

PRIVITY OF CONTRACT – THE BENEFITS OF REFORM

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INTRODUCTION

The rule of privity of contract means that only the parties to a contract have enforceable rights and obligations under the contract. A third party to the contract cannot enforce any of its terms nor have any burdens from that contract enforced on them. The latter aspect of the doctrine is relatively uncontroversial,¹ but the former has throughout its development provoked much criticism and debate.²

In Ireland, specific difficulties caused by the privity rule have been dealt with up until now by piecemeal legislative and judicial reforms. However, in 2008 the Law Reform Commission recommended a general reform of the doctrine of privity of contract, to allow third parties to enforce contracts which were made for their benefit.³ In its Report on *Privity of Contract and Third Party Rights*, the Commission outlined a detailed legislative scheme of third party rights, and a draft Contract Law (Privity of

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¹ Exceptions to this rule do exist, however. For example, the rule in *Tulk v. Moxhay* (1848) 2 Ph. 774 provides that a negative covenant relating to land can in certain circumstances be enforced against subsequent owners of the land. Section 47 of the Land and Conveyancing Law Reform Bill, 2006, which is currently before the Oireachtas, proposes to make freehold covenants (positive and negative) fully enforceable by and against successors in title.

² For the history and development of the doctrine of privity of contract, see Flannigan, “Privity of contract – the end of an era (error)”, (1987) 103 L.Q.R. 564.

³ Law Reform Commission, *Report on Privity of Contract and Third Party Rights* (L.R.C. 88 – 2008), hereafter “Report” or “Commission Report”. The Report forms part of the Commission’s *Second Programme of Law Reform 2000 – 2007*, and follows the publication in 2006 of a Consultation Paper *Privity of Contract: Third Party Rights* (L.R.C. CP 40 – 2006). The Report and Consultation Paper are both available at: www.lawreform.ie.

Contract and Third Party Rights) Bill was included in an Appendix to the Report. Similar reforms have occurred in other common law jurisdictions, either by means of legislation, such as the Contracts (Rights of Third Parties) Act, 1999 in England and Wales, or as a result of judicial reform, as in Canada. This article will outline and analyse the arguments in favour of reform and the legislative scheme proposed by the Commission.

I. THE CURRENT LAW IN IRELAND

In Ireland, it is a general principle of contract law that a third party to a contract cannot enforce the contract, or a term of the contract, even if it was intended to benefit them. For example, A might promise his father, B, that in return for the family farm, A will pay a sum of money to his sister, C. If A fails to pay the money, the privity rule prevents C from suing A to enforce this contract.⁴

There are many exceptions to the privity rule, both at common law and in the statute book.⁵ They developed in an *ad hoc* fashion as a response to specific situations where the courts or the legislature ascertained a need to grant third parties the right to enforce a contract made for their benefit. One of the most important of these exceptions is agency, which allows a principal to sue and be sued on a contract entered into by their agent on their behalf. The law of trusts provides another potential means of enforcement: a third party can enforce a contract if a completely constituted trust was created in their favour by the contract. In some earlier cases the courts were willing to imply the existence of a trust to give rights to third parties,⁶ but this has been criticised as a “cumbrous fiction”,⁷ and today courts are reluctant to find that there is a trust unless it is clear that this was

⁴ See Report, para. 1.07, Example 2. See also *McCoubrey v. Thompson* (1868) 2 I.R.C.L. 226; *Cadbury (Ireland) Ltd v. Kerry Co-Operative Creameries Ltd* [1982] I.L.R.M. 77.

⁵ See Report, paras. 1.10 – 1.61.

⁶ See for example *Drimmie v. Davies* (1899) 1 I.R. 176; *Kelly v. Larkin* [1910] 2 I.R. 550.

⁷ Lord Wright (1939) 55 L.Q.R. 189, 208.

the intention of the parties.⁸ Specific statutory exceptions to the rule include section 8 of the Married Women's Status Act, 1957, which provides that any contract entered into by a person that confers a benefit on their spouse or their children can be enforced by the spouse or children,⁹ and section 80 of the Consumer Credit Act, 1995, which provides that where a consumer 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 agreement or a misrepresentation by either the seller or the hire purchase company.¹⁰

The rule of privity of contract is also circumvented in practice by means of devices such as assignment¹¹ and collateral warranties. This is particularly the case with large-scale projects in the construction industry, where chains of assignment and collateral warranties are often used to ensure that all the parties involved in the project (contractors, subcontractors, engineers, architects, *etc.*) are contractually bound to each other in some way. For example, the rule of privity means that a sub-contractor is not liable in contract to a principal employer, as its contract is with the contractor and not the employer, but a collateral warranty could be entered into to ensure that the sub-contractor is so liable.

II. THE NEED TO REFORM THE PRIVACY RULE

In its Report, the Law Reform Commission identified a significant number of difficulties with the privity rule.¹² Perhaps the most important of these is the fact that, as the law currently stands, a third party cannot enforce a contract made for their benefit even if the contracting parties agreed that they should be able to do so. Thus, the privity rule "can thwart the intentions of

⁸ See for example *Cadbury (Ireland) Ltd v. Kerry Co-op Creameries Ltd* [1982] I.L.R.M. 77.

⁹ The contract must expressly confer a benefit on the spouse or child: *Burke v. Dublin Corporation* [1991] 1 I.R. 341.

¹⁰ See also s. 14 of the Sale of Goods and Supply of Services Act, 1980.

¹¹ See s. 28(6) of the Supreme Court of Judicature (Ireland) Act, 1877, which provides that an "absolute assignment" by the assignor of any debt or other legal chose in action can pass the legal right to the debt or chose in action to the assignee.

¹² See Report, paras. 2.02 – 2.66.

the contracting parties”¹³ and run counter to the basic principle of freedom of contract. Lord Steyn has summarised this criticism of the privity rule as follows:

The case for recognising a contract for the benefit of a third party is simple and straightforward. The autonomy of the will of the parties should be respected. The law of contract should give effect to the reasonable expectations of contracting parties ... [T]here is no doctrinal, logical or policy reason why the law should deny effectiveness to a contract for the benefit of a third party where that is the expressed intention of the parties ... It is, therefore, unjust to deny effectiveness to such a contract.¹⁴

This argument is not without its critics. It has been argued that only the intentions of the promisee, and not the intentions of both contracting parties, are thwarted by the privity rule, because if the original promisor “wishes to comply with his original promise all he needs to do is keep it”.¹⁵ However, generally in any contractual analysis it is the intention of the contracting parties at the time of contracting which is important, and not their intention when performance is due.

