

**The Doctrine of Privity of Contract:
The Common Law and the Contracts (Privity) Act 1982***

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I. INTRODUCTION—THE PROBLEMS AT COMMON LAW

It is a long established principle of the common law that contractual obligations only operate between the parties to the contract. A contract between A and B cannot confer legally enforceable rights or impose binding obligations on a third person, C. Only parties to a contract can sue or be sued upon it.

The decisive case that establishes the doctrine of privity of contract is *Tweddle v. Atkinson*.¹ The doctrine was re-affirmed by the House of Lords in 1915 in *Dunlop Pneumatic Tyre Co. Ltd. v. Selfridge & Co. Ltd.*²

In *Dunlop's* case, a contract between a wholesaler and a retailer contained a minimum price agreement controlling the resale of tyres manufactured by the plaintiffs. The plaintiff manufacturer sought to enforce this agreement against the defendant retailer. However, the House of Lords held that the plaintiff could not enforce the agreement. The plaintiff's claim for damages and for an injunction to restrain the retailer from selling below the agreed minimum price failed because of lack of privity. They had provided no consideration and were not parties to the contract. In an important statement Lord Haldane said:

... in the law of England certain principles are fundamental. One is that only a person who is a party to a contract can sue on it. Our law knows nothing of a *jus quaesitum tertio* arising by way of property, as, for example under a trust, but it

¹ (1861) 1 B. & S. 393.

² [1915] A.C. 847.

cannot be conferred on a stranger to a contract as a right to enforce the contract in personam.³

Both these cases have been followed and applied in a plethora of cases and notably in *Beswick v. Beswick*,⁴ *Coulls v. Bagot's Executor and Trustee Co. Ltd.*,⁵ *Lambly v. Silk Pemberton Ltd.*,⁶ *Midland Silicones Ltd. v. Scruttons Ltd.*,⁷ *Woodar Investment Development Ltd. v. Wimpey Construction U.K. Ltd.*,⁸ and *New Zealand Shipping Co. Ltd. v. A. M. Satterthwaite & Co. Ltd.*⁹ where Lord Wilberforce stated, in delivering the judgment of the majority of the Privy Council:

There is no need to question or even to qualify [*Midland Silicones Ltd v. Scruttons Ltd* [1962] A.C. 446] in so far as it affirms the general proposition that a contract between two parties cannot be sued on by a third person even though the contract is expressed to be for his benefit.¹⁰

Another situation in which the privity rule has made its presence felt is where a contracting party attempts to confer under his contract an immunity, or other limitation or qualification, on the liability of a third party for that third party's acts or omissions. For example, in *Midland Silicones Ltd. v. Scruttons Ltd.*¹¹ a ship owner had contracted with a goods owner on the basis that stevedores unloading the goods were to have the benefit of an exception clause in the bill of lading. Part of the goods were lost due to the stevedore's negligent unloading. The owner of the goods successfully sued the stevedores in negligence. The stevedores were held to be unable to rely on the exception clause in the bill of lading, because they were not parties to the contract it evidenced.

The New Zealand Parliament has recently implemented certain proposals advocated by the New Zealand Contract and Commercial Law Reform Committee to reform the doctrine of privity of contract, in the form of the Contracts (Privity) Act 1982. The Act embodies a new scheme that will govern the right of third parties to enforce promises made for their benefit. The Contracts (Privity) Act 1982 does not destroy the doctrine of privity of contract, but modifies it, by allowing, in certain circumstances, third parties to sue on a contract in respect of a promise made in their favour. The purpose of the legislation is to remedy the unjust results that the privity rule can give rise to.

The injustice that the rule can cause has recently been highlighted by Lord Scarman, with Lords Salmon and Keith concurring, where he

³ *Ibid.*, 853.

⁴ [1967] 3 W.L.R. 932.

⁵ (1963) 110 C.L.R. 460; [1967] A.L.R. 385.

⁶ [1976] 2 N.Z.L.R. 427.

⁷ [1962] A.C. 446.

⁸ [1980] 1 All E.R. 571.

⁹ [1974] 1 N.Z.L.R. 505.

¹⁰ *Supra*, 508-509.

¹¹ *Supra*.

called for relief in this area of the law in his judgment in *Woodar Investment Developments Ltd. v. Wimpey Construction U.K. Ltd.*¹²

One of the most severe instances is as follows: A and B contract on the basis that A (the promisor) will provide a benefit for C (a third party). B (the promisee) has no economic interest in the performance of the promise by A. In breach of contract A fails to confer the benefit on C. Only B can bring an action against A, since the privity rule prevents C from doing so. If B decides to sue A and specific performance is not, in the circumstances, an available remedy, then it would seem to be the law (Lord Scarman certainly thinks it is) that normally¹³ all B could recover in the action would be nominal damages, since he would suffer no economic loss by the breach of contract by A. So, in effect, B will be without a remedy. This would be the result even though B would have to find money or money's worth from somewhere else, at his own cost, in order to confer the benefit on C which A had contracted to provide.

