 Law Reform Commission of Hong Kong *Report on Privity of Contract* September 2005 at paragraph 3.9.

relation to privity. For this reason, it is not likely that the tools of the common law can match the precision that legislation can provide.[35]

2.45 It is the Commission's view that, while a general clause removing the bar to third party enforcement has the advantage of simplicity, it does not adequately deal with the difficulties that arise in practice. If anything, legislation such as the England and Wales *Contracts (Rights of Third Parties) Act 1999* has been criticised for not being detailed enough.[36]

2.46 For these reasons, the Commission believes that a general enabling clause would result in further confusion and complexity in an already perplexing area.

2.47 *The Commission provisionally recommends that reform of the privity rule should not take the form of a general provision enabling a third party to claim the benefit of contractual provisions for the third party's benefit. The Commission provisionally recommends that a more detailed scheme of third party rights is necessary.*

E Legislative reform of the rule of privity to include further exceptions to the rule in specific instances

(1) Introduction

2.48 In Chapter 1 the Commission identified a number of instances where the rule of privity created injustice to the third party, and inconvenience to a large number of commercial actors. The Commission noted how privity can affect each of these different areas in diverse ways. The Commission is concerned that any proposed legislation should in some way address these issues. For this reason, the Commission now turns to consider to what extent reform of privity should only involve the creation of further exceptions to the rule in specific instances.

(2) Comparative analysis

(a) England and Wales

2.49 In its 1996 Report on privity of contract, the Law Commission for England and Wales considered the option of reforming the rule of privity by creating further exceptions in specific instances.[37] They noted that this would have the advantage that particular needs of the parties in particular situations could be directly addressed in detail. There is also the added

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35 Andrews "Strangers to justice no longer: The reversal of the privity rule under the Contracts (Rights of Third Parties) Act 1999" [2001] CLJ 353.

36 Stevens "The Contracts (Rights of Third Parties) Act 1999" (2004) 120 LQR 292.

37 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 5.3.

advantage that there would be little room for debate as to whether or not it was intended that a third party would have enforceable rights in these specific instances.

2.50 However, the Law Commission ultimately rejected the approach as they considered that it ignores the fact that the rule of privity is fundamentally flawed. It was the Law Commission's view that creating further exceptions to the rule within a legislative scheme would result in increasing complexity while leaving unacceptable gaps in a third party's rights. Reform along these lines would achieve positive results in very specific instances, but overall the third party beneficiary would be in no better position than before.

(b) Other common law jurisdictions

2.51 The general consensus among law reform agencies and the legislatures of other common law countries is that introducing further exceptions to the privity rule in specific instances would not achieve the clarity or remove the confusion surrounding privity in its traditional form. The Law Reform Commission of Hong Kong agreed that reform along these lines ignored the underlying anomalies of the rule and that a failure to deal with these anomalies would only lead to further complexity.[38]

2.52 The Manitoba Law Reform Commission was also of the view that this approach to reform would be likely to increase complexity by adding further exceptions to a rule that is fundamentally flawed. It was also noted that it could have the effect of impeding any chance of further judicial reform.[39]

2.53 None of the states where legislation has been introduced have adopted this incremental approach to third party rights.

(3) Discussion

2.54 The Commission is aware that, to date, matters affecting third parties have been dealt with by creating further exceptions in specific instances, for example in sections 7 and 8 of the *Married Women's Status Act 1957;* the *Road Traffic Act 1961*; the *Sale of Goods Act and Supply of Services Act 1980*; and the *Consumer Credit Act 1995*.[40] This method of reform has worked well, in that it has tackled pressing needs in specific instances.

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38 Law Reform Commission of Hong Kong *Report on Privity of Contract* September 2005 at paragraphs 3.4 – 3.6.

39 Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80) October 1993 at p 56.

40 See paragraph 1.27ff, above.

2.55 However, the Commission notes that despite legislative intervention in a variety of different areas there remain injustices and commercial inconvenience and expense arising from the privity rule. The Commission agrees with the views expressed in other common law jurisdictions that the privity rule is flawed.

2.56 Reforming the rule in a piecemeal fashion would lead to increased complexity rather than provide for a straightforward scheme of third party rights. In addition to this, the Commission is mindful of the length of time that would be needed to address the specific problems by means of separate legislative provisions. In addition, the law would need to be kept under constant review, analysing when and how the privity rule continues to affect transactions and the rights of third party beneficiaries.

2.57 To reform the rule in this way would be to ignore the unfairness underlying the privity rule.

2.58 For these reasons, the Commission has concluded that reform of the privity rule cannot be achieved by creating further exceptions to the privity rule in specific instances.

2.59 *The Commission provisionally recommends that reform of the privity rule should not be by means of creating further exceptions to the privity rule in specific instances.*

F Detailed legislation creating comprehensive third party contractual rights

(1) Introduction

2.60 The Commission begins this section by noting that the enactment of detailed legislation creating comprehensive third party rights is the favoured method of reform in the other common law jurisdictions. However, the exact form of the legislation and the aims of such reforms have varied. After consideration of the alternatives the Commission's provisional view is that in order for reform of the privity rule to have any real effect, a detailed scheme of third party rights should be introduced by statute. The Commission's aim in this section is to set out in general terms the different approaches taken in various common law jurisdictions. The detailed content of the reforms will be discussed in further detail in Chapter 3.

(2) Comparative analysis

(a) Australia

(i) Western Australia

2.61 In 1969 Western Australia became the first common law jurisdiction to legislate for third party rights. Section 11(2) of the Western Australian *Property Law Act 1969* provides that:

> "where a contract expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract, the contract is, subject to subsection (3), enforceable by that person in his own name"

2.62 This general clause is followed by provisions limiting the rights of the third party in certain instances. For example, the Act provides that the promisor will be able to avail of all of the defences that would have been available against the promisee in any proceedings brought by a third party beneficiary.[41] The Act also provides that the contract can be cancelled or modified by the parties to the contract up to the time that the third party beneficiary has adopted it, either expressly or impliedly.[42]

2.63 The 1969 Act has been criticised for not going far enough. For example the Contracts and Commercial Law Reform Committee of New Zealand criticised it on a number of grounds:

i) It does not appear to allow a third party which was not in existence at the time the contract was made to enforce any rights.

ii) It appears to allow only those third parties named in the contract to benefit. The New Zealand Committee was concerned that this was too restrictive as class descriptions are common in contracts.

iii) It seems to exclude implied terms in favour of third parties.

iv) The requirement that each person named as a party has to be joined to the proceedings is overly restrictive.

v) It does not seem to require that the contracting parties ought to have had the intention to create legal obligations as regards the third party.[43]

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41 Section 11(2)(a) *Property Law Act 1969.*

42 *Ibid* at section 11(3).

43 New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981) at 49 – 50.

2.64 This reaction is indicative of the calls for a detailed scheme of accessible third party rights based on the intentions of the contracting parties.

(ii) Queensland

2.65 The reform in Western Australia was followed in Queensland by the *Property Law Act 1974.* The 1974 Act is more detailed than the Western Australia Act. Section 55(1) states that:

> "A promisor who, for a valuable consideration moving from the promisee, promises to do or to refrain from doing an act or acts for the benefit of a beneficiary shall, upon acceptance by the beneficiary, be subject to a duty enforceable by the beneficiary to perform that promise."

2.66 The Act also allows the contracting parties to vary or discharge the contract until the third party beneficiary accepts them.[44] Upon acceptance of the benefits in the contract, the beneficiary is entitled to remedies and relief in their own right against the promisor.[45] Furthermore upon acceptance of the benefits in the promise, the beneficiary is bound by the promise and subject to a duty enforceable against them.[46] Any defences that would have been available to the promisor in an action by a promisee can be raised against the beneficiary in a like manner.[47]

2.67 The legislation in Queensland does not require that the contract expressly purport to benefit the third party. Nor is there an obligation to join all parties to the proceedings. The New Zealand Contracts and Commercial Law Reform Committee had difficulty with the definition of "acceptance" and lack of provision for the third party beneficiary in respect of deeds and other covenants.

(iii) The Northern Territory

2.68 In the Northern Territory, section 56 of the *Law of Property Act 2000* emulates the provisions of the Queensland *Property Law Act 1974*.

(b) New Zealand

2.69 With the benefit of the experience in the Australian States, the *Contracts (Privity) Act 1982* was enacted in New Zealand following the recommendations of the 1981 Report of the New Zealand Contracts and

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44 Section 55(2) *Property Law Act 1974*

45 Section 55 (3)(a).

46 Section 55 (3)(b).

47 Section 55 (4).

Commercial Law Reform Committee.[48] After a review of the existing law on third parties, the Committee recommended that the privity rule should be amended, as they had "looked in vain for a solid basis of policy justifying the frustration of contractual intentions".

2.70 The New Zealand *Contracts (Privity) Act 1982* is more detailed again than its counterparts in Australia. Section 4 of the Act provides that:

> "Where a promise contained in a deed or contract confers, or purports to confer, a benefit on a person, designated by name, description, or reference to a class, who is not a party to the deed or contract (whether or not the person is in existence at the time when the deed or contract is made), the promisor shall be under an obligation, enforceable at the suit of that person, to perform that promise:
>
> Provided that this section shall not apply to a promise which, on the proper construction of the deed or contract, is not intended to create, in respect of the benefit, an obligation enforceable at the suit of that person."

2.71 The Act thus lays particular emphasis on the intentions of the parties. The intention has two elements: the parties must have intended to benefit the third party, but also they must have had the intention to create enforceable rights in that third party.

2.72 The Act also provides for the circumstances in which the contract may be varied or altered.[49] It does not prevent the parties from making express provision in the contract for their rights to vary the contract at any time.[50] Furthermore the court is given the power to authorise variation or discharge in certain circumstances.[51] The Act also provides that the promisor will have any defence that would normally have been available to them in any proceedings.[52]

2.73 The detailed provisions of the Act will be examined in Chapter 3. But it is worth noting at this point the comments of the New Zealand Law

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48 New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981)

49 Section 5 *Contracts (Privity) Act 1982.*

50 Section 6.

51 Section 7.

52 Section 9.

Commission who in 1993, over 10 years after its enactment, said that no serious problems posed by the terms of the Act had yet come to light.[53]

(c) Canada

2.74 The Commission has already highlighted the important role that the Canadian courts had in the development of third party rights in Canada.[54] In addition, a number of Canadian provinces have legislated to create a more comprehensive scheme of third party rights. This indicates the advantages of having a detailed scheme of third party rights.

(i) New Brunswick

2.75 Section 4 of the New Brunswick *Law Reform Act 1993*, which deals with privity of contract, is less detailed than the New Zealand 1982 Act. It provides that:

> "A person who is not a party to a contract but who is identified by or under the contract as being intended to receive some performance or forbearance under it may, unless the contract provides otherwise, enforce that performance or forbearance by a claim for damages or otherwise."

2.76 The section goes on to provide that any defence may be raised that could have been raised in proceedings between the parties.[55] It also provides that the contracting parties can amend or terminate the contract at any time, but that if by doing so they cause loss to the third party beneficiary they are liable for that loss.[56]

2.77 The Act could be criticised for not making clear what the test of enforceability ought to be. Nor does it deal with the questions of the third party's existing rights under common law or statute. At best the Act could be said to give a third party a statutory right of enforcement, but the New Brunswick legislature have left the finer details to be worked out in the caselaw. It can be compared with the legislation in Western Australia in this regard.

(ii) Québec

2.78 The Québec Civil Code was amended in 1991 to provide for a more detailed scheme of third party rights. Although Québec law has its origins in the civil law tradition, the move from a general enabling clause in

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53 New Zealand Law Commission *Contract Statutes Review* (Report No 25, 1993) at 228.

54 See paragraph 2.10, above.

55 Section 4(2) *Law Reform Act 1993.*

56 *Ibid* at section 4(3).

the original Code to a more detailed approach is suggestive of the trend towards detailed statutory rights for third parties. Article 1444 of the Civil Code provides that:

> "A person may make a stipulation in a contract for the benefit of a third person.
>
> The stipulation gives the third person beneficiary the right to exact performance of the promised obligation directly from the promisor."