Second, it has been argued that although the third party cannot sue the promisor for breach of contract, the *promisee* can always sue to enforce the contract, and this should suffice to give effect to the parties’ intentions.¹⁶ However, if the promisee has not suffered a loss they may only recover nominal damages, because as a general rule it is not possible for the promisee to recover damages in contract for the loss suffered by a third party.¹⁷ There are exceptions to this rule, in particular *The Albazero* exception,¹⁸ which arises when “loss is suffered in

¹³ Report, para. 2.03.

¹⁴ *Darlington Borough Council v. Wiltshier Northern Ltd* [1995] 1 W.L.R. 68, at 76.

¹⁵ Stevens, “The Contracts (Rights of Third Parties) Act, 1999”, (2004) 120 L.Q.R. 292, p. 293.

¹⁶ Stevens, “The Contracts (Rights of Third Parties) Act, 1999”, (2004) 120 L.Q.R. 292, p. 293.

¹⁷ See Report, paras. 1.63 – 1.68 and paras. 2.74 – 2.79.

¹⁸ *The Albazero* [1977] A.C. 774.

consequence of breach of contract, but the contract-breaker's position is that no-one is legally entitled to recover substantial damages from him".¹⁹ In this situation, the contracting party may be able to claim damages to represent the loss of a third party because otherwise the claim for damages falls into a "legal black hole". It is also possible that a court will give a broad interpretation to the loss suffered by the promisee, for example, by awarding damages to protect the promisee's "performance interest", *i.e.*, his interest in the provision of a benefit to the third party, or by awarding damages to compensate for the promisee's disappointment or inconvenience.²⁰ Such a broad measure of damages may be easier to obtain where the contract is a consumer transaction.²¹ It may also be possible to the promisee to obtain an order of specific performance to compel the promisor to perform their end of the bargain.²² However, the circumstances in which it is possible to recover damages to represent the loss suffered by a third party are limited and uncertain, and an order of specific performance will not always be available.²³

Even if the promisee can obtain substantial damages, the ability of the promisee to sue to enforce the contract would only assist third parties where the promisee (or, in the event of their death, their legal representative) is willing and able to bring such an action. It has been pointed out that "the stress and strain of litigation and its cost will deter many promisees who might fervently want their contract enforced for the benefit of third parties".²⁴ Furthermore, the ability of the promisee to sue would

¹⁹ *Technotrade Ltd v. Larkstore Ltd* [2006] E.W.C.A. Civ. 1079, para. 3 per Mummery J. The reference to damages is to damages in contract, and not in tort: see *Chia Kok Leong v. Prosperland Pte Ltd* [2005] 2 S.L.R. 484 (Singapore Court of Appeal).

²⁰ See Clark, *Contract Law in Ireland*, 5th ed. (Dublin: Thomson Round Hall, 2004), pp. 565 – 569.

²¹ See *Burke v. Dublin Corporation* [1991] 1 I.R. 341, at 353 where Finlay C.J. said that such cases may call for "special treatment" in relation to the measure of damages.

²² See for example *Beswick v. Beswick* [1968] A.C. 58.

²³ See generally Delany, *Equity and the Law of Trusts in Ireland* 4th ed., (Dublin: Round Hall, 2007), ch. 14.

²⁴ Law Commission for England and Wales, *Privity of contract: Contracts for the Benefit of Third Parties* (Law Com. No. 242, 1996), at para. 3.4.

be of little use to someone who is seeking to rely on an exemption clause contained in a contract to which they are not party.²⁵ Nor would the award of damages to a promisee be much consolation to a third party unless the third party could claim the sum awarded. If damages are awarded for the “use and benefit” of the third party, then the third party may be able to claim the sum, but if damages are merely awarded for the contracting party’s personal disappointment that the contract was not performed the third party may not be able to claim the sum.

More fundamentally, however, when the contracting parties intend to give a right of enforcement to a third party, it is difficult to see how it can be said that effect is given to that intention by allowing the promisee, but not the third party, to sue. It would surely be much simpler and clearer to give effect to the intentions of the contracting parties by allowing the third party to enforce the contract.

Another argument in favour of retaining the *status quo* is that contracting parties who wish to benefit a third party can always make use of one of the many exceptions to the rule, and that devices such as assignment and collateral warranties are frequently used to circumvent the privity rule. It could thus be said that privity does not cause real difficulties in practice. However, there are a number of difficulties with this argument.

First, the current exceptions do not cover every situation where an unjust or illogical result is caused by the privity rule. For example, section 7 of the Married Women’s Status Act, 1957 provides that a policy of life assurance which is expressed to be for the benefit of a spouse or child of the insured is enforceable by that spouse or child, but this section does not apply to other relatives or cohabitants under a contract of insurance.²⁶

²⁵ This is discussed in more detail below.

²⁶ Third parties who do not fall under the legislative exception would have to show that they come under an exception to the privity rule, for example by showing that a completely constituted trust was formed in their favour. However, in *Vandepitte v. Preferred Accident Insurance Corp of New York* [1933] A.C. 70, at 79-80 Lord Wright stated that “the intention to constitute the trust must be affirmatively proved: the intention cannot necessarily be inferred from the mere general words of the policy”.

Second, it is often unclear whether or not the courts will apply the privity rule or an exception to the rule, and there is always the possibility that the courts may, in an appropriate case, carve out a new exception to the rule – perhaps if not by outright reform,²⁷ then by developing existing exceptions or concepts. It must be said that the idea of a judicial development of the privity rule has its supporters, who suggest that “justice ... may in any event be achieved” by making use of devices such as constructive trusts or estoppel to allow a third party to bring an action in a suitable case.²⁸ Although it cannot be denied that in a suitable case these devices may bring about a desirable result (at least from the point of the third party), in this author’s view such developments would only add to the complexity of this area of law, and cause further uncertainty.²⁹ Mason C.J. in the Australian High Court has commented that the rights of third parties “should not be made to depend on the vagaries of such an intricate doctrine” as estoppel, and has said that it is doubtful whether estoppel would provide “an adequate protection of the legitimate expectations of [third parties]”.³⁰ Perhaps the real advantage of any such judicial development would be that it could act as a spur for legislative reforms.