In principle this is quite unacceptable and patently unjust, because it enables promisors to renege from their contractual undertakings and deprive third parties of benefits due to them, at the mere risk of being liable for nominal damages if sued by the promisee. Furthermore, in many such instances, no doubt, promisors will have reneged on contractual obligations and suffered no resulting penalty, because the promisee would not sue because of the prospect of receiving only nominal damages. Such defaulting promisors will have been able to get away with reneging on their contractual obligations, thereby defeating that aspect of the contract entirely, even though the promisee may have completely performed his side of the contract or parted with a substantial sum of money. The privity rule thus enabled such defaulting promisors to retain the fruits of their contract without fulfilling their obligations. Recognising a right of enforcement in the third party would enable the third party to recover substantial damages for the breach of contract thereby giving real effect to the contractual obligation.

The privity rule, which only allows contractual obligations to *operate* between the contracting parties can, therefore, sometimes cause something of a contradiction; for it can enable a contracting party to *avoid* his contractual obligations. The rule can be used to impede the operation of contractual obligations.

¹² *Supra*.

¹³ This will be the case unless B has contracted for a non-pecuniary benefit which the court is prepared to quantify in damages (see for example *Jackson v. Horizon Holidays Ltd* [1975] 3 All E.R. 92; [1975] 1 W.L.R. 1468) or unless the promisor's breach entitles the promisee to cancel their contract pursuant to section 7 of the Contractual Remedies Act 1979, the promisee may well recover more than just nominal damages by virtue of the Court's power to grant relief under section 9 of the Act.

Not surprisingly, the privity rule has in the past been circumvented on many occasions through legal ingenuity and judicial "sleight-of-hand". An excellent and full outline and analysis of these methods and devices is found in the New Zealand Contract and Commercial Law Reform Committee's report on Privity of Contract.¹⁴ For present purposes, however, a look at one such method will suffice, namely, the use of the constructive trust.

The courts have enabled third parties to obtain the benefits due to them under contracts by "finding" that the promisee contracted as trustee for the beneficiary. Where such a trust is found, the beneficiary can enforce the promise if the promisor defaults and if the promisee trustee will not enforce the promise.

Such a trust was found in *Lloyd's v. Harper*¹⁵ and *Les Affrèteurs Réunis Société Anonyme v. Leopold Walford (London) Ltd.*¹⁶ but the Court refused to do so in *re Schebsman*¹⁷ and *Midland Silicones Ltd. v. Scruttons Ltd.*¹⁸

However, there are problems associated with this method of avoiding the privity rule. First, a trust once constituted is generally irrevocable without the beneficiary's consent, which makes the situation too inflexible as it immediately takes away the contracting parties' right to vary their contract in this respect.

Secondly, and most importantly, the basic rule for the creation of a trust is a manifestation of intention to create a trust,¹⁹ but in the third party context the attempt is often to find a trust where it is quite clear that none of the contracting parties had an intention to create one, so that the trust found has frequently been of a most artificial nature. The courts have similarly applied a strained construction to contracts, to avoid the privity rule, by "showing" that the promisee was contracting as the agent of the third party.

Nor surprisingly, the courts have become more reluctant to find that such trusts exist and, although the door to finding such trusts is not locked, the courts are consistently failing to open it.²⁰

However, all the methods and devices that have been employed over the years to circumvent the doctrine of privity of contract in order to see that justice is done in individual cases have been merely singular, ad hoc solutions in an area of the law requiring substantive reform.

¹⁴ Privity of Contract: Report (Government Printer, Wellington, 1981).

¹⁵ (1880) 16 Ch.D. 290.

¹⁶ [1919] A.C. 801.

¹⁷ [1944] Ch. 83.

¹⁸ *Supra*.

¹⁹ "The intention to create a trust must be affirmatively proved" *Vandepitte v. Preferred Accident Insurance Corporation of New York* [1933] A.C.70, 79, 80, per Lord Wright. See also *New Zealand Shipping Co. Ltd. v. A.M. Satterthwaite & Co. Ltd.* [1974] 1 N.Z.L.R. 505.

²⁰ See Chesire and Fifoot, *Law of Contract*, (5th N.Z. ed., 1979), 379.

The Contracts (Privity) Act 1982 will bring this much needed reform.

II. THE CONTRACTS (PRIVITY) ACT 1982

A. *The Effect of Section 4*

Section 4 of the Act is the enabling section which allows enforceable rights to be bestowed by contract on third parties. It reads as follows:

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.