2.79 The Code states that the third party beneficiary need not be in existence at the time the contract was concluded.[57] The parties to the contract may revoke the stipulation in favour of the third party as long as the third party beneficiary has not advised the stipulator of his will to accept it.[58] The Code also makes provision for stipulations in wills and states that third party beneficiaries and their heirs may validly accept the stipulation even after the death of the promisor.[59] The Code also provides that the promisor may invoke any of the defences that would have been available to him/her should the action have been brought by a party to the contract.[60]

(iii) Manitoba

2.80 The Law Reform Commission of Manitoba attached a draft Bill to their 1993 proposals for reform of the rule of privity.[61] The Bill sets out a detailed scheme of third party rights. Section 3(1) of the Draft Bill provides that:

> "where a promise contained in a contract confers or purports to confer a benefit on a person who is not a party to the contract (whether or not the person is in existence at the time the contract is made), the promisor shall be under an obligation to perform that promise."

Section 4 of the Draft Act goes further and states that:

> "the obligation imposed on a promisor… shall be enforceable by the beneficiary as if he or she were a party to the contract and relief in respect of the promise shall not be refused on the ground that the beneficiary was not a party to the contract."

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57 Article 1445.

58 Article 1446.

59 Article 1449.

60 Article 1450.

61 Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80) October 1993.

2.81 The Manitoba Law Reform Commission's Draft Act also provides that it must have been the intention of the contracting parties to create enforceable obligations in respect of the benefit.[62] The Law Reform Commission recommended that detailed legislation be introduced outlining the rights of the parties to vary or cancel the terms of the contract; the power of the courts to vary or cancel the terms of the contract and the defences available to the promisor. Furthermore they recommended that the draft Act should be just one method available to the third party beneficiary to enforce their rights. As such they recommended that any existing rights or rights that might develop over time should not be affected.

(d) United States of America

2.82 As was seen above in relation to the judicial development of third party rights, there has been a third party beneficiary rule in place in the United States since the mid 19th century.[63] The law in this respect was authoritatively summarised in the American Law Institute's *Restatement (Second) of Contracts* in 1981. The Restatement recognises the power of the promisor and promisee to create enforceable rights in a beneficiary, by manifesting an intention to do so. Paragraph 304 is the central provision in relation to third parties. It provides that:

> "A promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise and the intended beneficiary may enforce the duty."

2.83 The Restatement deals with most of the issues affecting third party rights. It defines "beneficiary" by dividing potential beneficiaries into 2 categories: intended and incidental. Only intended beneficiaries have enforceable rights.[64] It deals with issues such as overlapping duties to the beneficiary and the promisee.[65] And the defences available to the promisor are laid down,[66] as are the rights of the parties to vary or cancel the contract.[67]

2.84 The Restatements do not of course have the force of law, but they have been cited in some courts as reflecting the law and have formed the basis for statutory reform in a number of States.

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62 Section 3(2).

63 See paragraph 2.04.

64 *Restatement (Second) of Contracts* Section 302.

65 Section 305.

66 Section 309.

67 Section 311.

(e) England and Wales

2.85 The *Contracts (Rights of Third Parties) Act 1999* was introduced following the recommendations of the Law Commission in their 1996 Report on privity of contract.[68] The 1999 Act brought to a close a long line of recommendations for reform, dating back to a report of the Law Revision Committee in 1937 which had recommended that the law in relation to third party rights should be reformed in order to frame a rule that would be more easily understood.[69]

2.86 The Law Commission's 1996 Report recommended reform by means of detailed legislation as to do so would introduce certainty to a complex and confusing area of law. They commented that detailed legislation would allow the legislature to provide for such matters as the contractual provisions that are enforceable by third parties, the rights of third parties to vary or discharge the contract, and the promisor's defences.[70] They concluded that detailed legislation could address all of the issues raised in the 1991 Consultation Paper[71] and the 1996 Report in a manner not open to the judiciary.[72]

2.87 Section 1 of the 1999 Act provides that:

> "(1) Subject to the provisions of this Act, a person who is not a party to a contract (a "third party") may in his own right enforce a term of the contract if –
>
> (a) the contract expressly provides that he may, or
>
> (b) subject to subsection (2), the term purports to confer a benefit on him.
>
> (2) Subsection 1(b) does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party."

2.88 This general enabling clause is followed by provisions allowing for a broad definition of a third party. It allows a third party who is identified

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68 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996).

69 Law Revision Committee Sixth Interim Report *Statute of Frauds and the Rule of Consideration* (1937) Cmd 5449.

70 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 5.7.

71 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Consultation Paper No 121) 1991.

72 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 5.8.

expressly in the contract by name, as a member of a class, or answering a particular description to enforce the terms.[73] It deals specifically with the third party's right to enforce an exemption clause in their favour.[74] The Act deals with the defences available to the promisor[75], and allows the parties to vary or cancel the contract up until the time that the third parties' rights have crystallised.[76] The Act expressly lays out the exceptions to the general rule,[77] and deals with arbitration clauses.[78] The Act expressly states that it shall not affect any of the existing exceptions available to the third party beneficiary.[79]

2.89 Reaction to the 1999 Act has in general been positive, with most commentators seeing its enactment as inevitable because England and Wales were one of the few remaining common law jurisdictions that had yet to create a system of general third party rights. Commentators have also welcomed the approach to third party beneficiaries by means of a detailed legislative scheme as such a method achieves the precision that "the tools of the common law cannot match".[80]

2.90 The Act has also been welcomed because not only does it provide precision and clarity on third party rights, it also allows the contracting parties to maintain their contractual freedom. The general approach means that the "largesse of the gift is entirely dependent upon the contracting parties".[81] Since its enactment, the law reform bodies in at least two other jurisdictions have based their proposals for reform on the 1999 Act.[82]

2.91 The detailed nature of the rights conferred by the 1999 Act will be discussed in Chapter 3.

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73 Section 1(3) *Contracts (Rights of Third Parties) Act 1999*.

74 Section 1(6).

75 Section 3.

76 Section 2.

77 Section 6.

78 Section 8.

79 Section 7(1).

80 Andrews "Strangers to justice no longer: The reversal of the privity rule under the Contracts (Rights of Third Parties Act) 1999" [2001] CLJ 353 at 355.

81 MacMillan "A birthday present for Lord Denning: The Contracts (Rights of Third Parties) Act 1999" (2000) 63 MLR 721.

82 See the Singapore *Contracts (Rights of Third Parties) Act 2001* and the Law Reform Commission of Hong Kong *Report on Privity of Contract* (September 2005).

(3) Discussion

2.92 The Commission is aware that the complexities and problems associated with the privity rule will mean that any reform proposals require careful thought. However, in this respect, the Commission's review leads us to the conclusion that it is appropriate to recommend the enactment of detailed legislation conferring rights on third parties. While there may be shortcomings with some of the legislation that has been introduced in other jurisdictions, these can be addressed in the Irish context through the enactment of detailed legislation. Ireland now remains in the very small minority of common law jurisdictions that have not limited the privity rule in some way. It is the Commission's view that in light of the experience of other jurisdictions, and the nature of the law in relation to third parties, reform by means of detailed legislation is an appropriate option, and therefore provisionally recommends this approach.

2.93 *The Commission provisionally recommends that the privity of contract rule should be reformed by means of detailed legislation.*

G Existing exceptions to the rule of privity

(1) Introduction

2.94 It is crucial to consider the continuing role, if any, of the existing exceptions, in light of any reform introduced. These exceptions, set out in Chapter 1, were introduced to remedy specific unfair or inconvenient results arising from the application of the privity rule. Reform of the rule in its entirety could negate the need for these exceptions. One option is to amalgamate the existing exceptions under one all-encompassing scheme of third party rights. Another option is to maintain existing exceptions alongside any proposed general reform. This would have the potential effect of offering dual protection to the third party beneficiary.

2.95 The Commission emphasises that, at the centre of any proposed reform, there must be clear and easily accessible rights available to third party beneficiaries. The object of reform is clarification and correction of injustice. It is the Commission's view that the issue of existing exceptions and how these will interact with a new scheme of third party rights is one that could test the overall effectiveness of the reform.

(2) Comparative analysis

(a) Australia

2.96 The Western Australian *Property Law Act 1969* is silent as to the existing exceptions. It can be assumed that the Act does not alter the third party rights available outside of the remits of that Act.

2.97 In Queensland, section 55(7) of the *Property Law Act 1974* provides explicitly that:

> "Nothing in this section affects any right or remedy which exists or is available apart from this section"

Section 56(7) of the Northern Territory *Law of Property Act 2000* is to the same effect. These provisions allow the courts the freedom to apply the existing exceptions to the rule of privity where to do so would be in the best interests of all involved. By keeping the existing exceptions in place, practitioners are allowed the time to adapt practices and advise clients on the best way to afford third parties enforceable rights.

(b) New Zealand

2.98 Section 14 of the *Contracts (Privity) Act 1982* states:

> "Subject to section 13 of this Act, nothing in this Act limits or affects—
>
> (a)Any right or remedy which exists or is available apart from this Act; or
>
> (b)The Contracts Enforcement Act 1956 or any other enactment that requires any contract to be in writing or to be evidenced by writing; or
>
> (c)Section 49A of the Property Law Act 1952; or
>
> (d)The law of agency; or
>
> (e)The law of trusts."

2.99 The section is more detailed than those in Australia, listing some of the existing exceptions to the rule of privity.

(c) England and Wales

2.100 Section 7(1) of the *Contracts (Rights of Third Parties) Act 1999* provides that:

> "Section 1 does not affect any right or remedy of a third party that exists or is available apart from this Act"

2.101 In its 1996 Report, the Law Commission for England and Wales was of the view that the existing statutory exceptions to the rule of privity should be preserved. They concluded that this could be achieved by enacting a general provision rather than a more elaborate statutory listing. They came to the same conclusion in relation to the common law exceptions. It was the view of the Law Commission that there was no merit in attempting to abolish the common law exceptions, particularly as some of these exceptions would give a third party more secure rights than those

envisaged by the 1999 Act.[83] Similarly, it recommended that the common law exceptions should not be codified or listed. To do so would deprive the judiciary of flexibility in the development of the law.

(d) Singapore

2.102 The *Contracts (Rights of Third Parties) Act 2001* was enacted following the recommendations of the Law Reform and Revision Division of the Attorney General's Chambers in Singapore.[84] Section 8(1) of the Act provides that:

> "Section 2 shall not affect any right or remedy of a third party that exists or is available apart from this Act."

(e) Hong Kong

2.103 The Law Reform Commission of Hong Kong published a report on privity of contract in 2005. It recommended that nothing in the Commission's proposed legislation should affect any right or remedy of a third party that exists or is available apart from the recommended legislation.[85]

(3) Discussion

2.104 It can be seen from this comparative analysis that most jurisdictions, in one form or another, have elected to allow their new legislation to co-exist with the general principles of common law and statutory provisions relating to third party rights.

2.105 Treitel, while welcoming the reform of the law in England and Wales in relation to privity of contract, has doubts as to whether the stated aims of clarity and comprehension are achieved by the approach taken in relation to these exceptions in England and Wales. He says: "the 1999 Act may have improved, but it has scarcely simplified, the law on this topic".[86]

2.106 In particular Treitel highlights the problems that could potentially arise from the complex structure of the 1999 Act (and similar provisions in other jurisdictions) in relation to these existing exceptions. He contrasts four different situations which could arise.

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83 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 12.1.

84 Law Reform and Revision Division of the Attorney General's Chambers in Singapore *The Contracts (Rights of Third Parties) Bill 2001* (LRRD No 2/2001).

85 The Law Reform Commission of Hong Kong *Report on Privity of Contract* (September 2005) at paragraph 4.168.

86 Treitel *The Law of Contract* (11th ed Sweet & Maxwell 2003) at 581.

First, where the third party acquires rights under the Act but not under the common law as they do not fall under any of the existing exceptions, the third party takes the rights subject to the provisions of the Act. Such provisions include the contracting parties' right to vary the contract and the defences available to the promisor against the third party, as these sections only apply to rights that have accrued by virtue of section 1 of the Act.

Second, where the third party acquires no rights under the Act but does acquire rights under one of the existing exceptions, the third party's rights are clearly not subject to the provisions of the Act.

Third, where the third party acquires rights under both the Act and under one or more of the existing exceptions, it seems that the third party can choose between making a claim under the Act or under the existing exception.

Fourth, where the third party acquires no rights under either the Act or the existing exceptions, the third party is no better off than before, and must rely on the court to create a new exception to the rule of privity.[87]

2.107 The law has thus been left in a somewhat confused state, with several different options available to the third party. The third scenario has particular potential for difficulty. If an action is brought under the Act, the promisor may avail of the defences, set off and counterclaims available to them. If an action is brought under an existing statutory or common law exception, a quite different set of rules apply.