The argument that the contracting parties can use a legal technique such as assignment to avoid the effects of the rule assumes that the parties are aware of the rule and its effects. However, many contracting parties may simply assume that a third party can sue to enforce a contract made for their benefit, and many third parties (for example, the recipient of a gift from a friend) may assume that they have enforceable rights under the main contract. Even if the contracting parties are aware of the existence of the rule, they are likely to need legal advice in relation to it, in particular to ascertain whether or not one of the

²⁷ As was arguably the case, for example, in Canada – see *Fraser River Pile & Dredge Ltd v. Can Dive Services Ltd* [1999] 3 S.C.R. 108.

²⁸ Byrne and Binchy, *Annual Review of Irish Law 2006* (Dublin: Round Hall Sweet & Maxwell, 2007), p. 430.

²⁹ See also the Report, paras. 2.68 – 2.73, where the Commission recommends that legislative reform of the privity rule is more appropriate than judicial reform.

³⁰ *Trident General Insurance Co v. McNiece Bros Pty Ltd* (1988) 165 C.L.R. 107.

many exceptions to the rule applies. Obtaining such advice is both inconvenient and expensive. Nor is there any guarantee that such advice will be conclusive – as discussed above, it can be unclear when the courts will apply the privity rule or an exception to the rule. Finally, if it is concluded that the privity rule applies, additional expense and inconvenience may be incurred in restructuring the transaction to avoid the effects of the rule. One commentator, carrying out an economic analysis of the rule, has stated: “[e]ven if the parties are fully informed of the rule and its effects, structuring their contracts to circumvent the rule entails wasteful transaction costs that a different rule could eliminate ... [an] efficient rule should minimize the transaction costs necessary for most parties to achieve their preferred outcomes”.³¹

For example, large complex construction projects may require the individual negotiating and signing of hundreds of separate collateral warranties, which can be difficult, expensive and time consuming. If the privity rule was abolished and replaced by a general scheme of third party rights, there would be a reduced need for such collateral warranties. Third party rights could be provided for in the main contract, without the need to go through the lengthy process of negotiating and obtaining separate warranties. The rights of third parties would also be easier to ascertain and manage, as all the rights would be contained in one document and not across several different warranties.³² In recent years in England, standard form construction contracts such as that produced by the Joint Contracts Tribunal have started to make use of the Contracts (Rights of Third Parties) Act, 1999 by including “Third Party Rights Schedules” as “a means of avoiding a proliferation of separate warranties and other collateral agreements”.³³ In its Report, the Law Reform Commission suggested that similar developments would be of benefit in the Irish context, and that many complex contractual arrangements

³¹ Trebilcock, “The Doctrine of Privity of Contract: Judicial Activism in the Supreme Court of Canada”, (2007) 57 *University of Toronto Law Journal* 269, 271 – 272.

³² See Report paras. 2.16 – 2.25.

³³ Joint Contracts Tribunal, *Major Project Construction Contract Guide*, (London; JCT, 2005), para. 122.

which are currently entered into could be simplified by the creation of a general exception to the privity rule.³⁴

One context in which the privity rule causes many difficulties is in relation to exemption clauses which seek to exclude or limit the contractual or tortious liability of a third party, such as an employee, sub-contractor, or agent of the contracting party.³⁵ A strict application of the privity rule means that third parties would not be able to rely on such a clause, as they were not party to the contract in which it was contained.³⁶ Exceptions to this rule have been developed in the courts,³⁷ which in some instances have been willing to allow third parties to rely on exemption clauses where to do so “is to give effect to the clear intentions of a commercial document”.³⁸ However, this approach is still quite limited. For example, it must be shown that the contractor was acting as the third party’s agent in obtaining the limitation of liability.³⁹ It has been argued that ensuring that this requirement is satisfied “imposes additional transaction costs and may present special difficulties where the subcontractors are not identified at the time the head contract is entered into and hence cannot be said to have authorized the head contractor to act on their behalf”.⁴⁰ However, a more basic criticism of the failure to fully recognise and enforce exemption clauses which are intended to protect third parties is that to do so is to ignore the allocation of

³⁴ Report, para. 2.14.

³⁵ See Report at paras. 2.35 – 2.45.

³⁶ See *Adler v. Dickson* [1955] 1 Q.B. 158.

³⁷ In Ireland, there is also possibly a legislative exception to the privity rule here. Section 34(1)(b) of the Civil Liability Act, 1961 provides that a defence “arising under a contract” is available in respect of a negligence action, but it is unclear whether this refers to a defence in *any* contract, or merely a contract to which the defendant is privy. See Quill, “Sub-contractors, Exclusion Clauses & Privity” (1991) I.L.T. 211.

³⁸ *New Zealand Shipping Co Ltd v. A M Satterthwaite & Co Ltd, The Eurymedon* [1975] A.C. 154, at 169, per Lord Wilberforce. See also *Port Jackson Stevedoring v. Salmond & Spraggon (The New York Star)* [1980] 3 All E.R. 257.

³⁹ See *Scruttons Ltd v. Midland Silicones Ltd* [1962] A.C. 446.