The term "benefit" used in the section is given a wide meaning by section 2. It is defined as including: (a) any advantage; and (b) any immunity; and (c) any limitation or other qualification of an obligation or a right to which a person (other than a party to the deed or contract) is or may be subject.

The effect of section 4 is that a third party can acquire a contractual right without being a party to a contract and, a fortiori, without giving consideration. Those third parties that do receive enforceable rights by contract are defined in section 2 of the Act as "beneficiaries". Where section 4 applies to a promise it does not destroy a promisee's rights in respect of the promise; it creates a separate and additional right in respect of the promise in the beneficiary, by imposing an obligation on the promisor to perform which the beneficiary can enforce.²¹

What this means, is that where section 4 applies to a promise, the promisor, in respect of that promise, assumes two distinct sets of legally binding obligations. One arises by ordinary contractual principles and is owed to the promisee and is enforceable by him as a party to the contract, the other, a quite separate obligation, arises by virtue of section 4 of the Act and is owed to the beneficiary and, by virtue of section 8, is enforceable by him as if he were a party to the contract. Section 8 provides as follows:

The obligation imposed on a promisor by section 4 of this Act may be enforced at the suit of the beneficiary as if he were a party to the deed or contract, and relief in respect of the promise, including relief by way of damages, specific performance, or injunction, shall not be refused on the ground that the beneficiary is not a party to the deed or contract in which the promise is contained or that, as against the promisor, the beneficiary is a volunteer.

B. *The Operation of Section 4*

The operation of section 4 is as follows: it provides a presumption,

²¹ Of course he can only exercise that right when the promisor fails to perform the promise and the beneficiary is deprived of the benefit due to him.

that where a promise contained in a contract confers, or at least purports to confer, a benefit on a designated third party, the promisor will be under an obligation, enforceable at the suit of that third party, to perform the promise. This presumption will be rebutted only if it can be shown, on the proper construction of the contract concerned, that the promise was not intended to create, in respect of the benefit, an obligation enforceable by that party.

Therefore, when section 4 *prima facie* applies to a promise the onus lies on the promisor (or promisee) who asserts that an enforceable right was *not* intended to be conferred on the third party concerned, to show this on the proper construction of the contract.

It is not necessary in order for contracting parties to create enforceable rights in designated third parties expressly to state in their contract that section 4 of the Act shall apply to this promise, or that the promisor shall be under an obligation enforceable at the suit of the said third party to perform this promise, because it will be presumed by section 4 that this is the case where a promise is made for the benefit of a designated third party. However, it would seem advisable to so expressly state when such is the intention of the contracting parties, since it ensures that a properly designated third party *will* have enforcement rights in respect of that promise and avoids the problem of the court having to construe the contract, with the accompanying possibility that the third party will be deprived of an enforceable right that he was in fact intended to receive, if the promisor has a change of heart and decides to litigate the point, or seeks a declaratory judgment.

Similarly, it is not in principle necessary, in order for contracting parties to negative potentially enforceable rights in third parties, expressly to state in their contract, "section 4 of the Contracts (Privity) Act 1982 shall not apply to this promise", or "the promisor will not be under an obligation enforceable at the suit of the said third party to perform this promise"—such clauses for convenience can be called "privity clauses"—because it is open to them to show that on the construction of their contract the third party was not intended to receive an enforceable right. Moreover, only properly *designated* third parties can receive enforceable rights in any event.

However, when promisors do not intend to be obligated to third parties it will be absolutely crucial, because of the presumption section 4 creates in favour of designated third parties, for them expressly to state this in their contract. Otherwise, the promisor may be involved in a needless waste of time and money in litigation with a third party, in what may not necessarily be a successful attempt to show that the third party was not intended to have a right of action against the pro-

misor. This could be simply avoided by inserting a privity clause into the contract.

However, from a practical point of view, although contracting parties can avoid doubt as to whether or not third parties are to receive enforceable rights by making an express stipulation in their contract, this will only occur where the contract is drawn up by a competent solicitor, or the parties themselves are aware of the Act's effect and draw up their contract with it in mind.

1. The requirement that a beneficiary be designated

Section 4 only applies to third parties "designated by name, description, or reference to a class". It therefore limits the generality with which a person, who is to have rights of enforcement in respect of a promise contained in a contract to which he is not a party, can be denoted. Being "designated" does not merely mean being "mentioned", instead it means, being specified, particularized, or picked out as the thing or person meant or wanted.

A designated third party need not be in existence at the time when the contract under which he is to receive a benefit is made. This provision in the section is important, because it enables a promisee to confer an enforceable right on a child or even a future spouse, that is not born when the contract is made.