2.108 There is a danger that adding a major statutory change to a well established regime dealing with third party rights will generate more uncertainty than is removed, especially if the old rules are kept in place.[88] By choosing not to deal with the existing exceptions and their role within any new scheme, there could be the danger of litigants picking and choosing when and how to enforce rights, adding to the complexity involved.

2.109 The Commission considers, however, that a review of the existing rules, particularly the statutory regimes, might be better left to a general consideration of the law in their respective subjects. The Law Commission for England and Wales envisaged that at least some of the existing exceptions would become redundant once the 1999 Act came into force, but this remains to be seen.[89]

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87 See Treitel *The Law of Contract* (11th ed Sweet & Maxwell 2003) at 663.

88 Stevens "The Contracts (Rights of Third Parties) Act 1999" (2004) 120 LQR 292, at 306.

89 See Tettenborn "Third party contracts – pragmatism from the Law Commission" (1996) JBL 602.

2.110 In the Irish context, the Commission considers that some of the existing statutory provisions could be superseded by reform of the privity rule along the lines of the 1999 Act, for example, sections 7 and 8 of the *Married Women's Status Act 1957*, which allow the surviving spouse or children to enforce the benefits owed to them under contract or a life insurance policy. A similar view applies to section 80 of the *Consumer Credit Act 1995*, which allows for a remedy against both the seller and the hire purchase company in the event of a breach of the hire purchase agreement, and section 14 of the *Sale of Goods and Supply of Services Act 1980*, which provides that the finance party becomes a party to the sale of goods to consumer so that the end result is that the finance house and the seller are joint and severally answerable to the buyer.

2.111 The Commission considers that provisions such as these may become redundant if new legislation is introduced allowing for a general third party right of enforcement. As a result of the analysis of the approaches in other jurisdictions, the Commission considers that there are three main options available to deal with the current statutory and common law exceptions.

(a) The legislation could contain a codification of the existing common law exceptions and a listing of the statutory exceptions

2.112 A codification of existing common law exceptions and a listing of the statutory exceptions would have the advantage of clarity in that all of the third party beneficiary's rights of enforcement will be contained in a single document. The interplay of the existing rules with the proposed reform could be set out clearly and the provisions of the reforming legislation would clearly apply to all equally. The reforming legislation could be used as a method of clarifying and simplifying the law in certain areas. For example, the law of assignment is currently in a very complex state, with rules of common law and equity overlapping with statute. To lay down these rules in a statute on third party rights could be extremely beneficial.

2.113 Likewise in relation to the current statutory provisions, it may be appropriate to decide what relationship they would have with a new regime. It could be decided from the outset which methods of allowing third party rights most fits the underlying policy behind the third party right and make clear which set of rules would apply.

2.114 The disadvantage of such an approach is that the resulting legislation may become quite long and complex. It is the Commission's view that the aim of reform of the privity rule is to remove the injustice and the complexity associated with it. The underlying basis for granting third party rights is to give effect to the intentions of the contracting parties. In other jurisdictions it was felt that simplicity was the key, and they could see no merit in attempting to abolish the common law exceptions, or repeal

statutory exceptions, as some of these give third parties more secure rights than would be given by any proposed reform.[90]

(b) A general clause could be introduced preserving the existing exceptions and providing that third parties will not be denied remedies already available to them

2.115 The option favoured by most law reform bodies was the introduction of a general clause stating that the new regime of third party rights was without prejudice to the existing rights and remedies available. The advantage of this approach is that, rather than seeking to abolish common law and statutory rights that have operated for centuries in many cases, the exceptions considered to be artificial and overly complex will fall into disuse and will eventually become redundant. It is not necessary for the legislation to predict what will happen eventually and over time, a task which would be extremely difficult given the vague and changing nature of some of the existing exceptions.

(c) The legislation could be silent as to the existing exceptions, leaving the courts the flexibility fashion how they will interplay with new legislation.

2.116 An approach which is silent as to the effect on the existing exceptions, while it would allow the courts the flexibility to develop the area on a case by case basis, ignores the fundamental basis and policy reasoning behind the reform of the privity rule. The Commission considers that at the heart of reform must be simplicity, clarity and accessibility. Avoiding the issue of existing exceptions would not achieve this result.

(d) Conclusion

2.117 The Commission considers that the issue of the existing rules and remedies available to third party rights will be a crucial one if the proposed reform is to have its intended effect. The Commission is mindful that a comprehensive treatment of these exceptions in the proposed legislation will be a complex task. Of course, the Commission is aware that the issues will need to be addressed at some stage following the enactment of reform and therefore should not be ignored. Certainly the relationship with the new reform and existing legislation ought to be examined. For the purposes of this Consultation Paper the Commission provisionally recommends that a general clause should be introduced which would preserve the existing exceptions and that third parties will not be denied existing remedies available to them. Nonetheless, the Commission also sees merit in a codification of the existing common law and statutory exceptions. The

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[90] Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 12.1.

Commission is aware that this approach would affect numerous interests, and invites submissions on this issue.

2.118 *The Commission provisionally recommends that a general clause should be included in the legislation which would preserve the existing exceptions to the privity rule and provide that third parties will not be denied existing remedies available to them. The Commission also invites submissions on whether the proposed legislation should include a comprehensive codification of the existing common law and statutory exceptions to the privity rule.*

CHAPTER 3 SPECIFIC ISSUES

A Introduction

3.01 In Chapter 2 the Commission provisionally recommended that reform of the privity rule should take the form of detailed legislation. In this Chapter the Commission examines the specific issues that must be addressed in order to formulate a comprehensive scheme of third party rights.

3.02 The Commission is conscious of the need for clarity on the circumstances in which a third party will be entitled to enforceable rights. The reforms choices to be made must reflect the actual injustices and inconveniences caused by the privity rule.

3.03 In Part B, the Commission outlines the circumstances in which a third party can enforce their rights under a contract. In Part C, the Commission examines how the third party is to be identified. In Part D, the rights of the parties to vary or cancel the contract is explored. In Parts E and F, the rights of the promisor and promisee, and their effect on third parties, are discussed. In Part G the Commission examines whether certain types of contracts should be excluded from any reforming legislation.

B When can the third party enforce their rights under a contract?

(1) Introduction

3.04 The Commission considers that the question of the circumstances under which the third party can enforce their rights under a contract is clearly of central importance. While this Consultation Paper proposes to reform the privity rule so that contracts made for the benefit of a third party are enforceable by the third party, it is equally clear that it would not be appropriate if all third parties had enforceable rights.

3.05 To give an example, a contract between the Department of Education and a developer to build a school would clearly benefit the students who will attend the school once it is finished. It is another matter to say that the students could sue the developers if there was an inordinate delay in completing the school. Clearly there must be limits to when and how a contract can be enforced by a third party, and, in general, any test of enforceability will be based on the intentions of the parties to the contract.

However, the extent to which reliance can be placed on the parties' intentions will be relative to the underlying policy of enabling a third party to enforce their rights under a contract.

3.06 The Commission now proceeds to discuss this issue from a comparative point of view.

(2) Comparative Analysis

(a) Western Australia

3.07 Section 11(2) of the Western Australia *Property Law Act 1969* states simply that where a contract "expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract the contract is… enforceable by that person in his own name".

3.08 The Western Australian *Property Law Act 1969* does not clearly express the necessity of the parties to have intended that the third party should have enforceable rights, but merely states that they most have intended to confer a benefit on the third party.[1]

(b) Queensland

3.09 Section 55(6) of the *Property Law Act 1974* defines "promise" as:

> " a promise –
>
> (a) which is or appears to be intended to be legally binding; and
>
> (b) which creates or appears to be intended to create a duty enforceable by a beneficiary;"

3.10 This creates a dual intention test which first requires that the promise is in general intended to be legally binding, and second that it must have been intended to be enforceable by the third party beneficiary. In this way, the parties remain in control of their transactions. While the Act lays greater emphasis on the dual intentions of the contracting parties, it does not require that the intention to benefit be expressly stated in the contract. Thus such an intention may be implied from the terms of the contract.

(c) New Zealand

3.11 The New Zealand Contracts and Commercial Law Reform Committee emphasised that the kind of promise that is enforceable is one of the most important issues in any review of the privity rule. They were also

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[1] See the comment of Mason CJ and Wilson J in the High Court of Australia in *Trident General Insurance Co Ltd v McNiece Brothers Ltd* (1988) 165 CLR 107, at paragraph 30.

of the opinion that the Australian legislation mentioned above left unclear the nature of the benefit which can be enforced. [2]

3.12 The Committee was of the view that the intention of the parties, ascertained by the normal rules of interpreting contractual language should have the decisive effect in determining whether the third party would have enforceable rights. They therefore recommended that reform should relate to those terms of the contract that, correctly interpreted, were intended by the parties to benefit the third party, and to be enforceable by the third party.[3] Thus section 4 of the New Zealand *Contracts (Privity) Act 1982* contains the proviso that a contract that purports to confer a benefit on a third party will be enforceable by that third party:

> "Provided that this section shall not apply to a promise which, on the proper construction of the deed or contract, is not intended to create, in respect of the benefit, an obligation enforceable at the suit of that person."

3.13 The 1982 Act thus applies to promises to confer benefits on sufficiently designated third parties, whether or not the parties intended that they be enforceable, but with the proviso allowing the contracting parties to show that the beneficiary was not intended to have an action.[4] The decision in *Waikato Regional Airport Ltd v Attorney General*[5] shows how the proviso operates in practice. The Ministry of Agriculture and Forestry was named as a third party beneficiary of a promise from South Pacific Air Charters Ltd that they were prepared to pay for border control services. However, on examination of the facts, the New Zealand High Court upheld Smith Pacific's defence that they had never intended the promise to have the effect that the Ministry could recover directly from them. Similarly, in *Saunders & Co v Bank of New Zealand*[6] the New Zealand High Court decided that the statutory appointment by the District Law Society of a solicitor to investigate the affairs of a law firm was a regulatory matter and did not confer a benefit on the law firm. However, even if the contract had conferred a benefit on the law firm, the proviso in section 4 would have applied, as on the proper construction of the contract, it was not intended that the contract would be legally enforceable by the law firm.[7]

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2 New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981) at 54.

3 *Ibid* at 55.

4 Law Commission of New Zealand *Contract Statutes Review* (Report No 25) at 219.

5 [2001] 2 NZLR 670.

6 [2002] 2 NZLR 270.

7 *Ibid* at paragraph 21.

3.14 Another aspect of section 4 of the 1982 Act is that the promise must be contained in a deed or a contract between the promisor and promisee. For example, in *Morton-Jones v RB & JR Knight Ltd*[8] it was held that a solicitor's letter purporting to designate a third party as the beneficiary of an existing agreement was not covered by the 1982 Act.

3.15 Thus it can be seen that the formula used in section 4 of the 1982 Act, based on the intentions of the parties, can be used to prevent a third party from maintaining an action on that contract. In this way the autonomy of the parties is maintained.

(d) United States

3.16 Section 304 of the American Law Institute's *Restatement (Second) of Contracts* provides that:

> "a promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise and the intended beneficiary may enforce the duty"

This view of third party rights is based on the categorisation of beneficiaries into two groups: intended beneficiaries and incidental beneficiaries. Section 302 of the Restatement defines these as follows:

> "(1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intentions of the parties and either
>
> > (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or
> >
> > (b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.
>
> (2) An incidental beneficiary is a beneficiary who is not an intended beneficiary."

3.17 Under this analysis, the granting of enforceable rights to a third party is entirely dependent on the intentions of the contracting parties. The third party will have enforceable rights where it was intended that the contract would benefit them. Where this analysis has been used, the courts have applied a direct benefit test, which means that they insist on proof of

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8 [1992] 3 NZLR 582.

the contracting parties' intention to confer a benefit directly on the third party.[9]

3.18 In *Chancellor Manor v United States*[10] the United States Federal Court of Appeals stated that:

> "in order to prove third-party beneficiary status, Appellants must demonstrate that the contract not only reflects an express or implied intention to benefit the party, but that it reflects an intent to benefit the party directly…This direct benefit requirement reflects the reality that third-party beneficiary status is an 'exceptional privilege.'"[11]

3.19 This analysis places considerable emphasis on a clearly-stated intention by the parties to benefit third parties.

(e) Canada

3.20 As already discussed,[12] the courts in Canada have developed a "principled exception" approach to the rule of privity. This was first formulated in *London Drugs Ltd v Kuehne & Nagel International Ltd*[13] and later developed in *Fraser River Pile & Dredge Ltd v Can-Dive Services Ltd*,[14] and is also based upon the intentions of the contracting parties. The principled exception approach involves two elements:

i) Did the parties to the contract intend to extend the benefit in question to the third party seeking to rely on the contractual provision? and

ii) Are the activities performed by the third party seeking to rely on the contractual provision the very activities contemplated as coming within the scope of the contract in general, or the provision in particular, again as determined by reference to the intentions of the parties?[15]

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9 De Cruz "Privity in America: a study in judicial and statutory innovation" (1985) 14 Anglo-American L Rev 265 at 275.

