NEW RIGHTS FOR THIRD PARTIES

By Alison Green

The Contracts (Rights of Third Parties) Act 1999 confers new rights on those intended to benefit from contracts, including insurance contracts, even though they were not parties to those contracts. The Act was passed on 11 November 1999 and applies to contracts entered into on or after 11 May 2000. It may also be applied expressly to contracts entered into before 11 May.

For many years there had been criticism of the operation of the doctrine of privity in English law. The common law rule of privity provides that no one may enforce a contract to which he is not a party. This has sometimes worked unfairly where the parties to the contract intended a third party to benefit from it, but that third party turns out to be unable to enforce it. Over the years the courts have developed exceptions to the rule by, for example, extending principles of agency and trust law to circumvent the rule. The legislature has also created exceptions on a piecemeal basis to cater for particular situations where the rule has caused difficulties (see for example section 83 of the Fire Prevention (Metropolis) Act 1774, Third Parties (Rights against Insurers) Act 1930, section 56 of the Law of Property Act 1925).

In 1996 the Law Commission issued a Report entitled "Privity of Contract: Contracts for the Benefit of Third Parties" (Cm.3329), in which it examined the criticisms that had been made of this rule. The Law Commission accepted most of those criticisms and recommended that:

> *"the rule of English law whereby a third party to a contract may not enforce it, should be reformed so as to enable contracting parties to confer a right to enforce the contract on a third party".*

How privity of contract causes problems: an illustration in construction contracts

Simple construction contracts

In straightforward building contracts difficulties can arise where one contracting party enters a contract which should benefit a third party to the contract. To illustrate this, a son contracts with a builder for work to be done on the house of his elderly mother. If the work is done defectively, it is only the son who has a contractual right to sue the builder. On traditional principles and subject to the decisions in *Linden Gardens Trust v Lenesta Sludge Disposals Ltd* [1994] AC 85, and *Darlington BC v Wiltshire Northern Ltd* [1994] AC 85, the son can only recover nominal damages as he will have suffered no direct financial loss as a result of the builder's failure to perform. The mother could not sue for her losses because she was not a party to the contract, and the tort of negligence does not normally allow the recovery of pure economic loss.

Complicated construction contract

In complex construction projects there are a web of agreements between the participants in the project, allocating responsibilities between the client, the main contractor, sub-contractors and consultants, such as architects and engineers. The privity rule means that only parties within each contractual relationship can sue each other in contract. This means that one cannot in the 'main' contracts simply extend the benefit of the architect's and engineer's duties of care and skill, and the contractor's duties to build according to the specifications, to subsequent tenants or purchasers of the development. This cannot be achieved at present without either joining the third party in question into the contract which contains these obligations, which in the case of a subsequent purchaser or tenant is impractical, since their identity may be unknown at the start of construction, or even for a long time afterwards, or by executing a collateral warranty - extending the benefit of the duties in question. These collateral warranties are generally supported by separate nominal consideration or are made under deed and thus are not tied to consideration in the main contract.

Apart from contractual remedies, a subsequent purchaser or owner has little protection in tort (see *Murphy v Brentwood DC* [1991] 1 AC 398 and *D & F Estates Ltd v Church Commissioners for England* [1989] AC 177).

The Contracts (Rights of Third Parties) Act seeks to implement, with some amendments, the Law Commission's recommendations. It is required reading for those advising third parties to a contract.

Main provisions of the Act

Right of third party to enforce contractual term

Section 1 of the Act provides that a third party may in his own right enforce a contractual term where:

* he is expressly given the right to do so in the contract; or
* the contract purports to confer a benefit on him and the parties to the contract have not made it clear that they did not intend the third party to have a right to enforce.

Thus, the new Act will enable the contracting parties to make it clear whether they wish to give a third party the right to enforce a term of the contract.

To illustrate how this may work in practice: a main contractor may enter into an insurance contract which expressly provides that a third party may enforce the contract. Alternatively, in the absence of such an express provision, a term in the contract may be construed as conferring such a benefit on a third party. It will not,

however, be construed in that way if it can be shown that the parties did not intend the term to be enforceable by the third party.

Sufficient identification

It is not every third party who may enforce such a contract. The third party has to be expressly designated in the contract by name or as a member of a class or as answering a particular description. Presumably, if the contract refers to subcontractors on a particular site, that would be sufficient identification for these purposes. One advantage of the new legislation is that it is not necessary that a particular third party should be in existence when the contract was entered into. Thus, the fact that the main contractor had not hired a particular sub-contractor at the time when he entered into the insurance contract would not prevent that sub-contractor from taking advantage of the legislation if sub-contractors, as a group, are identified as intended beneficiaries of the contract.

Less need for collateral warranties

The Law Commission considered that its proposed reforms would enable contracting parties to avoid the need for collateral warranties by laying down third party rights in the main contract (see para 3.17 of the Law Commission's Report) and would also enable them to mirror the terms in existing collateral warranties. There is no reason why the architect's engineer's and contractor's liability to the third party could not be limited as it presently is under some collateral warranty agreements, so as to exclude economic loss and so as to be limited to a specified share or a just and equitable share of the third party's loss. The Act allows contracting parties to provide for a wider or a narrower sphere of operation for defences and set-offs, if they so wish.

Variation and rescission of contract

Section 2(1) of the Act provides that where a third party has a right to enforce a term in the contract, the contracting parties cannot, without the third party's consent, vary or rescind it so as to extinguish or alter the third party's rights. However, the parties to the contract may agree expressly in the contract that no consent from the third party is required to vary or rescind the contract or that consent is only required in specified circumstances.

Defences

Section 3 of the Act sets out the defences that a promisor can raise in an action by the third party, and broadly speaking, they include any defence or set-off that could have been raised against the promisee, and any defence, set-off or counterclaim that would have been available if the third party had been a party to a contract. The express terms of the contract can limit or expand the availability of defences to the promisor.

Other provisions

Section 4 preserves the promisee's rights against the promisor intact, and section 5 protects the promisor from having to pay out twice, once to the promisee and again to the third party.

Excluded contracts

Certain types of contract are excluded from the ambit of the Act, namely:

* contracts on a bill of exchange, promissory note or other negotiable instruments;
* the memorandum or articles of association of a company;
* employment contracts;
* certain contracts for the carriage of goods.

Conclusion

This Act is likely to make it much easier for third parties to secure the benefit of contracts intended to apply for their benefit. They will not have to rely on the contracting parties to enforce contracts on their behalf which has caused problems where, for example, a contracting party may have disappeared or been unwilling to assist.

Those advising third parties should make sure that their clients will be in a position to take advantage of the new legislation. Those advising insureds should ensure that the contracts make it clear who are intended to benefit from them, eg employees under health insurance plans. Those advising insurers should check that the policy wordings cover those who are intended to benefit from the contracts but do not inadvertently give rights of entitlement to those who were not meant to have them. Many insurers are unlikely to welcome the prospect of numerous third parties being able to enforce their policies directly. If so, they must take action to re-draft their policies by 11 May 2000, either to make it clear as to who may benefit or not benefit from their terms, or to limit or place conditions on the third party's rights, for example, by stating that if he wishes to enforce the rights he is to do so by way of arbitration and not litigation.

This Act should not be ignored. If one does not deal expressly with the impact of this Act in one's contract, it will ultimately be for a court to apply the rather vague test of whether a term "purports to confer a benefit" on a third party. It would be preferable for all concerned with the contract to clarify the position of third parties at the outset.

Alison Green, LLM, Barrister
4 Field Court
Grays Inn
London WC1