What is meant by being "designated by description" cannot be answered in specific terms, since it will depend on the circumstances of the particular case whether or not a person can be said to be "designated by description". In general terms however, it would seem to mean that there is such a description if the identity of the intended beneficiary is evident, or at least ascertainable at the appropriate time, namely: (a) when the benefit falls to be conferred on the beneficiary; or (b) when either of the contracting parties seek to vary or discharge the beneficiary's rights in respect of the promise; or (c) otherwise when the promisor needs to know who the beneficiary is.

Allowing beneficiaries to be designated by description preserves a promise for the benefit of a person who has been so identified but does not have the status specified, at the time of the formation of the contract, as for example in the case of a promise for the benefit of the spouse of the promisee, which was made when the promisee was unmarried.

Allowing beneficiaries to be designated by reference to a class is a necessary provision. It enables the benefit of enforceable rights to be conferred on a class of beneficiaries that may continually change in number and identity, as for example where the beneficiaries are the employees of a particular firm. Employees will come and go, but those

people who are employees of the firm at any particular point in time will have the benefit of the enforceable rights at that time. To give a more specific example, the benefit of an exception clause could be conferred on "the stevedores" of a shipping company as a designated class of section 4 beneficiaries and the limitation or exemption of liability that the clause would give, would extend to those people employed as stevedores by that company at any time in question.

Although the way is open for promisors to make themselves obligated to a large number of third parties, the fundamental point is that if a promisor agrees to a term giving such third parties enforceable rights, then that is the promisor's choice and the consequences of it must rest on his head. This is as it should be for it preserves the freedom of contracting parties to make such bargains as they see fit. Contracting parties will not usually agree to terms that are unduly deleterious to them.

2. *Discriminating between those third parties who are intended to have enforceable rights and those who are not*

The question of bother regarding section 4 is how effective it will be in differentiating between third parties who have promises intentionally made for their benefit and upon whom the contracting parties wish to bestow rights of action in respect of that benefit, and third parties who receive mere incidental benefits in the performance of the contract, (which is an inevitable occurrence in the performance of most contracts) and who are not intended to have a right of action. The American experience shows²² that differentiating between the two cases is by far the most troublesome problem in reforming the privity doctrine. A number of examples illustrate this:

- (a) A labourer who was employed by a federal construction firm successfully sued his employer to recover extra pay for overtime work, as a third party beneficiary of a contract between his employers and the U.S. government. The contract contained a provision requiring the firm to obey all applicable laws of the United States. It was held that since this included the "Eight Hour Pay Law"—which directs employers to pay employees extra money for overtime work—there was in effect a promise by the employer to the U.S. government to pay employees extra money for overtime work, and the employee cook was entitled to enforce this promise: *Filardo v. Foley Bros., Inc.*²³

²² The vast majority of its states allow third parties to enforce promises made for their benefit.

²³ 78 N.E. 2d 480.

- (b) A power company's buildings and facilities were damaged in the course of the construction of a sewer tunnel by the defendant contractors nearby. The power company successfully brought an action against the contractor for all the damage it incurred, as a third party beneficiary of the sewer tunnel construction contract between the city of St. Joseph (who commissioned the works) and the contractor, on the basis that the contract contained a promise by the contractor to "protect repair and restore property and structures from damage"—even though the damage was held to have been caused by the city's negligent investigation of the condition of the underlying soil prior to the tunneling: *St. Joseph Light & Power Co. v. Kaw Valley Tunneling Inc.*²⁴
- (c) The owner of a car which was towed away by the defendant, pursuant to a contract with the city of New York for towing away abandoned cars, successfully sued the defendant as a third party beneficiary of that contract. Under the contract the defendant was required to hold the car without touching it for five days before destroying it, but in breach of contract cannibalised the car after only three days: *Turkel v. Fiore*.²⁵

These cases, and there are many more like them reported²⁶, are notable in that in none of them is there an intention on the face of the contract to confer an enforceable right on the third party concerned, yet the third party was held to have an enforceable right in each case.

The *Filardo* case in particular illustrates the American tendency to use the third party beneficiary law to ensure the due performance of statutory duties. The *St. Joseph* and *Turkel* cases show how a third party can successfully plead in contract what is essentially a tort claim.

If similar results were possible under the Act²⁷, the legislation would be going far beyond the mere reform of the privity rule and in the long term could see what are essentially tort cases being pleaded in contract. The effect of this on the future direction of contract law in New Zealand would be dramatic and it could become a significant vehicle for the introduction of social change, as it has been in America.

It remains to be seen how effective section 4 will be in differentiating between those cases in which third parties are intended to have the right to bring actions against promisors and those in which they are

²⁴ 589 S.W. 2d 260.

²⁵ 308 N.Y.S. 2d 432.

²⁶ See for example Jackson, *Contract Law in Modern Society*, West, (1973), 562-563.