10 (2003) 331 F.3d 891 (Fed. Cir. 2003).

11 (2003) 331 F.3d 891 at 901.

12 See paragraph 2.10ff, above.

13 [1992] 3 SCR 299.

14 [1999] 3 SCR 108.

15 *Ibid* at 126.

3.21 The Manitoba Law Reform Commission[16] also recommended a dual intention test that would require both an intention to benefit and the normal contractual requirement of an intention to create an enforceable right. They were of the opinion that to simply require an intention to benefit, or an expressed intention in favour of a third party, was too broad in scope and could lead to situations in which "incidental" beneficiaries would get enforceable rights where this was not the intention of the parties.

(f) England and Wales

3.22 The *Contract (Rights of Third Parties) Act 1999* adopted the dual intention test recommended by the Law Commission for England and Wales in their 1996 Report.[17] Section 1 of the 1999 Act provides:

> "(1) subject to the provisions of this Act, a person who is not a party to a contract (a "third party") may in his own right enforce a term in the contract if –
>
> (a) the contract expressly provides that he may or
>
> (b) subject to subsection (2), the term purports to confer a benefit on him.
>
> (2) Subsection 1(b) does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party."[18]

3.23 The Law Commission analysed the test of enforceability in terms of two separate and distinct limbs. The first limb would be satisfied with the use of words such as "and C shall have the right to enforce the contract". It also includes exclusion or limitation of liability clauses, as the Law Commission felt that such clauses had no legal meaning unless they were intended to affect legal rights. The Law Commission was of the view that where a third party is expressly designated as a person whose liability is excluded, this third party should be able to rely on the exclusion clause in their own right.[19]

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16 Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80) 1993 at 58-59.

17 Law Commission for England and Wales *Report on Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraphs 7.1ff.

18 It should be noted that the text of the Act differs slightly from the Draft Bill annexed to the Report by the Law Commission. The 1999 Act provides that a term in a contract can be enforced by a third party beneficiary, while the Draft Bill had provided for the enforcement of the contract itself.

19 Law Commission for England and Wales *Report on Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 7.10.

3.24 The second limb of the test of enforceability is designed to deal with situations where the parties do not expressly state that they are conferring legal rights on a third party. The Law Commission described it in the following manner:

> "In general terms it establishes a rebuttable presumption in favour of there being a third party right where a contractual provision purports to confer a benefit on an expressly designated third party. But that presumption is rebutted where on the proper construction of the contract the parties did not intend to confer a right of enforceability on the third party."[20]

The provision is similar to the test of enforceability in the New Zealand *Contracts (Privity) Act 1982.*

3.25 Therefore the second limb of the test of enforceability is not dependent on the contracting parties expressly giving the third party a right of action. It instead renders a term that "purports to confer a benefit" enforceable. However, section 1(2) of the 1999 Act allows this presumption to be rebutted where it can be shown that, on the correct interpretation of the contract, the parties actually did not intend the term to have this effect. The 1999 Act does not specify where the onus of proof lies, but the Law Commission stated that the onus is on the person who contends that the parties did not have that intention, so doubts as to the parties' intentions will be resolved in the third party's favour.[21]

3.26 In *Nisshin Shipping Co Ltd v Cleaves & Co Ltd*[22] an arbitration clause in a charterparty was neutral as to whether the parties had intended it to be enforceable by the third party. There was no expression to the contrary contained in the document, and as there is a strong presumption in favour of enforcement of rights, it was held that the third party was entitled to enforce the arbitration clause. In *Laemthong International Lines Co Ltd v Artis*[23] clause 1 of an indemnity, given by the receiver of cargo to the charterers, referred to indemnifying the charterers' "servants and agents", and Clause 3 referred to security being provided to the vessel owners. It was decided that the owner came within the definition of agents. As the security was deemed to be primarily of benefit to the owners, the contract was one that purported to benefit the owners (third parties) within the meaning of the 1999 Act and they were entitled to enforce the indemnity.

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20 Law Commission for England and Wales *Report on Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 7.17.

21 *Ibid* at paragraph 7.18.

22 [2004] 1 All ER (Comm) 481.

23 [2005] 2 All ER (Comm) 167.

3.27 A potential difficulty with the second limb of enforcement, and section 1(2) of the 1999 Act on the rebuttal of the presumption, is that while the Law Commission's proposals advocate a subjective test of what the parties intended should be the outcome of their agreement, ordinarily, courts will try to establish the contracting parties' intention, as expressed in the language used in the contract itself.[24] The use of the words "on a proper construction of the contract" in the 1999 Act indicates that the court will use ordinary rules of construction in order to gauge the intentions of the parties.

3.28 In *National Bank of Sharjah v Dellborg*[25] Saville LJ in the English Court of Appeal highlighted difficulties with both the subjective and objective approaches to interpreting contracts for the benefit of third parties:

> "[Third parties] are unlikely in the nature of things to be aware of the surrounding circumstances. Where the words of the agreement have only one meaning, and that meaning is not self evidently nonsensical, is the third party justified in taking that to be the agreement that was made, or unable to rely on the words used without examining (which it is likely to be difficult or impossible for third parties to do) all the surrounding circumstances? If the former is the case, the law would have to treat the agreement as meaning one thing to the parties and another to third parties, hardly a satisfactory state of affairs. If the latter is the case, then unless third parties can discover all the surrounding circumstances and are satisfied that they make no difference, they cannot safely proceed to act on the basis of what the agreement actually says. This again would seem to be highly unsatisfactory."[26]

3.29 It is the Commission's view that in the interests of fairness, the appropriate test ought to be an objective one. In this way, the contracting parties will not be able to produce evidence of surrounding circumstances to show that they did not intend the meaning that the ordinary interpretation of the words of the contract would indicate. This is important because the third party may have no knowledge of these surrounding circumstances.

3.30 The Commission considers that this issue should be dealt with in a clear way in any reforming legislation.

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24 See Roe "Contractual Intention under Section 1(1)(b) and 1(2) of the Contracts (Rights of Third Parties) Act 1999" (2000) 65 MLR 887 at 888.

25 Unreported 9 July 1997, at paragraph 25. Cited in Roe "Contractual Intention under Section 1(1)(b) and 1(2) of the Contracts (Rights of Third Parties) Act 1999" (2000) 65 MLR 887 at 891.

26 Unreported Court of Appeal 9 July 1997 at paragraph 25, also cited in Roe "Contractual Intention under Section 1(1)(b) and 1(2) of the Contracts (Rights of Third Parties) Act 1999" (2000) 65 MLR 887 at 891.

3.31 Burrows, who was involved in the Law Commission's 1996 Report on privity of contract, mentions some of the justifications for the inclusion of the second limb of enforceability in the 1999 Act.[27] The first is that contractual rights between two parties are not merely a matter of express rights, they also include implied rights through the concept of implied terms. Just as normal contract law would be unduly restricted by ignoring these implied terms, third party rights would suffer the same artificial confinement. The parties to a contract may not express all of their intentions for the contract in words, but that is not to say that they did not intend a certain outcome.

3.32 Secondly, Burrows states that examination of the cases where privity had caused problems indicates that reform which was confined to contracts which expressly confer rights on a third party would not remedy the problems. He refers to *Beswick v Beswick*[28] where although it was obvious that the agreement entered into was designed to benefit the widow through the payment of an annuity, there was no express right of enforcement contained in the contract. Under a strict test of expressed intention, he thought that the 1999 Act would not have assisted the widow.

3.33 Thirdly, Burrows noted that only well-drafted and thought through contracts would expressly provide for third party enforceable rights. Such contracts do not reflect modern and day to day transactions where such careful legal advice may not be sought out.

(3) Discussion

3.34 If a third party could enforce the terms of a contract where they have justifiably and reasonably relied on them regardless of the intentions of the contracting parties, it could seriously infringe on the contracting parties' freedom of contract. The parties would never be entirely sure how a third party might rely on a contract they have entered into. It would lead to an indeterminate class of incidental beneficiaries gaining enforceable rights and could serve to undermine the overall policy objectives behind reform of the rule of privity. The Commission considers that a third party should not be able to enforce a contract term simply because they have relied on it. Instead, whether a third party can enforce a term of the contract should be ascertained from the intentions of the contracting parties. The Commission now turns to examine the options for the test of enforceability of third party rights.

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27 Burrows "The Contracts (Rights of Third Parties) Act 1999 and its implications for commercial contracts" [2000] LMCLQ 540.

28 [1968] AC 58. Discussed at paragraph 1.19, above.

(a) The parties must have expressly conferred a benefit directly on a third party.

3.35 This approach has the advantage of excluding from the outset incidental and implied beneficiaries. As a result only the beneficiaries that the parties have expressly provided for in the contract will be included and given a right of enforcement.

3.36 However, this approach seems to ignore the reality that it is normal in the law of contract for terms to be implied when interpreting the intentions of parties. The Commission has concluded that this form of test, while certainly clear, is overly restrictive and will not help to resolve a lot of the problems created by the privity rule.

(b) The third party would have enforceable rights where the parties intended that they should receive the benefit of the contract, regardless of whether they intended that the third party should have enforceable rights.

3.37 This broad approach would provide that any third party intended to benefit under the contract could enforce its terms. The Commission considers that this approach would not be sufficient to exclude merely "incidental" beneficiaries from maintaining an action. It would not be appropriate, for example, for a large class of persons to each have enforceable rights in their own names merely because they were to benefit from the contract. To take an example already mentioned, while an agreement between the Department of Education and a developer to build a school may benefit students in the local area, it would be inappropriate for the students to have the right to sue the developer under this contract.[29]

(c) The third party could have enforceable rights where the parties intended to benefit them and also intended that they should be entitled to enforce the contract

3.38 This "dual intention test" has been the favoured approach since the New Zealand *Contracts (Privity) Act 1982*. It requires not only that the contractual parties intended to benefit from a particular term in a contract, but also that the contracting parties intended that the third party should have enforceable rights. This approach has the advantage of being consistent with the ordinary contractual requirement of an intention to create legal obligations.

3.39 The problem with this test is that it is often difficult to gauge accurately the intentions of contracting parties if they are not expressed in the contract. As a result, the application of this kind of test could be overly restrictive.

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[29] See paragraph 3.05 above.

3.40 The Commission recommends that the normal rules of contractual interpretation be used in order to gauge the intentions of the parties to the contract. This means that first and foremost the courts will look to the actual wording of the contract. Where these are ambiguous, or where it is unclear whether the parties intended to confer enforceable rights on a third party, Lord Wilberforce's "matrix of facts"[30] pertaining to the background of the contract may be drawn from. This essentially means looking at the surrounding circumstances known to both parties. Thirdly, if the ordinary meaning of the words of the contract would lead to an absurd result, the court can consider whether they can reasonably bear some other meaning, in light of the surrounding circumstances. If all else fails, the courts can also then look at evidence as to how the market itself works.[31]

3.41 In addition, the Commission considers that the onus should be on contracting parties to show that they did not intend the promise to be enforceable by the third party. Third parties would be entitled to assume that a contract made for their benefit was enforceable by them, and it would be for the contracting parties to prove that that was not their intention.

3.42 *The Commission provisionally recommends that the test of whether a third party may enforce terms under a contract made for their benefit should satisfy two criteria:*

> *1. The parties intend that the third party is to receive the benefit of the contract or a term of the contract; and*
>
> *2. The parties intend that the term benefiting the third party should be enforceable by the third party in their own name.*

The Commission also provisionally recommends that the contracting parties should be given the opportunity to rebut any presumption in favour of enforceable third party rights. The intentions of the parties should be determined using the normal principles of interpretation in contract law.