⁴⁰ Trebilcock, “The Doctrine of Privity of Contract: Judicial Activism in the Supreme Court of Canada”, (2007) 57 *University of Toronto Law Journal* 269, 280. It is possible for the subcontractor to ratify the head contractor’s actions after the fact, but this may involve a further increase in transaction costs.

risks and obligations agreed upon by the contracting parties.⁴¹ The problem has been summarised in the Supreme Court of Canada as follows:

[A]n application of the [privity rule] so as to prevent a third party from relying on a limitation of liability clause which was intended to benefit him or her frustrates sound commercial practice and justice. It does not respect allocations and assumptions of risk made by the parties to the contract and it ignores the practical realities of insurance coverage. In essence, it permits one party to make a unilateral modification to the contract by circumventing its provisions and the express or implied intention of the parties. In addition, it is inconsistent with the reasonable expectations of all the parties to the transaction, including the third party beneficiary who is made to support the entire burden of liability.⁴²

Taking into account views such as these, the Law Reform Commission concluded:

A contracting party who agrees to take on certain risks, or who has agreed that their rights to bring an action against a third party will be limited, should not be able to circumvent this agreement merely because it is the third party and not the contracting party who seeks to rely on it. To the extent that the law currently prevents third parties from relying on such clauses, it is clearly in need of reform.⁴³

⁴¹ See Trebilcock, "The Doctrine of Privity of Contract: Judicial Activism in the Supreme Court of Canada", (2007) 57 *University of Toronto Law Journal* 269.

⁴² *London Drugs v. Kuehne & Nagel International Ltd* [1992] 3 S.C.R. 299 at 423, per Iacobucci J. See also *Fraser River Pile & Dredge Ltd v. Can Dive Services Ltd* [1999] 3 S.C.R. 108.

⁴³ Report, para. 2.45. See also paras. 3.15 – 3.18. It should be noted that this recommendation is subject to the normal rules on the incorporation and construction of exemption clauses, so that exemption clauses should still be subject to close judicial control and scrutiny. In particular, legislative measures such as the European Communities (Unfair Terms in Consumer Contracts) Regulations, 1995 (S.I. No. 27 of 1995) would have to be taken into account: see Report, paras. 3.137 – 3.141.

The final argument put forward by the Commission in favour of reform was that the current law in Ireland does not reflect the international trend in favour of the enforcement of third party contractual rights. Third party rights have been long recognised in the United States⁴⁴ and in civil law jurisdictions such as France⁴⁵ and Germany,⁴⁶ and in recent years the privity rule has been significantly reformed in common law jurisdictions such as England and Wales,⁴⁷ Singapore,⁴⁸ New Zealand,⁴⁹ Canada⁵⁰ and Australia.⁵¹ Third party rights have been conceptualised differently in different jurisdictions, according to each jurisdiction's legal framework and needs. It would thus not be possible to simply "transplant" the law on third party rights from another jurisdiction into our own. Rather, in reforming the privity rule, legislators in Ireland should benefit and learn from the experience in other jurisdictions, and choose carefully from the different schemes which exist elsewhere.

⁴⁴ The law in the United States is reflected in s. 304 of the American Law Institute's *Second Restatement of Contracts*, which 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". See *Lawrence v. Fox* (1859) 20 N.Y. 268; *Choate, Hall & Stewart v. SCA Services Inc* (1979) 378 Mass. 535.

⁴⁵ See Article 1121 of the French Civil Code.

⁴⁶ See §328 - 333 of the German Civil Code (*Bürgerliches Gesetzbuch*).

⁴⁷ See the Contracts (Rights of Third Parties) Act, 1999, s. 1, which was enacted following the recommendations of the Law Commission in their 1996 Report *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com. No. 242, 1996).

⁴⁸ See the Contracts (Rights of Third Parties) Act, 2001.

⁴⁹ See the Contracts (Privity) Act, 1982, which was enacted following the New Zealand Contracts and Commercial Law Reform Committee, *Report on Privity of Contract* (Wellington: Department of Justice, 1981).

⁵⁰ In Canada, s. 4 of the New Brunswick Law Reform Act, 1993 and Article 1444 of the Quebec Civil Code provide for third party rights. There has also been a substantial amount of judicial reform of the privity rule: see *Fraser River Pile & Dredge Ltd v. Can Dive Services Ltd*. [1999] 3 S.C.R. 108. However, legislative reforms have still been advocated by the Law Reform Commission of Nova Scotia in its Final Report on *Privity of Contract (Third Party Rights)* (Halifax: Law Reform Commission of Nova Scotia, 2004).

⁵¹ See s. 11(2) of the Western Australia Property Law Act, 1969, s. 55 of the Queensland Property Law Act, 1974, and s. 56 of the Northern Territory Law of Property Act, 2000.

The models in England and Wales are of particular benefit in this context, as in both cases the privity rule was reformed by means of detailed legislation. In New Zealand, section 4 of the Contracts (Privity) Act, 1982 provides that:

[W]here 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.

This is subject to the proviso that the section does 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”.

In England and Wales, section 1 of the Contracts (Rights of Third Parties) Act, 1999 provides that a third party can enforce a term of a contract if the contract “expressly provides that he may” or “if the term purports to confer a benefit on him”, although the latter situation is subject to the proviso that it 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”.⁵² The kind of term that a third party can enforce is said to include a term of a contract which excludes or limits the liability of the third party.⁵³

A further consideration for the Commission in this regard is the continuing work of the European Commission on the Common Frame of Reference of Contract Law. In 2003 the European Commission’s “Action Plan on A More Coherent European Contract Law” proposed the development of a Common Frame of Reference (CFR) which could be used by the Commission in reviewing existing legislation and drafting new legislation.⁵⁴ In the 2004 “Way Forward” Paper the Commission suggested that the main purpose of the CFR would be to provide

⁵² Sections 1(1) and 1(2).

⁵³ Section 1(6).

⁵⁴ [2003] O.J. 63/1 COM [2003] final.

“fundamental principles, definitions and model rules” which could serve as a legislators’ guide or “tool box”.⁵⁵ The first major publication to result from this project is the Draft Common Frame of Reference prepared by the Study Group on a European Civil Code and the Research Group on European Community Private Law (*Acquis* Group).⁵⁶ Published shortly after the Law Reform Commission’s Report, it includes a section on the “effect of [a] stipulation in favour of a third party”⁵⁷ which states that the parties to a contract “may, by the contract, confer a right or other benefit on a third party”⁵⁸ and the benefit conferred “may take the form of an exclusion or limitation of the third party’s liability to one of the contracting parties”.⁵⁹ Although currently the focus of the European Commission is now on aspects of the consumer *acquis*, as opposed to contract law more generally,⁶⁰ the Draft Common Frame of Reference is important in that it reflects a consensus on the principles that underlie contract law in Europe. It is clear that the rights of third parties to enforce contracts made for their benefit is one of those principles, and yet Ireland lags behind the rest of Europe in its failure to recognise such a right.