²⁷ It must be noted however that the cited cases would be decided differently under the Act as in none of the cases does the contract contain a designated beneficiary: in the first the promise is to "obey applicable laws"; in the second the promise is to "protect repair and restore property"; and in the third it is to "hold" cars for a certain time.

not. In the final result, an onus will rest on the judges administering the Act correctly to construe the contractual intentions contained in the contracts before them.

There is a likelihood however, that results similar to those in the American cases, where there is no intention to bestow an enforceable right on a third party but no express stipulation on the matter in the contract, could occur under the Act. This could occur not just when a judicial activist is "construing" a contract, but simply where a contractual promise confers or purports to confer a benefit on a third party that is apparently designated in the contract and there is nothing on the face of the contract to rebut the section 4 presumption that that third party is intended to receive an enforceable right. Only time will tell whether this will be an area for concern.

A. Variation and Discharge

1. The effect of the variation or discharge of a promise to which section 4 applies or of an obligation imposed by section 4

A primary concern in the Act is the variation or discharge of a promise to which section 4 applies, or of the obligation imposed by section 4 in respect of that promise, or of both. It is useful to analyse the four situations that can arise in this respect. These are:

(a) The discharge of the promise; or (b) The variation of the promise; or (c) The discharge of the obligation; or (d) The variation of the obligation.

(a) If the promise is discharge, then simultaneously the obligation imposed by section 4 in respect of that promise must also be discharged. This is because the obligation is one to perform the promise while the promise remains part of the contract. Therefore, to discharge the promise is to discharge the beneficiary's enforceable right in respect of that promise, since that right is derivative from and dependent upon the promise for its continued existence—the right to enforce the obligation being the right to bring an action on the promise.

(b) The position as to the variation of the promise is similar. If the promise is varied (in so far as the benefit to the beneficiary is concerned) then the obligation must change with it. What will result when the promise is so varied is an obligation to perform the newly constituted promise. It is therefore clear, that varying or discharging the promise, has the effect of varying or discharging the section 4 obligation accordingly.

(c) The effect of discharging just the obligation is to reinstate

the position at law with respect to the beneficiary under the strict doctrine of privity of contract; the beneficiary having no right to compel the performance of the promise. The actual promise remains part of the contracting parties' contract but only the promisee can bring an action if the promisor fails to perform it.

- (d) Variation of the obligation simply involves varying what the promisor is obligated to the beneficiary, personally, to perform. This might include making the obligation extend to only part of the promise. In the case of an obligation to pay a beneficiary a sum of money varying the obligation could, for example, involve making the promisor obligated to the beneficiary to pay only part of the amount promised. Thus, contracting parties can vary or discharge a beneficiary's right solely by varying or discharging the section 4 obligation, while leaving the normal contractual obligation that is owed to the promisee intact.

In summary, the essential point is that a beneficiary's right in respect of a promise will be varied or discharged if the section 4 obligation alone is so varied or discharged, and the beneficiary's right will also be varied or discharged if the promise itself is varied or discharged.

2. *Variation or discharge of a beneficiary's rights*

It is clear, that giving a beneficiary an enforceable right that is to be of substance must involve limiting the right of the contracting parties to vary and discharge the terms of their contract in so far as they adversely affect the beneficiary's rights. Sections 5, 6 and 7 provide a solution to the problem of restricting the rights of contracting parties to modify and abrogate their contractual stipulations, that does the least violence to the notion of a contract being a bargain of which the contracting parties control the operation.

Sections 5, 6 and 7 represent a trade-off or compromise between the right of contracting parties to create, vary and discharge their contractual stipulations, on the one hand, and the protection of beneficiaries whose position has been materially altered by reliance on promises made in their favour.

Section 5 limits the right of contracting parties to alter their contract in derogation from a right that has been conferred on a beneficiary. The relevant parts of the section provide as follows:

- (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 on the promise; or
- (c) A beneficiary has obtained against the promisor the award of an arbitrator upon a submission relating to the promise—
the promise and the obligation imposed by that section may not be varied without the consent of that beneficiary.

The basic idea is that contracting parties are free to vary or discharge a beneficiary's rights until the beneficiary's position is materially altered (by an act or omission) in reliance on the promise—presumably by material alteration of position is meant an alteration of position to one's detriment. The sort of situation that is envisaged is, by way of illustration, where a beneficiary in reliance on a promise to be given an annuity on retirement, fails to renew a life assurance endowment policy and it lapses. In addition, express provision is made in section 5(1) (a) to protect a beneficiary whose position is materially altered by the reliance of *another person* on the promise. This covers the type of situation where, for example, a husband is to receive an annuity upon his retirement as a beneficiary of a contract between his employers and an insurance company, and his wife in reliance on this promise believing her and her husband's future to be financially secure, withdraws all the money from their joint bank account, invests it in a company which, then, becomes insolvent and the savings are lost. The effect of the section is that where the position of a beneficiary has been materially altered by the reliance of the beneficiary or some other person on the promise, or the beneficiary has obtained against the promisor judgment upon the promise, or the award or an arbitrator upon a submission relating to the promise, then, subject to sections 6 and 7 of the Act, the contracting parties cannot vary or cancel the obligation which the promisor owes to the beneficiary without the beneficiary's consent.