C Identification of a third party beneficiary

(1) Introduction

3.43 The Commission is concerned with remedying the unfair situation where a third party beneficiary does not, but should have, enforceable rights under a contract. However, the Commission is equally concerned not to impose too restrictive a burden on the parties to a contract. In this respect

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30 *Prenn v Simmonds* [1971] 1 WLR 1381 at 1384-1385.

31 See Roe "Contractual Intention under Section 1(1)(b) and 1(2) of the Contracts (Rights of Third Parties) Act 1999" (2000) 65 MLR 887 at 889; and McDermott *Contract Law* (Butterworths 2001) Chapter 9.

the Commission considers that there must be a line drawn concerning the identification of the third party beneficiary. Another related issue is whether the third party needs to be in existence at the time the contract is entered into.

3.44 One of the obvious ways of identifying a third party is to name them in the contract. However, contracts purporting to confer a benefit on a third party are not necessarily that straightforward. Take the example of an employer who wishes to extend the benefit of a health insurance scheme to their employees. It would be absurd to require that the contract name all employees, present and future, who they intend should benefit and have enforceable rights.

3.45 The Commission turns to examine the approaches to the designation, ascertainability and existence of third parties in other jurisdictions.

(2) Comparative Analysis

(a) Australia

3.46 Section 11(2) of the Western Australian *Property Law Act 1969* uses the terms "named as a party in the contract" to define a party to the contract. The New Zealand Contracts and Commercial Law Reform Committee viewed this as overly restrictive.[32] It appears to import that it would only be when a person was named in a contract that they would have enforceable rights. In light of the fact that class descriptions are common this is unnecessarily restrictive.

3.47 The Queensland *Property Law Act 1974* defines a beneficiary as:

> "a person other than the promisor or promisee, and includes a person who, at the time of acceptance is identified and in existence, although that person may not have been identified or in existence at the time when the promise was given."[33]

The Northern Territory *Law of Property Act 2000* emulates this approach. The definition appears much less restrictive than the Western Australian legislation allowing as it does, those people that are identified in the contract but have not yet come into existence. This kind of situation could be found in contracts providing for as yet unborn children, or future employees or tenants.

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32 New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981) at 49.

33 Section 55(6).

(b) New Zealand

3.48 Section 4 of the *Contracts (Privity) Act 1982* allows those third parties designated by "name, description or reference to a class (whether or not that person is in existence at the time when the deed or contract is made)" to enforce a promise made for their benefit. This reflects the fact that third parties are often identified by class description rather than by name. It also provides for persons who have not yet come into existence.

(c) United States

3.49 Section 308 of the American Law Institute's *Restatement (Second) of Contracts* states that:

> "It is not essential to the creation of a right in an intended beneficiary that he be identified when a contract containing the promise is made."

The commentary on the Restatement notes that the inability to identify a beneficiary at the time the contract is made may be an indication that the parties did not intend to benefit them. If this is the case then it could be used as a means of determining if a beneficiary is an incidental or intended one. However, there is no rule against a beneficiary who subsequently comes into existence and falls into the category of intended beneficiary from maintaining an action on the contract.

3.50 Furthermore United States case law indicates that it is enough that the third party is identifiable as a member of a class or group of persons.[34] It is also unnecessary that the third party is identifiable at the time the contract is entered into, provided that when the time comes for the performance of the promise they are clearly identifiable as an intended beneficiary.[35]

(d) England and Wales

3.51 Section 1(3) of the *Contracts (Rights of Third Parties) Act 1999* provides that:

> "The third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description but need not be in existence when the contract is entered into."

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[34] *Guardianship Depositors Corporation v Brown* (1939) 290 Mich 433, cited with approval in *Jachim v. Coussens* (1979) 88 Mich. App. 648.

[35] *Levy v Daniel's U Drive Auto Renting Co* (1928) 108 Conn 333. See also De Cruz "Privity in America: a study in judicial and statutory innovation" (1985) 14 *Anglo-American L Rev* 265.

Identification is a necessary, but not a sufficient, condition for the application of the 1999 Act. In other words, it is necessary that the third party be identified adequately in the contract, but they must also satisfy the other requirements of the Act, notably in relation to the test of enforceability before they can bring an action on the contract.

3.52 The Law Commission for England and Wales concluded that to confine identification to where a third party is specifically named was too restrictive a test. They recommended that the third party should be identifiable by name, description or as a member of a class[36] and that the third party need not be in existence at the time of the contract.[37]

3.53 Identification of a third party by name is the most obvious method and can provide relatively few problems. However, difficulties may arise where there is an error in the contract as the name, or where the third party beneficiary changes their name for whatever reason (for example following a company merger or acquisition).[38]

3.54 Identification as a member of a class or by description means that identification by name is not necessary. This would apply to specific groups, such as present and future tenants or employees of a company. It could also apply to members of a general group such as nominees of the promisor, or those persons that enter into contracts in the future with the promisor (for example, sub-contractors).

3.55 The Law Commission departed from the position in New Zealand where it has been held that the description "his/her nominee" is not a sufficient identification of a third party beneficiary for the purposes of the *Contracts (Privity) Act 1982*. It was the Law Commission's view that the description "B's nominee" was a sufficient description for the purposes of their proposed reform.[39]

3.56 The Law Commission for England and Wales recommended that that there should be no requirement that the third party be in existence at the time of acceptance by another third party.[40] Thus, for example, an agreement entered into by an employer for the benefit of employees could be

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36 Law Commission for England and Wales *Report on Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 8.1.

37 *Ibid* at paragraph 8.6.

38 See Merkin "Contracts (Rights of Third Parties) Act 1999" in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 103.

39 Law Commission for England and Wales *Report on Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 8.3.

40 *Ibid* at paragraph 8.8.

enforced not only by employees who accepted it at its inception, but also those who subsequently joined the company. Section 1(3) of the 1999 Act is unclear on this issue. There is no express requirement that the third party be in existence at the time of acceptance by another third party, but the Act does not state that the third party need not be in existence at this time.

3.57 Third party issues can be raised in relation to pre-incorporation companies. Because of the privity rule, when a contract is entered into by a company that has yet to be incorporated, the post-incorporation company is not a party to the contract and can therefore not enforce it. To remedy this situation, a system of agency and principal was developed in the common law, and eventually dealt with in England under section 36C of the *Companies Act 1985*. This provides that the purported agent for the unincorporated company is liable on the contract. The Law Commission concluded that contracts on behalf of a third party were different to contracts for the benefit of a third party. Because of this, they recommended that no special provision for pre-incorporation companies ought to be made and that general reform of pre-incorporation contract law should be left to specialist legislation. Having said that, the Law Commission also stated that there should be no restriction on a corporate third party's right to enforce an otherwise enforceable contract simply because it was entered into before the third party's incorporation.

3.58 In Ireland, section 37(1) of the *Companies Act 1963* provides that a contract entered into by a pre-incorporation company may be ratified by the company once it is formed. The effect of this is that all rights and obligations arising from the transaction are enforceable by and against the newly formed company.

3.59 The Commission agrees with the view expressed by the Law Commission that any further reform of this area should be within the context of the general review of company law, currently being concluded by the Company Law Review Group.[41]

(3) Discussion

3.60 The Commission notes that the importance of being able to identify the third party with a degree of certainty. However the Commission is conscious of the commercial and every-day reality that those persons who may be the intended beneficiaries of a contract may not exist or may not necessarily be identifiable at the time the contract is made. For these reasons the Commission is of the opinion that the requirement that a third party should be named in the contract is overly restrictive. In the same vein, requiring the third party to be in existence at the time the contract is entered into is equally narrow. The Commission invites views on whether there

[41] See www.clrg.org

should be an express provision that there is no requirement that a third party who wishes to enforce the contract be in existence at the time of acceptance by another third party.

3.61 It is the Commission's view that the important matter is that at the time that the promise is being executed, it is in the minds of the contracting parties that the third party ought to benefit and, importantly, be entitled to enforce the promise. In this respect, the Commission provisionally recommends that the approach taken by the Law Commission for England and Wales in the 1996 Report should be adopted.

3.62 *The Commission provisionally recommends that the third party should be identified in the contract either by name or description. Such a description should include being a member of a class or group of persons. The Commission provisionally recommends that there should be an express provision that there is no requirement that the third party be in existence at the time of entering into the contract. The Commission invites views on whether there should be an express provision that there is no requirement that a third party who wishes to enforce the contract be in existence at the time of acceptance by another third party.*

D The rights of the parties to vary or cancel the contract

(1) Introduction

3.63 A key feature of contractual freedom is the right of parties to modify or alter the terms of any contract by mutual agreement.[42] One of the objections to creating third party rights is that it would deprive the contracting parties of the right to vary or rescind their contract. This is one of the reasons why, for example, restrictions were placed on the use of trusts in this context.[43] On the other hand, a third party beneficiary may rely on the contract, or alter their position because of the contract and their legitimate expectation of what they will gain from it. Consequently, reform of the privity rule must achieve a balance between the sometimes conflicting notions of the parties' freedom of contract and the third parties' anticipatory reliance.

3.64 This balance is usually achieved by the formulation of a test for the crystallisation of the third party's rights, after which the contracting parties' freedom will necessarily be limited. This means that the contracting parties are free to modify or cancel the terms of the contract until a certain determinable point. In the context of a contract designed to benefit a third

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42 See generally, *Chitty on Contracts Volume 1: General Principles* 29th ed (London Sweet & Maxwell 2004) from paragraph 22-032.

43 See Treitel *The Law of Contract* 11th Ed (Thompson: London 2003) at 657.

party, this is usually reached when the third party either accepts, relies on, adopts or becomes aware of the contract and how they stand to benefit.

3.65 The exact form of this test has varied in the different jurisdictions in which reform has occurred, and the Commission turns now to examine these.

(2) Comparative Analysis

(a) Australia

3.66 Section 11(3) of the Western Australian *Property Law Act 1969* provides that:

> "Unless the contract referred to in subsection (2) otherwise provides, the contract may be cancelled or modified by the mutual consent of the persons named as parties thereto at any time before the person referred to in that subsection has adopted it either expressly or by conduct."

3.67 Similarly section 55(2) of the Queensland *Property Law Act 1974* and section 56(2) of the Northern Territory *Law of Property Act 2000* provide that:

> "Prior to acceptance the promisor and the promisee may, without the consent of the beneficiary, vary or discharge the terms of the promise and any duty arising from it"

"Acceptance" is defined in section 55(6) of the Queensland Act and section 56(6) of the Northern Territory Act as:

> "an assent by words or conduct communicated by or on behalf of the beneficiary to the promisor, or to some person authorised on the promisor's behalf, in the manner (if any), and within the time, specified in the promise or, if no time is specified, within a reasonable time of the promise coming to the notice of the beneficiary."

3.68 In *Westralian Farmers Co-operative Ltd v Southern Meat Packers Ltd*[44] the 1969 Act was examined, but the exact meaning of adoption as a test for crystallisation was not made clear. While the word "adoption" is not defined in the 1969 Act, the definition of acceptance in the 1974 and 2000 Acts as "assent by words or conduct" would appear to mean the same thing. The statutes may use different terms, but they appear to have a similar effect. However, the Commission considers that any test of crystallisation should be clear and not leave room for uncertainty.

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44 [1981] WAR 241; noted in 57 ALJ 640.

(b) New Zealand

3.69 In their 1981 Report on privity of contract, the Contracts and Commercial Law Reform Committee of New Zealand examined the option of allowing variation of the contract until the time of judgment against the promisor, but concluded that the rights of parties to vary or cancel the terms of the contract should be more limited.[45]

3.70 Ultimately, section 5(1) of the New Zealand *Contracts (Privity) Act 1982* states:

> "(1) Subject to sections 6 and 7 of this Act, where, in respect of a promise to which section 4 of this Act applies,—
>
> (a) The position of a beneficiary has been materially altered by the reliance of that beneficiary or any other person on the promise (whether or not that beneficiary or that other person has knowledge of the precise terms of the promise); or
>
> (b) A beneficiary has obtained against the promisor judgment upon the promise; or
>
> (c) A beneficiary has obtained against the promisor the award of an [arbitral tribunal] upon a submission relating to the promise,—
>
> the promise and the obligation imposed by that section may not be varied or discharged without the consent of that beneficiary."

Thus, once the third party beneficiary has "materially altered" their position in reliance on the promise made, the parties are no longer entitled to vary or cancel the terms of the contract that affect the third party.