III. THE SCHEME PROPOSED BY THE LAW REFORM COMMISSION

In its Report, the Law Reform Commission recommended that the privity rule should be reformed by means of detailed legislation. The scheme proposed by the Commission recognizes that there must be limits to when and how a contract can be enforced by a third party – contracting parties should not be liable to an indeterminate number of third parties merely because the contract incidentally benefits them. The most important limitation

⁵⁵ *European Contract Law and the revision of the acquis: The Way Forward* COM [2004] 651 final.

⁵⁶ Von Bar, Clive, Schulte-Nolke (eds.), *Principles, Definitions and Model Rules of European Private Law, Draft Common Frame of Reference (DCFR), Interim Outline Edition* (Munich: Sellier, 2008).

⁵⁷ Book II, ch. 9, s. 3.

⁵⁸ Book II, 9:301(1).

⁵⁹ Book II, 3:301(1).

⁶⁰ See the European Commission’s *Second Progress Report on the Common Frame of Reference*, COM [2007] 447 final.

on the rights of third parties to sue is that a third party does not have a right to enforce a contract, or a term of a contract, if the contracting parties did not intend for them to have this right. Even if a third party has a right of enforcement, it is clear that this is to be subject to the terms and conditions of the contract itself.⁶¹ Thus, the intention of the contracting parties is paramount. The corollary of this is that the proposed legislation is optional, and contracting parties can exclude it if they wish.⁶²

Taking the principle of the autonomy of the contracting parties as its starting point, the Commission's proposed statutory scheme deals with issues such as when third parties can enforce their rights under a contract, the identification of the third party, the ability of the contracting parties to cancel or vary the contract, the defences available to the promisor, the remedies available to the third party, and the possibility of overlapping claims. The Commission also discussed whether existing exceptions to the privity rule should be retained, and whether certain types of contracts should be exempted from the proposed legislation.

A. When Should a Third Party be able to Enforce their Rights under a Contract?

The Commission recommended that third parties should be able to enforce a term of a contract in three different situations.⁶³ First, the Commission recommended that a third party should be able to enforce a term of the contract when the term expressly benefits the third party, provided it was the intention of the contracting parties that the third party should be able to enforce this term. In other words, once the contract expressly confers a benefit on a third party, a presumption arises that the parties intended for the third party to have a right of action to enforce this term. This presumption can be rebutted by the contracting parties

⁶¹ See Report, paras. 3.46 – 3.49, and Draft Bill, s. 3(7).

⁶² See Report, paras. 3.152 – 3.153, and Draft Bill, s. 9(8). The mere failure to exclude the operation of proposed legislation will not guarantee that a third party has a right to enforce the contract.

⁶³ Report, paras. 3.02 – 3.19. For the sake of clarity, the Commission recommended that, provided all other requirements were met, the fact that a third party has not provided any consideration for the contracting party's promise should not be an obstacle to their right to enforce the contract: Report, para. 3.27, and Draft Bill s. 3(6).

(or rather, the promisor⁶⁴) if they can show that they did not intend for the third party to have such a right. Second, the Commission recommended that a third party should be able to enforce a term of the contract when the contract expressly states that the third party has a right of enforcement, regardless of whether or not the contract benefits the third party. Third, the Commission recommended that a third party should have a right to rely on a term of a contract which excludes or limits the liability of the third party, provided that was the intention of the parties.

The Draft Bill makes an important distinction between express and implied benefits. When a contract expressly benefits the third party, there is a presumption that the contracting parties intended for the third party to have a right of enforcement. However, if the contract impliedly benefits a third party, there is no such presumption, and the third party has no rights unless the contract expressly gives that third party a right to enforce the contract. This creates certainty for, and protects, contracting parties, in that third parties cannot enforce contracts which only incidentally benefit them unless the contract expressly states that they may do so.

The Draft Bill provides that when ascertaining the intentions of the parties the court should interpret the contract “in light of the surrounding circumstances which are reasonably available to the third party”.⁶⁵ This is an important addition to the Draft Bill, which will hopefully avoid some of the confusion which has been caused by a lack of similar clarification in the English Contracts (Rights of Third Parties) Act, 1999. In its 1996 Report, the Law Commission for England and Wales favoured an approach whereby the courts would take into account the surrounding circumstances,⁶⁶ but this was not expressly provided for in the 1999 Act, and it was argued that the Act restricts the courts to the contract itself when establishing the intentions of the

⁶⁴ The Commission makes clear that the defendant to any action will generally be the promisor, *i.e.* the contracting party who promised to benefit the third party. See Report, para. 3.50.

⁶⁵ Draft Bill, s. 3(2).

⁶⁶ *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com. No. 242, 1996) at para. 7.18.

parties.⁶⁷ The English Court of Appeal has recently confirmed, however, that the courts should, in an appropriate case, take into account all the surrounding circumstances,⁶⁸ although it is unclear whether or not there is a requirement that these surrounding circumstances be readily available to the third party.⁶⁹ The approach taken by the Law Reform Commission in the Draft Bill would seem to be a sensible one, which enhances certainty while balancing the interests of the contracting parties and the third party.

B. Identification of a Third Party Beneficiary

It is clearly important that the third party beneficiaries of contracts be easily identifiable, and thus the Commission recommended that the third party must be expressly identified.⁷⁰ However, the Commission recognised that a requirement that a third party beneficiary be individually named in the contract could be overly restrictive. For example, the contracting parties may want to benefit multiple third parties who are part of a particular group or class, such as all the employees of a company. Naming each individual third party would be cumbersome and commercially inconvenient in such a situation. The Commission thus recommended that it should be possible to identify the third party either by name or by description, and that this description

⁶⁷ Roe, "Contractual Intention under section 1(1)(b) and 1(2) of the Contracts (Rights of Third Parties) Act, 1999", (2000) 65 M.L.R. 887.