It is clearly imperative that the parties should not be able to affect a beneficiary's right once he has secured judgment. It would be monstrous if a court or arbitration decision in a beneficiary's favour could be overridden by the contracting parties, since that would render the judgment or award ineffective. Sections 5 (1) (b) and (c) ensure that this cannot happen.

Nothing in section 5 or in any other section of the Act restricts the right of contracting parties to alter or cancel their contractual obligations before one of the three situations in section 5 occurs. Therefore, contracting parties are free at any time, before one of the three situations in section 5 occurs, to vary or cancel obligations in derogation of a beneficiary's rights.

3. *Variation or discharge of a beneficiary's right permitted by section 6 by agreement or in accordance with an express contractual provision*

Section 6 is not subject to any other section—its provisions are

expressly paramount to all others in the Act. It provides contracting parties with the right to vary their contract in derogation of a beneficiary's rights, at all times, provided the requirements of subsection (a) or (b) are complied with.

Section 6 reads as follows:

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
 - (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 promise became known to him; and
 - (iv) The variation or discharge is in accordance with the provision.

Section 6(a) recognises the right of all the interested parties (i.e. promisor, promisee, and beneficiary) to agree to vary or discharge section 4 obligations. This, however, does not give the contracting parties any additional power to vary or discharge obligations, because section 5, if it applies, only precludes variation or discharge without the beneficiary's consent, i.e. the beneficiary can still consent to the variation or discharge of his rights. Section 6(a) therefore merely expresses what section 5 implies.

Section 6(b) sets out the position where the contract contains an express provision for the variation or discharge of obligations. In such a case, the contracting parties are free to vary or discharge obligations in accordance with that provision provided that the beneficiary has not materially altered his position in reliance on the promise before becoming aware of the provision and provided that the provision was contained in the contract when the promise was made. Section 6(b) clearly provides contracting parties with an additional power to discharge beneficiary rights.

A beneficiary who with prior knowledge of an amending provision in the parties' contract acts in reliance on a promise can have no complaint if his rights in respect of that promise are later discharged or varied in accordance with the provision; since all acts in reliance on the promise by him were subject to the known danger that his rights in respect of the promise could at any time be varied or discharged in accordance with that provision. Moreover, if a beneficiary is only intended to receive a conditional or qualified right then that is all he should get—he does not have to act on that right.

Where a beneficiary has been misled, or only partially informed as to the effect of such a provision, by a contracting party, it would be manifestly unjust and unconscionable to allow either of the contracting parties to assert such a provision to vary or destroy the beneficiary's rights, after he has materially altered his position in reliance

on the promise. Section 6(b) (ii) prevents this however, by prohibiting contracting parties from invoking such a provision after the beneficiary's position has been materially altered in reliance, unless the provision was *known* to the beneficiary prior to the reliance.

Section 6(b) (ii) states that the provision must be known to the beneficiary ". . . whether or not the beneficiary has knowledge of the precise terms of the provision". For the provision to be known to the beneficiary he must be aware of the provision's effect i.e. what it does and how it qualifies his rights; even though the precise terms of the provision may be unknown to him. The beneficiary must know the substantive effect that the provision will have on his rights if it is invoked, and when it can be invoked.

This knowledge requirement could go too far however, and weigh too heavily in a beneficiary's favour, where for example, the beneficiary is warned and is alert to such a provision in the parties' contract but has contrived to avoid finding out what its effect is, for fearing of finding out that it adversely affects his rights, despite the best efforts of the contracting parties to inform him of its effects. For example, they may try to tell him personally but he will not listen; or he may be sent a letter containing the information as to the effect of the provision on his rights, but does not bother to read it; or generally where he acts wilfully blindly as to the provision's effects but knowing that there is a provision that in some manner affects him.

In these and similar situations, where the beneficiary should be estopped by his conduct from denying knowledge of the provision, the beneficiary must be taken to have constructive knowledge of the provision. "Knowledge" in section 6(b) (ii) must therefore be taken to include knowledge both actual and constructive.