3.71 Section 6 of the Act contains a method by which the contracting parties can vary or rescind the contract at any time in the following circumstances:

> "Nothing in this Act prevents a promise to which section 4 of this Act applies or any obligation imposed by that section from being varied or discharged at any time—
>
> (a) By agreement between the parties to the deed or contract and the beneficiary; or
>
> (b) By any party or parties to the deed or contract if—
>
> (i) The deed or contract contained, when the promise was made, an express provision to that effect; and

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[45] New Zealand Contracts and Commercial Law Reform Committee *Privity of Contract* (1981) at 59.

(ii) The provision is known to the beneficiary (whether or not the beneficiary has knowledge of the precise terms of the provision); and

(iii) The beneficiary had not materially altered his position in reliance on the promise before the provision became known to him; and

(iv) The variation or discharge is in accordance with the provision."

3.72 There is little by way of interpretation of the exact meaning of "materially altering" one's position, but from a reading of section 6, it appears to involve some kind of reliance on the promise made. Whether this reliance needs to be detrimental is not made clear. Once it has been found that the third party beneficiary has materially altered their position in reliance on the promise, the contracting parties, unless they have expressly provided for a power of variation or rescission in the contract, cannot alter the contract without the consent of the beneficiary.

3.73 Section 7 of the 1982 Act gives the court a discretion to vary or discharge the contract on application by the promisor or promisee, and if it does so, to order the payment of compensation to the third party beneficiary.

(c) Canada

3.74 Section 4(3) of the New Brunswick's *Law Reform Act 1993* provides that the contracting parties are free to amend or cancel the terms of the contract at any time. However, where by doing so they cause loss (either by way of expense or by carrying out an obligation in expectation that the contract is performed) to the third party beneficiary, they must compensate the third party for this loss.

3.75 Article 1146 of the Civil Code of Québec provides that the stipulation in favour of a third party may be revoked provided the third person beneficiary has not advised the stipulator or the promisor of his will to accept the promise.

3.76 The Manitoba Law Reform Commission was of the opinion that a reasonable and fair balance must be found between the interests of the contracting parties to vary and terminate third party rights and the interest of the beneficiary in securing the promised benefit.[46] The Manitoba Law Reform Commission concluded that there were two options available in relation to the appropriate crystallisation test. The first was the "trust" model based on the acceptance of the beneficiary, while the second was the

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[46] Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80) October 1993 at 62.

"contract" model based on reliance. In the end it favoured the contract model, as it was consistent with general contracting principles. The Manitoba Law Reform Commission concluded that the right of the contracting parties to vary or terminate the contract should not be excluded except where the position of the third party had been materially altered by his/her own, or another's, reliance.

3.77 The Ontario Law Reform Commission was, however, aware of the opinion that the situation in respect of the right of parties to vary or cancel a contract which purports to benefit a third party was exactly the kind of one that illustrates the difficulties of trying to create specific and detailed legislation. In their opinion, such questions were best left to the courts to tease out on a case by case basis.

(d) United States of America

3.78 Section 311 of the American Law Institute's *Restatement (Second) of Contracts* provides that the parties to a contract are free to discharge or modify the terms of a contract at any time, provided the contract itself does not contain any provision forbidding such changes being made. However section 311(3) goes on to provide that:

> "Such power terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise or brings suit on it or manifests assent to it at the request of the promisor or promisee."

3.79 In *Karo v San Diego Symphony Orchestra Association*[47] the United States Court of Appeals interpreted the rights of the parties to modify or discharge their agreement in the following way:

> "The Restatement (Second) of Contracts provides that in the absence of terms in a third party beneficiary contract prohibiting change or modification of a duty to an intended beneficiary, the promisor and promisee retain power to discharge or modify the duty by subsequent agreement... The power to modify terminates when the beneficiary materially changes position in justifiable reliance on the promise before receiving notification of the modification."[48]

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47 (1985) 762 F 2d 819.

48 *Ibid* at 822.

This decision was cited with approval in subsequent cases such as *Price v Pierce*[49] and *Malden Mills Industries Inc v Ilgwu National Retirement Fund*.[50]

3.80 Thus it is evident that there is a strong emphasis in the United States on the parties' freedom to contract and their right to modify their contract. At the same time, their freedom is restrained once the third party has materially altered their position in justifiable reliance on the promise. It is clear that the courts will look at the particular facts of the case and determine if on balance, the third party beneficiary would be unjustifiably placed at a disadvantage if the parties were given free reign to modify the contract at any time.

(e) England and Wales

3.81 The Law Commission for England and Wales gave extensive consideration to the issue of the right of contracting parties to discharge or vary a contract. The Commission considered the options from one end of the scale - permitting the parties the right to vary the contract at any time - to the other end of the scale - not allowing the parties to vary the terms in a contract at any time without the consent of the third party. They rejected both extremes as being overly lenient and overly restrictive respectively. In the end they narrowed the options down to three possible tests: reliance by the third party, detrimental reliance by the third party, or acceptance of the terms.[51]

3.82 As to reliance and detrimental reliance, the Law Commission accepted that reliance was more consistent with the basic notion that the law of contract will seek to protect expectation interest.[52] The Law Commission sought to address the basic injustice that was caused by the operation of the privity rule. In their view, this was that the third party has reasonable expectations that the promise will be performed and that they will benefit. Reliance indicates that expectations have been engendered in the third party. The Law Commission's opinion was that to require the reliance to be detrimental shifts the focus away from protecting the third party's expectation interest to protect the third party's reliance interest.[53] Such a

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49 (1987) 823 F.2d 1114.

50 (1991) 766 F Supp 1202.

51 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraphs 9.18 – 926.

52 See Chapter 5 Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 119.

53 Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 9.19.

shift would require too much from the third party seeking enforcement of the promise in their own name.

3.83 On the other hand, acceptance is a much clearer way in which the third party can communicate their assent to the terms of the contract. A third party who has done this should be secure in the knowledge that they will obtain what they are entitled to. In the same way, the contractual parties are clear as to the position of the third party. Should the contracting parties wish to vary or discharge the contract, they will be aware of the effect this would have on the third party, and whether they will need to get consent from the third party.

3.84 The Commission ultimately recommended a two-fold test based on reliance and acceptance as alternatives, and this is reflected in section 2 of the *Contracts (Rights of Third Parties) Act 1999* which provides:

> "(1) Subject to the provisions of this section, where a third party has a right under section 1 to enforce a term of the contract, the parties to the contract may not, by agreement, rescind the contract, or vary it in such a way as to extinguish or alter his entitlement under that right, without his consent if-
>
> (a) the third party has communicated his assent to the term to the promisor,
>
> (b) the promisor is aware that the third party has relied on the term, or
>
> (c) the promisor can reasonably be expected to have foreseen that the third party would rely on the term and the third party has in fact relied on it."

3.85 The parties are also given the option of including in their contract a provision relating to the variation or rescission of the contract. The 1999 Act allows the parties to include express provisions in the contract permitting the parties to vary or rescind at any time without consent of the third party,[54] or indeed, to provide their own circumstances in which the consent of the third party may be required.[55] Allowing this re-affirms the central importance of the parties' intention behind the reform of the rule.

(3) Discussion

(a) The options available

3.86 As already discussed, reform of the privity rule should give effect to the intentions of the parties, while also protecting the legitimate

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54 Section 2(3)(a).

55 Section 2(3)(b).

expectations of the third party. The question that must be asked is whether the law should protect the parties', now changed, intentions, or whether it should protect the reasonable expectations of the third party beneficiary.[56] The Commission considers that reform of the privity rule must achieve a balance between these two equally compelling reasons for reform.

3.87 From an analysis of the issues and of the approach taken in other jurisdictions, three main options for a crystallisation test emerge.

(i) Awareness of the third party beneficiary of the terms of the contract

3.88 This is the test of crystallisation that is most favourable to the third party beneficiary. Essentially the test would mean that once the third party becomes aware of the terms of a contract made to benefit them, the contracting parties are restricted to varying the contract only with the consent of the third party. This test was rejected in many jurisdictions as it encroaches too much on the freedom of contracting parties. In addition, if the third party was aware of a contract but did not rely on it, or materially alter their position because of it, the third party may not even wish to take advantage of the contract for whatever reason. In such a case, they would not be affected by its variation, or even its rescission.

3.89 However, it might be argued that, if the protection of legitimate expectations is one of the cornerstones on which reform of the privity rule should be based, greater protection ought to be given to the third party.[57] If contracting parties have freely chosen to enter into a contract intended to benefit a third party and the purpose of the contract is to benefit that third party, there should be no reason why the third party should have to take any extra steps themselves in order to protect the legitimate expectation.

3.90 While this argument certainly favours the third party beneficiary, the Commission considers that it does so at too great a price in terms of the rights of the contracting parties themselves. It is the Commission's view that the expectations of the third party can be protected by less restrictive means.

(ii) Reliance on the promise that the promise will be performed by the parties

3.91 The Commission agrees with the approach taken in other jurisdictions such as New Zealand and England and Wales, that justifiable reliance by the third party on the promise should affect the parties' rights of variation and rescission. The Law Commission for England and Wales

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[56] MacMillan "A birthday present for Lord Denning: The Contracts (Rights of Third Parties) Act 1999" (2000) 63 MLR 721 at 727.

[57] See Adams, Beyleveld & Brownsword "Privity of Contract – the benefits and burdens of law reform" (1997) 60 MLR 238 at 257.

defined reliance as "conduct induced by the belief (or expectation) that the promise will be performed or, at least, that one is legally entitled to performance of the promise".[58] The Commission considers that once a contract is entered into for the benefit of a third party, that third party is justifiably entitled to rely on that promise. The Commission therefore agrees that the reliance need not necessarily be detrimental reliance and that a third party should be able to rely on a promise made in their favour even where they have not incurred any expense in reliance on the promise, or placed themselves at some kind of disadvantage. In the Commission's view, it would not be appropriate for the contracting parties to modify and even cancel terms of a contract at any time, merely because the third party had not incurred any loss.

(iii) Acceptance or adoption by the third party of the terms drafted for their benefit.

3.92 The Commission considers that a positive act of acceptance of the terms of the contract by the third party should be sufficient notice of the third party's legitimate expectation. The Commission considers that acceptance - defined in the Queensland *Property Law Act 1974* as "an assent by words or conduct communicated by or on behalf of the beneficiary to the promisor" - should be an alternative means of crystallising the third party's claim. To confine the test to acceptance alone would, in the Commission's view, be overly narrow. The Commission therefore provisionally recommends that reliance and acceptance should be used as alternatives in establishing the point at which the contracting parties will have to seek consent of the third party before modifying the contract.

(b) The parties' right to formulate their own test

3.93 The Commission considers that, in light of the fundamental importance of the contracting parties' freedom of contract, they should be free to include in their contract an express term providing for variation or termination. Such provisions are, for example, common in construction contracts, where the specification of the works can be altered as the project progresses.[59]

(c) Conclusion

3.94 On the issue of variation and rescission of third party rights by the contracting parties, the Commission is provisionally inclined towards the

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[58] Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 9.14.

[59] See Merkin "Contracts (Rights of Third Parties) Act 1999 in Merkin (ed) *Privity of Contract: The Impact of the Contracts (Rights of Third Parties) Act 1999* (LLP 2000) at 120.

option of reliance on and acceptance by the third party as a suitable gauge for determining when a third party will be affected by changes made to the contractual arrangements. Aware that this is quite a complex issue, the Commission welcomes views on this matter.

3.95 *The Commission provisionally recommends that reliance and acceptance should be used as alternative methods of determining when a third party's rights have crystallised. After reliance or acceptance by the third party, the contractual parties will be unable to modify or terminate the contract without the consent of the third party. The Commission also provisionally recommends that the contracting parties should remain free to include in the contract an express provision for the variation or termination of third party rights. The Commission welcomes views on this matter.*

E General Defences, Set-off and Counterclaims

(1) Introduction

3.96 When an action for breach of contract is taken by one contracting party against another contracting party, various defences can be used. For example, it can be argued that the contract was based on a fundamental mistake, misrepresentation, duress or undue influence, which could render a contract void or voidable. The defendant may claim that performance of the contract has become impossible, or that the plaintiff had seriously breached the contract.

3.97 Set-off and counterclaims both involve cross-claims for monetary compensation. Set-off is limited to situations that arise out of the same transaction and cannot exceed the amount of the plaintiff's claim. Counterclaims, on the other hand, are not limited in this way. Both are available when an action is brought under a contract by the other contracting party.