⁶⁸ *Prudential Assurance Co Ltd v. Ayres* [2008] E.W.C.A. Civ 52; [2008] All E.R. (D) 90 (Feb), reversing the decision of Lindsay J. in the High Court at [2007] E.W.H.C. 775 (Ch), [2007] All E.R. (D) 43.

⁶⁹ In *Prudential Assurance Co Ltd v. Ayres* the surrounding circumstances were reasonably available to the third party, so the issue of what was to happen if they were not so available did not arise. In *Investors Compensation Scheme Ltd v. West Bromwich Building Society* [1998] 1 W.L.R. 896 Lord Hoffman stated that the background which may be taken into account when interpreting a contract includes "absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man" but that this was subject to "the requirement that it should have been reasonably available to the parties": [1998] 1 W.L.R. 896, at 912. It is unclear however whether or not this includes third parties. See also the views of Saville L.J. in *Saville National Bank of Sharjah v. Dellborg* (Court of Appeal, unreported, Saville L.J., 9 July 1997).

⁷⁰ Draft Bill, s. 3(4).

should include being a member of a class or group of persons.⁷¹ The Commission also recognised that the contracting parties may wish to benefit third parties who are not yet in existence, for example, all the future employees of a company, or children who are not yet born, or persons who enter into sub-contracts in the future with one contracting party. The Commission saw no reason why such third parties should be excluded from the remit of the legislation, once it was possible to identify them with sufficient certainty, and thus recommended that there should be no requirement that the third party be in existence at the time of formation of the contract.⁷²

C. The Right of the Contracting Parties to Vary or Cancel the Contract

In determining the right of the contracting parties to mutually agree to vary or cancel the contract, the Commission had to compromise between two sets of competing interests. If the contracting parties had an unlimited power to vary the contract, the third party's rights would be relatively meaningless, as these rights could be changed by the mutual agreement of the contracting parties at any time. However, if the contracting parties could never agree to vary the terms of the contract it could restrict the contracting parties' ability to renegotiate and deal with problems as they arise over the course of performance. In particular, problems could arise where the third party's rights are a minor aspect of a complex contract, but the contracting parties' inability to vary those terms concerning the third party means that the main provisions of the contract cannot be changed.

In many jurisdictions where third party rights are recognised, the contracting parties are free to vary or cancel the terms of the contract until a certain determinable point. After this point, they may not vary or terminate the contract without the consent of the third party. This point, when the third party rights are said to have "crystallised", may occur when the contract is formed;⁷³ when the third party accepts the contract;⁷⁴ when the

⁷¹ Report, para. 3.23 and Draft Bill, s. 3(4).

⁷² See Report, para. 3.24, and Draft Bill, s. 3(5).

⁷³ This is the case in Scotland, where third parties can enforce contractual rights on the basis of a *ius quaesitum tertio*. See MacQueen, "Third Party

third party “adopts” the contract;⁷⁵ or when the third party relies on or materially alters their position in reliance on the contract.⁷⁶ In England and Wales the contracting parties lose the right to vary the contract if the third party communicates assent to the term to the promisor, or if the promisor is aware that the third party has relied on the term, or if 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 upon it.⁷⁷ The sheer variety of solutions to this problem shows that the issue is far from simple, and that many different approaches could be taken.

The Commission concluded that the contracting parties should not be able to cancel or vary the contract once it has been assented to, either by word or conduct, by the third party and either contracting party is aware of this fact.⁷⁸ If the consent of the third party is not obtained, the variation or cancellation of the contract will not affect the rights of the third party, who may bring an action based on the terms of the contract which existed before the variation.⁷⁹ In taking this approach, the Commission opted for simplicity and certainty over the interests of the contracting parties, and it is one of the few places in the Report where the rights of the third party could be said to “trump” those of the contracting parties. However, the rights of contracting

Rights in Contract: English Reform and Scottish Concerns”, (1997) 1 *Edinburgh Law Review* 488, pp. 489 – 490.

⁷⁴ See the Northern Territory Law of Property Act, 2000, s. 56(2).

⁷⁵ See the Western Australia Property Law Act, 1969, s. 11(3).

⁷⁶ See the New Zealand Contracts (Privity) Act, 1982, s. 5(1), and s. 311 of the American Law Institute’s *Restatement (Second) of Contracts*.

⁷⁷ The Contracts (Rights of Third Parties) Act, 1999, s. 2(1).

⁷⁸ Report, paras. 3.33 and 3.41, and Draft Bill, ss. 4(1) and 4(2). The term “assent” is preferable to “acceptance”, as the latter tends to imply a requirement of communication. There is no requirement that the third party communicate acceptance, but rather the test is based on the awareness of the contracting parties. This is to prevent a situation where the contracting parties are aware that the third party has assented to the arrangement (for example, the third party may have been present at the time the contract was agreed upon) but the promisor seeks to rely on the fact that the third party never formally communicated acceptance of the agreement. Of course, communication of acceptance is one way of ensuring that the contracting parties are aware of the third party’s assent.

⁷⁹ Report, paras. 3.36 and 3.41.

parties are wider than would initially appear, by virtue of the fact that they remain free to include in their contract an express term allowing them to vary or terminate the rights of the third party under the contract. The Commission pointed out that this would reduce the rights of the third party, but that this “should remain the choice of the contracting parties who are, of course, free not to contract or to benefit the third party at all”.⁸⁰

As an added protection for the contracting parties, the proposed legislation provides that the courts should have the discretion to authorise a variation or cancellation of the contract, on such terms as seem appropriate, where the third party’s consent cannot be obtained because their whereabouts cannot reasonably be ascertained or because they lack the mental capacity to give assent.⁸¹ In this situation the court can impose such conditions as it sees fit, including a condition requiring the payment of compensation to the third party.⁸²

D. The Defences Available to the Promisor

To avoid a situation where the third party is placed in a better position than the contracting parties, and to protect the position of the promisor, the Commission recommended that the promisor should be entitled to avail of any defence that would have been available if the promisee had taken the action, provided it arises out of or in connection with the contract in which the promise is contained.⁸³ For example, the promisor may be able to rely on the undue influence or misrepresentation of the promisee, or on a failure of performance or breach by the promisee. Importantly, the defences available to the promisor include the right to set-off, against the claim of the third party, any claim the promisor has against the promisee. However, the promisor’s claim cannot exceed the amount claimed by the third party, and,

⁸⁰ Report, paras. 3.37, 3.42 and Draft Bill, s. 4(3).