The main point with respect to this knowledge requirement is clear though. Section 6(b) (ii) places a strong onus on promisors to ensure that beneficiaries have actual or constructive notice of any provision in the promisor's contract qualifying their rights, since it is the promisor who will be liable for invalidly interfering with a beneficiary's rights. It will be incumbent on promisors therefore, to give, or attempt to give, beneficiaries the requisite information as to any such provision at least as soon as possible after a promise for their benefit is made in the contract.

It must also be stressed that the promisor must ensure that the provision is contained in the contract at the time the promise for the beneficiary's benefit is made. Otherwise, even if the provision is known to the beneficiary prior to reliance section 6(b) (i) will prevent the contracting parties from using it.

However, there is one situation in which section 6(b) could lead to an injustice. It is where a beneficiary's position is materially altered by

the reliance of another person on the promise, at a time when the beneficiary is unaware of the fact that there is a provision of the type contemplated by section 6(b) qualifying his right, then subsequently he is informed of the provision's existence, after which one of the contracting parties invokes the provision to vary or discharge his right.

On a literal construction section 6(b) (iii) could be seen as allowing this to occur, because it only appears to require knowledge on the beneficiary's part prior to him altering his position in reliance, not where another person's reliance alters the beneficiary's position.

If such a result did occur, it would be patently unjust, as the beneficiary would be deprived of the opportunity of notifying those people who he could foresee as potentially altering his position by their reliance on the promise (e.g. the beneficiary's spouse), of the existence of that provision and advising them to act accordingly. This would occur because he has been told about the provision too late i.e. after his position has already been materially altered by some other person's reliance.

However in such a case, the requirement of section 6(b) (ii) of knowledge of the provision on the beneficiary's part would serve no purpose at all. It is submitted that for that reason and on the basis of the injustice that could otherwise be caused which would be contrary to the scheme of the Act, section 6(b) (ii) and section 6(b) (iii) must be read as requiring prior knowledge of the provision, whenever the beneficiary's position has been materially altered by his or *any other person's* reliance on the promise, before the provision can be invoked.

4. *The power of the court under section 7 to authorize the variation or discharge of beneficiary rights*

Section 7 also modifies the effect of section 5. It gives promisors and promisees the opportunity to apply to the court for an order authorising the variation or discharge of obligations in two situations, namely:

- (a) where variation or discharge is precluded without the beneficiary's consent by section 5(1)(a); or
- (b) where it is uncertain whether variation or discharge is precluded by section 5(1) (a).

Section 7 is in the following terms:

- (1) Where, in the case of a promise to which section 4 of this Act applies or of an obligation imposed by that section,—
 - (a) The variation or discharge of that promise or obligation is precluded by section 5 (1) (a) of this Act; or
 - (b) It is uncertain whether the variation or discharge of that promise is precluded,—
 a Court, on application by the promisor or promisee, may, if it is just and practicable to do so, make an order authorising the variation or discharge of the promise or obligation or both on such terms and conditions as the Court thinks fit.

(2) If a Court—

(a) Makes an order under subsection (1) of this section; and

(b) Is satisfied that the beneficiary has been injuriously affected by the reliance of the beneficiary or any other person on the promise or obligation,—
the Court shall make it a condition of the variation or discharge that the promisor say to the beneficiary, by way of compensation, such sum as the Court thinks just.

Section 7(1) (a) provides for situations where variations or discharge is precluded without the beneficiary's consent by section 5(1)(a), but it is just that the contracting parties should be permitted to vary their contract adversely to the beneficiary.

Section 7(1)(b) covers situations where it is uncertain, or there is disagreement as to whether or not a beneficiary's position has been materially altered by reliance on a promise made in his favour (i.e. whether or not section 5(1) (a) applies). It ensures that a promisor can avoid possible liability for discharging or varying an obligation owed to a beneficiary, when such discharge or variation is in fact precluded without the beneficiary's consent by section 5(1) (a), by giving the promisor (or promisee) the right to apply to the court to make an order authorising the desired variation or discharge; and in all such cases the court will be able to decide on the matter.

It follows that section 7 fulfills an important function, since it provides for the kinds of problems that may arise concerning the variation or discharge of beneficiary rights when a beneficiary cannot be located (for example, when he is overseas). If section 5(1) (a) applies and the beneficiary cannot be contacted to obtain his consent to a variation or discharge of his rights, or if because the beneficiary cannot be contacted it is uncertain whether section 5(1) (a) applies, then the promisor (or promisee) will be able to apply to the court to authorise such variation or discharge and the court will be able to decide on the matter.

The most striking aspect of the section is the discretionary power given to the court. This is in keeping with the policy in recent statutes, where the court is given wide discretionary powers to grant relief—some of the more notable examples can be seen in sections 9 and 10 of the Contractual Remedies Act 1979, section 7 of the Contractual Mistakes Act 1977, and section 7 of the Illegal Contracts Act 1970.