3.98 If a third party is to be given enforceable rights, it is important that the third party should not be placed in a better position than either of the contracting parties. The third party's rights should be enforceable subject to the usual defences available to the contracting parties. At the same time, it is important to decide the scope of defences, set-off and counterclaims available to the contracting parties, as some of these may not be appropriate in the context of a third party claim.

3.99 There are different levels of protection which might be available to the contracting parties. At one end of the spectrum, only defences that affect the validity or existence of the contract, or the particular contractual provision which benefits the third party, could be made available to the third party. At the other end, all defences, as well as set-off and counterclaims,

that would have been available between the contracting parties could be made available.

(2) Comparative Analysis

(a) Australia

3.100 Section 11(2)(a) of the Western Australian *Property Law Act 1969* provides that

> "all defences that would have been available to the defendant in an action or proceeding in a court of competent jurisdiction to enforce the contract had the plaintiff in the action or proceeding been named as a party to the contract shall be so available."

3.101 Section 55(4) of the Queensland *Property Law Act 1974* and section 56(4) of the Northern Territory *Law of Property Act* provide that:

> "subject to subsection (1), any matter which would in proceedings not brought in reliance on this section render a promise void, voidable or unenforceable, whether wholly or in part, or which in proceedings (not brought in reliance on this section) to enforce a promissory duty arising from a promise is available by way of defence shall, in a like manner and to the like extent, render void, voidable or unenforceable or be available by way of defence in proceedings for the enforcement of a duty to which this section gives effect."

3.102 Thus the Australian legislation allows any defence to be raised against the third party. The defences are not limited to those that arise directly from the contract or the particular provision that purports to benefit the third party. Although it is not explicitly stated, such defences may include set-off, but could not be said to include counterclaims.[60]

(b) New Zealand

3.103 The Contracts and Commercial Law Reform Committee of New Zealand examined the approach taken in the Australian jurisdictions and agreed that all the defences which would have been available in an action between the contracting parties should be available in an action by the third party. This was subject this to one condition: that the defences and cross-claims should be limited to those arising out of the contract in question.

3.104 Section 9 of the *Contracts (Privity) Act 1982* provides that:

> "(2) Subject to subsections (3) and (4) of this section, the promisor shall have available to him, by way of defence,

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[60] See Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 10.5

counterclaim, set-off, or otherwise, any matter which would have been available to him—

(a) If the beneficiary had been a party to the deed or contract in which the promise is contained; or

(b) If—

(i)The beneficiary were the promisee; and

(ii)The promise to which the proceedings relate had been made for the benefit of the promisee; and

(iii)The proceedings had been brought by the promisee.

(3) The promisor may, in the case of a set-off or counterclaim arising by virtue of subsection (2) of this section against the promisee, avail himself of that set-off or counterclaim against the beneficiary only if the subject-matter of that set-off or counterclaim arises out of or in connection with the deed or contract in which the promise is contained.

(4) Notwithstanding subsections (2) and (3) of this section, in the case of a counterclaim brought under either of those subsections against a beneficiary,—

(a) The beneficiary shall not be liable on the counterclaim, unless the beneficiary elects, with full knowledge of the counterclaim, to proceed with his claim against the promisor; and

(b) If the beneficiary so elects to proceed, his liability on the counterclaim shall not in any event exceed the value of the benefit conferred on him by the promise."

3.105 The *Contracts (Privity) Act 1982* went further than the recommendation of the Law Reform Committee. Section 9(4) provides some additional protection for the third party by stating that any counterclaim will not be available against them if they decide not to proceed with the claim against the promisor and that any counterclaim that does proceed cannot exceed the value of the benefit. However, this arguably does not provide as much protection for the third party as the Australian legislation, which does not seem to allow any counterclaims against the third party.

(c) Canada

3.106 Section 4 of the New Brunswick *Law Reform Act 1993* allows the promisor in an action brought by a third party "any defence … that could

have been raised in proceedings between the parties".[61] Similarly, the Law Reform Commission of Nova Scotia recommended that "in legal proceedings involving a third party beneficiary, any defence should be available that could have been raised in proceedings between the parties".[62]

3.107 The Manitoba Law Reform Commission recognised the widespread view that third party rights are essentially derivative and not independent and direct. Therefore, as a general rule, the promisor should have the same defences available that would have been available as against the promisee. However the Manitoba Law Reform Commission accepted that in relation to third parties, there ought to be some qualification in respect of set-off and counterclaims. They recommended that such claims should be limited to those that arise in connection with the contract. In line with the approach taken in New Zealand they also recommended that the beneficiary should be protected from counterclaims and set-off where they discontinue their own claim. [63]

(d) United States of America

3.108 Section 309 of the *Restatement (Second) of Contracts* provides that the rights of the third party are subject to the normal constraints that would arise as between the promisor and the promisee. Thus the absence of mutual assent or consideration, lack of capacity, fraud, and mistake may be asserted against the third party. If a contract ceases to be binding by reason of, for example, public policy, non-occurrence of a condition or failure of performance, the rights of the third party are discharged. A third party's right is also subject to any claim or defence arising from the third party's own conduct or agreement. However, the rights of the third party are not subject to the promisor's claims against the promisee, or even the promisee's claims against the third party beneficiary.

(e) England and Wales

3.109 Section 3(2) of the *Contracts (Rights of Third Parties) Act 1999* provides that:

> "The promisor shall have available to him by way of defence or set-off any matter that--
>
> > (a) arises from or in connection with the contract and is relevant to the term, and

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61 Section 4(2).

62 Law Reform Commission of Nova Scotia *Final Report on Privity of Contract (Third Party Rights)* (2004) at 20-22.

63 Manitoba Law Reform Commission *Report on Privity of Contract* (Report #80, 1993) at 63.

(b) would have been available to him by way of defence or set-off if the proceedings had been brought by the promisee."

3.110 The 1999 Act allows the promisor to raise defences that question the validity or enforceability of the contract if they could have done so against the promisee. However, the defence must be relevant to the term of the contract the third party is seeking to enforce. In this way, the promisor cannot rely on wholly extraneous matters in their defence of the third party's claim. Section 3(2) would also seem to allow set-off only, and not allow the promisor to counter-claim against the third party.

3.111 The wording of the 1999 Act differs slightly from the wording of the Draft Bill attached to the Law Commission's 1996 Report. While the Draft Bill provided that the defence or set-off had to arise from or be in connection with the contract, the 1999 Act narrows the application of the defences further by requiring that it must also be relevant to the term that the third party is seeking to enforce. This appears to be because section 1 of the 1999 Act refers to the enforceability of a "term" in a contract, rather than the contract as a whole, by the third party beneficiary.[64]

3.112 Section 3(3) of the 1999 Act allows the contracting parties to include express provisions in the contract making other defences or set-off available to them, provided they would have been available to them in an action brought by a promisee. Section 3(5) of the 1999 Act provides that the contracting parties may provide by an express term of the contract that certain matters are not to available to the promisor by way of defence, set-off or counterclaim.

3.113 Section 3(4) states

> The promisor shall also have available to him-
>
> (a) by way of defence or set-off any matter, and
>
> (b) by way of counterclaim any matter not arising from the contract,
>
> that would have been available to him by way of defence or set-off or, as the case may be, by way of counterclaim against the third party if the third party had been a party to the contract.

This section seems to provide that a third party's right is subject to any defence, set-off or, within limits, counterclaim arising from the third party's own conduct. This could include a claim that a contracting party was

64 See MacMillan "A birthday present for Lord Denning: The Contracts (Rights of Third Parties) Act 1999" (2000) 63 MLR 721 at 728.

induced to enter into the contract on foot of a misrepresentation by the third party.

3.114 Finally, the 1999 Act makes special provision where the third party is seeking to enforce an exclusion or limitation of liability clause. The third party can only enforce the clause to the extent that they could have done if they were a party to the contract. In this way, the validity of the exclusion or limitation clause depends on the position between the contracting parties, as well as that between the contracting parties and the third party.

(3) Discussion

3.115 It is clear from this discussion that there are a number of different ways of approaching the rights of the contracting parties to defend an action brought by a third party. One approach would be to simply allow the promisor to raise all defences that would have been available to them in an action brought by the promisee. A second option is to allow all defences that would have been available, subject to the qualification that only those defences that arise from the contract can be used. A third option would to be to restrict the defences to those arising from the term that is being enforced, subject to detailed rules so that the contracting parties are left in no doubt.

3.116 Whatever method is chosen, the Commission considers that the contracting parties should not be placed in a worse position than they would have been in had the action been between them. At the same time, the third party should not be subjected to defences relating to extraneous matters unknown to them, that do not arise in connection with the terms of the contract that they are seeking to enforce.

3.117 For these reasons, the Commission recognises that any defences available to the contracting parties must be restricted to those that arise from or in connection with the contract, and which are relevant to the term being enforced. The Commission also accepts that if there are other factors particular to the conduct of the third party which would affect the term being enforced, the contracting parties should be able to rely on these factors. The Commission is fully aware however, that in the interest of the rights of the third parties, any provision in relation to defences should not exceed those that would have been available between the contractual parties.

3.118 In relation to set-off and counterclaims, the Commission is aware that any reform of the privity rule will be concerned with conferring benefits, and not burdens, on the third party. The Commission sees merits in an approach which allows the contracting party to avail of the remedy of set-off, which is limited in scope. However, the Commission recognises that it may be necessary to exclude or limit counterclaims by the contracting party.

Any such provision will require careful consideration, and the Commission invites views on this issue.

3.119 *The Commission provisionally recommends that in an action brought by a third party, the promisor should have available by way of defence or set-off, all matters that arise from or in connection with the contract, that are relevant to the term that the third party is seeking to enforce. In addition, the Commission provisionally recommends that the promisor should be able to rely on any other issues relevant to the conduct of the third party, that would have been available had the third party been a party to the contract. The Commission provisionally recommends that the contracting parties should be free to include an express provision restricting or expanding the scope of the defences or set-off. The Commission invites views on whether the promisor's ability to counterclaim against the third party should be limited.*

F Overlapping claims

(1) Introduction

3.120 In the previous section the Commission examined the rights of the promisor in a contract for the benefit of a third party. The Commission is conscious, however, that the rights of the promisee will also be affected by the granting of enforceable rights to a third party. The two are connected because while the promisee normally has certain remedies against the promisor in a contract that purports to benefit a third party, the promisor should not be subjected to a double liability.

3.121 The rights of the third party and the promisee are independent from each other. It is not suggested here that, by giving the third party the right to enforce a term in a contract that purports to benefit them, this right of enforcement is automatically taken from the promisee. Rather, the rights are concurrent. The duties of the promisor are owed to both the promisee and the third party. The duties may also differ as to the promisee and the third party.

3.122 The Commission has already provisionally recommended that the remedies available to the promisee, although not an adequate means of protecting third party rights, should be preserved and left to the development of the courts.[65] By the same reasoning, the rights of the promisee to enforce the contract should remain as a valid means of enforcing a contract for the benefit of a third party. It is the Commission's view, however, that the proposed reform should not expose the promisor to the risk of double liability.

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65 See paragraph 2.36

(2) Comparative Analysis

(a) Australia

3.123 Section 55(7) of the Queensland *Property Law Act 1974* provides that nothing in the section affects any rights or remedy that exists or is available apart from the section. Section 56(7) of the Northern Territory *Law of Property Act 2000* contains an equivalent provision. As a result, the promisee retains their rights against the promisor. The Western Australian *Property Law Act 1969* is silent on this point.

(b) New Zealand

3.124 Section 14(1)(a) of the *Contracts (Privity) Act 1982* provides that nothing in the 1982 Act limits or affects any right or remedy existing apart from the Act.

(c) United States of America

3.125 The American Law Institute's *Restatement (Second) of Contracts* contains provision for the overlapping duties owed by the promisor to the beneficiary and the promisee. Section 305 states that:

> (1) A promise in a contract creates a duty in the promisor to the promisee to perform the promise even though he also has a similar duty to an intended beneficiary
>
> (2) Whole or partial satisfaction of the promisor's duty to the beneficiary satisfies to that extent the promisor's duty to the promisee.

3.126 This acknowledges that while the promisee has the same right to performance as any other promisee, the promisor is entitled to protection against double liability.