⁸¹ Report, paras. 3.38, 3.43 and Draft Bill, s. 4(4). The provision in s. 4(5) of the Draft Bill, whereby the court may dispense with consent required if it “cannot reasonably be ascertained whether or not the third party has in fact assented to the term” would seem to be superfluous in light of the fact that the contracting parties can vary the rights of the third parties if they are unaware whether or not the term was assented to.

⁸² Draft Bill, s. 4(6).

⁸³ Report, paras. 3.52, 3.59 and Draft Bill, s. 5(2).

as is the case with other defences, must arise out of or in connection with the contract.⁸⁴ There is of course potential for injustice in a situation where the third party is unaware of the conduct giving rise to the defence, but the Commission reasoned that “where two relatively innocent parties are affected by the improper conduct of the promisee, the right of the promisor to avail of the defence should prevail over the right of the third party”.⁸⁵

In addition, the Commission recognised that in certain situations it could be important to take the conduct of the third party into account. For example, the promisor may have entered into the contract because of the undue influence of the third party, rather than the undue influence of the promisee. Thus, the Commission recommended that the rights of the third party should also be subject to any defence which would have been available if the third party had been a party to the contract.⁸⁶ Similarly, the Commission reasoned that the promisor should be free to counterclaim against the third party, where the promisor would in any event have had a right of action against the third party. The Commission stressed that this is not imposing any additional burdens on the third party, as any such action could have been taken in any event.⁸⁷

E. The Remedies Available to the Third Party

One of the criticisms the Commission had of the privity rule was that it could cause an injustice to a third party who reasonably expected the contract to be performed. This injustice was said to be “particularly clear” where the third party had relied on the contract to their detriment, but it could also be seen “simply where the third party has a reasonable expectation that a contract, or term of a contract, made for its benefit, would be

⁸⁴ Report, para. 3.57, and Draft Bill, s. 5(2). The Draft Bill should perhaps clarify here that the promisor’s right to set off cannot exceed the amount claimed by the third party.

⁸⁵ Report, para. 3.53.

⁸⁶ Report, paras. 3.55, 3.60 and Draft Bill, s. 5(3).

⁸⁷ Report, para. 3.58. Throughout the Report, the Commission is clear that these reforms are not intended to impose burdens on third parties. See in particular paras. 3.46 – 3.49.

enforced”.⁸⁸ The proposed reforms thus aim to protect the third party’s expectation interest, and not merely their reliance interest.⁸⁹ In practical terms, this means that a third party who brings an action for breach of contract is entitled to a full range of remedies, including damages to compensate their expectation interest and specific performance, subject to the normal rules governing such remedies.⁹⁰

The remedy of the third party is not limited to compensation for loss incurred in reliance on the promise contained in the contract, and is not contingent on the third party having relied on the contract in any way.⁹¹ Although the possibility of linking the remedy available to a third party to its reliance loss may initially seem attractive, particularly as a means of reflecting the fact that a third party has not provided any valuable consideration for the promise contained in the contract,⁹² such a limitation could cause the creation of a “two tier” system of third party rights, whereby third parties who can rely on an existing exception to the rule (for example, section 8 of the Married Women’s Status Act, 1957) could claim full damages, while third parties who have to rely on the proposed legislation could only claim damages reflecting the extent of their reliance on the contract. Such a system would increase the complexity of litigation and cause much uncertainty.

F. Overlapping Claims

Under the proposed scheme, the rights of the promisee and the third party to enforce the contract are independent of each other, and neither has priority of action over the other.⁹³ The promisee does not have to wait for the third party to refuse the opportunity to sue before they can bring an action, and vice versa. Nor is there any requirement that the promisee be joined as a party to the litigation when a third party sues to enforce the contract (or vice versa), but the Commission recommended that

⁸⁸ Report, para. 2.07.

⁸⁹ Report, para. 2.94.

⁹⁰ See Report, paras. 3.63 – 3.68, and Draft Bill, s. 3(8).

⁹¹ See Report, para. 3.32, footnotes 31 and 32.

⁹² See Report, para. 3.27, and Draft Bill, s. 3(6).

⁹³ Report, paras. 3.71, 3.76, and Draft Bill, s. 6.

this should be possible in an appropriate case.⁹⁴ However, to avoid the risk that a promisor could face double liability, once a promisor has fulfilled their duty to the third party, either wholly or partly, the promisor should to that extent be discharged from their duty to the promisee.⁹⁵ Similarly, if a situation arises in which a promisor is liable to pay substantial damages to a promisee for breach of its promise to benefit the third party,⁹⁶ the court should reduce any award to the third party to take account of the sum recovered by the promisee.⁹⁷

⁹⁴ Report, paras. 3.71 and 3.76.

⁹⁵ Report, para. 3.72, 3.78, and Draft Bill, s. 7(1).

⁹⁶ As discussed above, the promisee may not be able to show that they have recovered a loss, and may not be able to recover substantial damages representing the loss suffered by a third party. Furthermore, the *Albazero* exception only applies if the party who has suffered the loss (*i.e.* the third party) has no legal claim against the contract breaker, which is not the case under the proposed reforms.

⁹⁷ Report, paras. 3.75, 3.79, and Draft Bill, s. 7(2).