(d) England and Wales

3.127 Section 4 of the *Contracts (Rights of Third Parties) Act 1999* provides that third party rights do "not affect any right of the promisee to enforce any term of the contract". The Law Commission for England and Wales was convinced that there was no reason to remove a contractual right from the promisee merely because the contract gives rights of enforcement to the third party.[66] They also recommended that although no legislative provision was required, a promisor that had fulfilled their duty to the third

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[66] Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 11.2.

party, whether wholly or partly, should to that extent be discharged from its duty to the promisee.[67]

3.128 The Law Commission also addressed the issue of priority of action. It was acknowledged that potentially there could be problems if the promisor was faced with the costs and inconvenience of two actions brought by the third party and the promisee at the same time. However, they regarded the promisee and the third party as having separate rights, and concluded that it would be wrong to bar one claim over another.

3.129 The Law Commission addressed the issue of the promisee's rights where a promisor has been released by the third party. It considered that this should not discharge the promisor's obligation to the promisee. This is because the performance of a single promise might benefit both promisee and third party. Therefore in that kind of situation the promisee should not be denied their right of action. The simple solution to this is to require the promisor to seek release of their duties from the promisee. However, again it was felt that no legislative provision on this matter was necessary.

3.130 Section 5 of the 1999 Act contains further provisions designed to protect the promisor from double liability, by stating that:

> "Where under section 1 a term of a contract is enforceable by a third party, and the promisee has recovered from the promisor a sum in respect of -
>
> (a) the third party's loss in respect of the term, or
>
> (b) the expense to the promisee of making good to the third party the default of the promisor,
>
> then, in any proceedings brought in reliance on that section by the third party, the court or arbitral tribunal shall reduce any award to the third party to such extent as it thinks appropriate to take account of the sum recovered by the promisee."

(3) Discussion

3.131 The Commission has concluded that, provided the promisor is protected from double liability, there is no reason why the promisee should not maintain their right of action on a contract to benefit a third party. In other words, the fact that a third party has a right to enforce an agreement directly should not be a bar to a promisee maintaining their own action directly.

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[67] Law Commission for England and Wales *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com No 242, 1996) at paragraph 11.6.

3.132 In order to safeguard the rights of the promisor, the Commission has also concluded that once a promisor has fulfilled their duty to the third party they should discharged from their duty, to the extent that it has been fulfilled, to the promisee. Likewise, although it is unlikely to occur under existing law,[68] if the promisee has recovered substantial damages representing the third party's loss, the third party should not be entitled to maintain their own action against the promisor for the same loss.

3.133 *The Commission provisionally recommends that, unless otherwise agreed between the parties, the promisee should retain the right to enforce a contract even if the contract is also enforceable by the third party. The Commission provisionally recommends that, in order to prevent double recovery, where a promisor has fully or partially fulfilled their duty to the third party they should be proportionately discharged from their duty to the promisee.*

G Exceptions

(1) Introduction

3.134 Although there is a need for reform of the privity rule, it is possible that not every type of contract should be subject to any reforming legislation. Sometimes, the granting of third party rights may be contrary to public policy or may cause uncertainty. It is possible, therefore, that certain types of contracts should be excluded from any reforming legislation.

3.135 The Commission now turns to examine whether certain types of contracts should be excluded from any reforming legislation.

(2) Comparative Analysis

(a) England and Wales

3.136 The *Contracts (Rights of Third Parties) Act 1999* does not apply to every type of contract. Section 6(2) of the 1999 Act provides that it confers no rights on a third party in the case of any contract binding on a company and its members under section 14 of the *Companies Act 1985.*

3.137 Section 6(3) provides that the 1999 Act confers no right on a third party to enforce any term of a contract of employment or worker's contract against, respectively, an employee or worker. Contracts of employment are not excluded entirely, and it is still possible, for example, for a third party to enforce a term of an employment contract against an employer.

3.138 Section 6(1) of the 1999 Act provides that it "confers no rights on a third party in the case of a contract on a bill of exchange, promissory note

[68] See paragraph 2.25ff, above.

or other negotiable instrument". In this group of exceptions third parties can acquire rights under other rules of law and it is not the purpose of the 1999 Act to extend these rights.

3.139 Likewise, section 6(5) provides that:

> "Section 1 confers no rights on a third party in the case of-
>
> (a) a contract for the carriage of goods by sea, or
>
> (b) a contract for the carriage of goods by rail or road, or for the carriage of cargo by air, which is subject to the rules of the appropriate international transport convention,
>
> except that a third party may in reliance on that section avail himself of an exclusion or limitation of liability in such a contract."

3.140 The 1999 Act excludes this group of contracts as they are governed by separate regimes. Contracts for the carriage of goods are governed by the *Carriage of Goods by Sea Act 1992*. Contracts for the international carriage of goods by road, rail or air are governed by international conventions which have the force of law in the United Kingdom. Such schemes are carefully regulated, and it could cause uncertainty if third parties could acquire additional rights under the 1999 Act. However, a third party can still rely on an exemption and limitation clause contained in these kinds of contracts, provided the normal requirements for such reliance are fulfilled.[69]

(b) Singapore

3.141 Like the 1999 Act in England and Wales, the Singapore *Contracts (Rights of Third Parties) Act 2001* excludes contracts for the carriage of goods by sea, contracts for the carriage of goods by road, rail, or air, and negotiable instruments.[70] Nor does it apply to contracts that are binding on a company and its members under section 39 of the Singapore *Companies Act*.[71]

(c) Hong Kong

3.142 Similarly, the Hong Kong Law Reform Commission identified two categories of contract that their proposed reform should not apply to. The first is where a third party already has an enforceable right under existing rules or reflecting international conventions: such as bills of

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69 Section 6(5) of the *Contracts (Rights of Third Parties) Act 1999*.

70 Section 7(4) of the *Contracts (Rights of Third Parties) Act 2001*.

71 Section 7(2) of the *Contracts (Rights of Third Parties) Act 2001*.

exchange, contracts for the carriage of goods by sea, contracts for the carriage of goods by air and letters of credit.[72]

3.143 The second category is where a third party has no rights of enforceability under existing rules, but there are sound policy reasons for maintaining this position. Such contracts include contracts under section 23 of the Hong Kong *Companies Ordinance* which creates a contract between the company and its members.

(3) Discussion

3.144 It is common for legislation affecting contracts to exclude different types of contracts from its remit.[73] In other jurisdictions, legislation reforming the privity rule has excluded different types of contracts from its remit, because to include them would upset the existing regulation of those types of contracts. For example, it may be important that the contract between a company and its members is only dealt with under company law, and not affected by any general contract reforms. Similarly, the law of negotiable instruments and the carriage of goods by sea is carefully regulated, and any changes may cause uncertainty. It could be argued that any changes to these types of regimes should be dealt with separately, and not as part of a general reform of contract law.

3.145 However, it is important to consider what kinds of contracts should be excluded and to what extent they should be excluded. For example, it could be suggested that contracts of employment should be entirely excluded and instead governed by general employment law. However, it is clear from some of the decisions mentioned in this Paper that the privity rule can have an adverse effect in the employment context.[74] Indeed, the development of a third party rule in the Canadian Supreme Court originated in a case involving third party employees.[75] Thus, the England and Wales *Contracts (Rights of Third Parties) Act 1999* does not entirely exclude employment contracts from its remit, but provides that a third party cannot enforce a term of a contract of employment against an employee. Such distinctions may be of vital importance in any reforming legislation.

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72 The Law Reform Commission of Hong Kong *Report on Privity of Contract* (2005) at paragraph 4.174.

73 For example, the *European Communities (Unfair Terms in Consumer Contracts) Regulations 1995* (SI No27 of 1995) as amended by the *European Communities (Unfair Terms in Consumer Contracts) (Amendment) Regulations 2000* (SI No307 of 2000) does not apply to contracts of employment, contracts relating to succession rights, contracts relating to rights under family law, or contracts relating to the incorporation and organisation of companies or partnerships.

74 See for example, paragraphs 1.96, 1.107 and 2.11, above.

75 *London Drugs v Kuehne & Nagel International Ltd* [1992] 3 SCR 299. See the discussion at paragraphs 1.101 and 2.11ff, above.

3.146 The Commission is of the view that although it is possible that any reforming legislation should not apply to every type of contract, it is important to consider carefully what types of contracts should be excluded from its remit, and to what extent they should be excluded. The Commission welcomes views on this matter.

3.147 *The Commission provisionally recommends that certain types of contracts should be excluded from any reforming legislation and invites views on this matter.*

CHAPTER 4 SUMMARY OF PROVISIONAL RECOMMENDATIONS

4.01 The provisional recommendations of this Consultation Paper may be summarised as follows:

Chapter 1 The Need for Reform

4.02 The Commission provisionally recommends that the rule of privity be reformed to allow third parties to enforce rights under contracts made for their benefit. [Paragraph 1.172]

Chapter 2 Options for Reform

4.03 The Commission provisionally recommends that the development of third party contractual rights should take the form of legislation, which is most suited to address the injustices and inconveniences associated with the current privity of contract rule. The Commission provisionally recommends that legislative reform of the privity rule should not constrain judicial development of third party rights. [Paragraph 2.24]

4.04 The Commission provisionally recommends that reform of the promisee's remedies should not form part of the proposals to reform the privity rule. [Paragraph 2.36]

4.05 The Commission provisionally recommends that reform of the privity rule should not take the form of a general provision enabling a third party to claim the benefit of contractual provisions for the third party's benefit. The Commission provisionally recommends that a more detailed scheme of third party rights is necessary. [Paragraph 2.47]

4.06 The Commission provisionally recommends that reform of the privity rule should not be by means of creating further exceptions to the privity rule in specific instances. [Paragraph 2.59]

4.07 The Commission provisionally recommends that the rule of privity be reformed by means of detailed legislation. [Paragraph 2.93]

4.08 The Commission provisionally recommends that a general clause should be included in the legislation which would preserve the existing exceptions to the privity rule and provide that third parties will not be denied existing remedies available to them. The Commission also invites submissions on whether the proposed legislation should include a

comprehensive codification of the existing common law and statutory exceptions to the privity rule. [Paragraph 2.118]

Chapter 3 Specific issues

4.09 The Commission provisionally recommends that the test of whether a third party may enforce terms under a contract made for their benefit should satisfy two criteria:

> 1. The parties intend that the third party is to receive the benefit of the contract or a term of the contract; and
>
> 2. The parties intend that the term benefiting the third party should be enforceable by the third party in their own name.

The Commission also provisionally recommends that the contracting parties should be given the opportunity to rebut any presumption in favour of enforceable third party rights. The intentions of the parties should be determined using the normal principles of interpretation in contract law. [Paragraph 3.42]

4.10 The Commission provisionally recommends that the third party should be identified in the contract either by name or description. Such a description should include being a member of a class or group of persons. The Commission provisionally recommends that there should be an express provision that there is no requirement that the third party be in existence at the time of entering into the contract. The Commission invites views on whether there should be an express provision that there is no requirement that a third party who wishes to enforce the contract be in existence at the time of acceptance by another third party. [Paragraph 3.62]

4.11 The Commission provisionally recommends that reliance and acceptance should be used as alternative methods of determining when a third party's rights have crystallised. After reliance or acceptance by the third party, the contractual parties will be unable to modify or terminate the contract without the consent of the third party. The Commission also provisionally recommends that the contracting parties should remain free to include in the contract an express provision for the variation or termination of third party rights. The Commission invites views on this matter. [Paragraph 3.95]

4.12 The Commission provisionally recommends that in an action brought by a third party, the promisor should have available by way of defence or set-off, all matters that arise from or in connection with the contract, that are relevant to the term that the third party is seeking to enforce. In addition, the Commission provisionally recommends that the promisor should be able to rely on any other outside issues relevant to the conduct of the third party, that would have been available had the third party been a party to the contract. The Commission provisionally recommends that

the contracting parties should be free to include an express provision restricting or expanding the scope of the defences or set-off. The Commission invites views on whether the promisor's ability to counterclaim against the third party should be limited. [Paragraph 3.119]

4.13 The Commission provisionally recommends that, unless otherwise agreed between the parties, the promisee should retain the right to enforce a contract even if the contract is also enforceable by the third party. The Commission provisionally recommends that, in order to prevent double recovery, where a promisor has fully or partially fulfilled their duty to the third party they should be proportionately discharged from their duty to the promisee. [Paragraph 3.133]

4.14 The Commission provisionally recommends that certain types of contracts should be excluded from any reforming legislation and invites views on this matter. [Paragraph 3.147]