G. Existing Exceptions

As discussed above, the harshness of the privity rule is mitigated somewhat by multiple common law and legislative exceptions. Unsurprisingly, the Commission recognised that the reforms proposed would not be an adequate or suitable substitute for these exceptions, some of which, for example, the law of agency, trusts and tort law, are separate areas of law in their own right and not merely a means of avoiding the privity rule. Some of the existing exceptions could give third parties more secure rights than those in the proposed legislation, and it would be somewhat bizarre if a measure designed (in part) to improve the rights of third parties could in fact reduce the current protection available to them. The Commission thus recommended that the existing exceptions should be retained.⁹⁸ Commenting on the equivalent provision of the Contracts (Rights of Third Parties) Act, 1999, Treitel has said that the retention of the existing exceptions leaves the law in an overly complex state, as a third party who cannot claim under the Act could still rely on an existing common law or statutory exception.⁹⁹

However, although it cannot be denied that the creation of a further avenue for a third party to enforce contracts may lengthen the discussion of privity in the average text book on contract law, in many ways the law on the topic will become more certain. One of the criticisms the Commission has of the current law is that it is uncertain – it is difficult for contracting parties and third parties to say with any certainty whether or not the third party has a right to enforce the contract. To a large extent this uncertainty exists because there is always the possibility that a court, in its eagerness to avoid the harshness of the privity rule, may find that an exception to the rule exists based on an “artificial and forced use”¹⁰⁰ of an existing concept such as trusts or estoppel. In contrast, if the proposed scheme is enacted, the judiciary is

⁹⁸ See Report, paras. 3.80 – 3.88, and Draft Bill, s. 9(5).

⁹⁹ Treitel, *The Law of Contract*, 11th ed., (London: Sweet & Maxwell, 2003), p. 581.

¹⁰⁰ The Law Commission for England and Wales has pointed out that some of the exceptions to the rule have developed through the “somewhat artificial and forced use of existing concepts”: *Privity of Contract: Contracts for the Benefit of Third Parties* (Law Com. No. 242, 1996) para. 12.1.

“unlikely to carve out a doctrine of third party rights which will operate in parallel to the statutory scheme”.¹⁰¹ Given the relative ease with which third party rights can be conferred under the proposed legislation, the failure of the contracting parties to make use of that legislation will generally be a clear indication that they did not intend for a third party to have any rights of enforcement. The introduction of a legislative scheme of third party rights should thus reduce reliance on concepts such as trusts, and the law should become clearer as a result.

H. Excluded Contracts

Certain categories of contract are excluded from the ambit of the scheme. Certain contracts are excluded on policy grounds. For example, the proposed legislation is not intended to give any third party a right to enforce any contract of employment against an employee.¹⁰² A similar exclusion can be seen in section 6 of the English Contracts (Rights of Third Parties) Act, 1999, which was proposed after government fears that employees could become liable in contract to third parties in the case of losses caused by strikes or industrial disputes.¹⁰³ This exclusion does not prevent third parties from bringing an action against the employer where the employer has promised to benefit them; nor does it prevent third party employees from enforcing terms of contracts which benefit them.

Other types of contracts are excluded because the creation of additional third party rights would undermine existing rules and regimes. For example, the proposed legislation does not apply to the contract formed between a company and its shareholders, and between individual shareholders, under section 25 of the Companies Act, 1963.¹⁰⁴ Nor does it apply where the third party

¹⁰¹ Andrews, “Strangers to Justice No Longer: The Reversal of the Privity Rule under the *Contracts (Rights of Third Parties) Act, 1999*”, [2001] C.L.J. 353, 379. See also MacMillan, “A Birthday Present for Lord Denning: *The Contracts (Rights of Third Parties) Act, 1999*”, (2000) 63 M.L.R. 721, pp. 730-731.

¹⁰² Report, paras. 3.90 – 3.92, and Draft Bill, s. 9(3).

¹⁰³ 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* (London: LLP Professional Publishing, 2000), p. 134.

¹⁰⁴ Report, paras. 3.93, 3.98, and Draft Bill, s. 9(2).

is a company which has not yet been incorporated.¹⁰⁵ Aware of the review being carried by the Company Law Review Group and the Department of Enterprise Trade and Employment, the Commission errs on the side of caution in refusing to let specific rules be affected by a general reform of contract law, preferring instead that any such review occur as part of a general reform of company law.

Similarly, the Commission recommended the exclusion of negotiable instruments, as these are already governed by the Bills of Exchange Act, 1882,¹⁰⁶ and the exclusion of letters of credit, which are subject to their own regime which reflects international commercial practice.¹⁰⁷

Finally, the Commission recommended the exclusion of contracts for the international carriage of goods by air, rail and road, as such contracts are already governed by international agreements which could be undermined by the creation of additional third party rights,¹⁰⁸ and the exclusion of contracts for the carriage of goods by sea, as these are governed by the Bills of Lading Act, 1855.¹⁰⁹ With regard to the latter type of contract, the Commission recognised the need to reform this Act, in much the same manner as was done in the United Kingdom with the Carriage of Goods by Sea Act, 1992, but concluded, perhaps optimistically, that this should be done by means of a specific review of the law relating to the carriage of goods by sea, and not by means of a general reform of the privity rule.¹¹⁰

CONCLUSION

Before the introduction of reforms in England, Lord Diplock described the privity rule as “an anachronistic short-coming that has for many years been regarded as a reproach to

¹⁰⁵ Report, paras. 3.94 – 3.98, and Draft Bill, s. 9(2).

¹⁰⁶ Report, paras. 3.112 – 3.113, and Draft Bill, s. 9(1)(a).

¹⁰⁷ Report, paras. 3.114 – 3.115, and Draft Bill, s. 9(1)(b).

¹⁰⁸ Report, paras. 3.99 – 3.104, and Draft Bill, s. 9(4)(b).

¹⁰⁹ Report, paras. 3.105 – 3.111, and Draft Bill, s. 9(4)(a). A third party can however enforce an exclusion or limitation clause in such a contract if the other requirements of the Act are met.

¹¹⁰ For criticism of the current law in Ireland, see White, *Commercial Law* (Dublin: Thompson Round Hall, 2002), pp. 644 – 645.

[the] law".¹¹¹ In its Report, the Law Reform Commission's Report agrees that there is a need to reform the doctrine, and the Draft Bill sets out in detail the means of doing so. It is to be hoped now that heed will be paid to the recommendations in the Report, and that legislation will be forthcoming. Contract law in Ireland will be more logical, certain, fair and commercially convenient, and more in line with the law in most other jurisdictions, as a result of any such move.

¹¹¹ *Swain v. The Law Society* [1983] 1 A.C. 598 at 611.