Under section 7 (1) the court is given a very wide discretion as to whether or not to make an order. All that is required is that it is "just and practicable" to do so and accordingly the court has the power to decide whether it will make an order on the circumstances it deems appropriate in each case. Any order the court makes will be on such terms and conditions as the court thinks fit. Thus, the court is given an absolute discretion to impose terms and conditions on the contracting parties, to achieve what it perceives as the just solution in the circum-

stances, to protect the beneficiary from loss that he may suffer by being unable to regain his pre-reliance position.

This freedom on the part of the court, to decide on the granting of orders as the circumstances of individual situations dictate, brings with it the danger of inconsistent results being reached in basically similar cases and raises the very old problem of the limits within which a judicial discretion should be exercised. However it would seem clear²⁸ that a court's decision under the section will only be seen as wrong and impeachable if it is *manifestly* unjust and could not be seen as "just and practicable" in the circumstances.

Section 7(2) ensures that a beneficiary whose position has been materially altered by reliance on the promise will not suffer substantial loss as a result of not being able to regain his pre-reliance position if the obligation owed to him is varied or discharged by the court, because if an order is made under section 7(1) and a beneficiary has been injuriously affected by reliance on the promise the court *must* make it a condition of any order it makes that the promisor pays to the beneficiary a just sum by way of compensation. The compensation to be paid to the beneficiary is "such sum as the court thinks just". So the court again makes the award it deems just in the circumstances.

Though it is not expressly stated in section 7(2), it is fairly implied that the compensation that a beneficiary will receive will be compensation for loss he suffers because of the injurious reliance on the promise, as opposed to compensation for the modification or abrogation of his rights. This is an important point, because compensating a beneficiary for loss suffered as a result of reliance on a promise, will usually involve a quite different sum of money being awarded than if he was compensated for the modification or abrogation of his rights.

5. The cumulative effects of sections 5, 6 and 7

The cumulative effect of sections 5, 6 and 7 is that contracting parties are free to vary or discharge stipulations made in favour of a beneficiary without his consent until such time as the beneficiary obtains judgment, or the position of the beneficiary has been materially altered, by reliance on the promise, whichever occurs first. Where the beneficiary's position has been materially altered, so that variation or discharge of the obligation owed to him is precluded, or where it is uncertain whether variation or discharge is so precluded, the promisor (or promisee) may apply to the court for an order varying or discharging the obligation imposed by section 4. The court may then make an order, authorising such variation or discharge if it thinks it just and practicable to do so and on such terms and condi-

²⁸ See Burrows, "Statutes and Judicial Discretion" (1976), N.Z.U.L.R. 1.

tions as it sees fit, provided that it will be a condition of such an order that the promisor pays the beneficiary a just sum by way of compensation if the beneficiary has been injuriously affected by reliance on the promise.

The contracting parties can at all times vary or discharge the obligation with the consent of the beneficiary to whom it is owed. Also, it is recognised that if there is an express provision in their contract providing for the variation or discharge of section 4 obligations then either of the contracting parties may at any time discharge or vary the obligation in accordance with the requirements of section 6(b).

D. Claims by a Promisee and Beneficiary Against a Promisor and Double Liability

As has been noted, both the beneficiary and the promisee have the right to bring an action against the promisor if he fails to perform the promise made in the beneficiary's favour.

This raises the question of the promisor being double liable for the breach of a single promise. This difficulty (if it is one) to a large extent arises because there are three parties interested in the contract and common law procedure only contemplates two sides to a case.²⁹ However, although it seems unfair to subject the promisor to suits both by the beneficiary and the promisee, a doctrine that a promisee cannot sue upon a contract made upon sufficient consideration furnished by him cannot be reconciled with principle.

It is worthwhile in this respect to look at two main American cases on point.

First, *Hartman Ranch & Co. v. Associated Oil*³⁰ where beneficiaries were suing a promisor in respect of a promise made for their benefit. In that case the Court said:

. . . Appellant suggests that if it is liable in an action by the lessor it may be held twice for the same obligation, since it is also liable to its promises with whom the contract of assumption was made. *This danger is not real.* The rules pertaining to third party beneficiary contracts avoid such a result and will protect appellant . . . The recovery of damages by [the beneficiaries] herein in the amount of one-eighth royalty on the oil and gas lost through drainage and depletion will bar an action for said one-eighth by [the promisees].³¹

The second case concerns the classic third party beneficiary contract, where A owes C a sum of money and B for consideration promises A to discharge A's debt to C. In *Heins v. Byers*³² however, it is the promisee who is suing the promisor. In that case the defendants promised to pay certain bank debts of the plaintiff promisee in con-

²⁹ See for example, *Aetna Life Insurance Co. v. Maxwell* 82 F. 2d 988 (C.A.) and *Maumee Valley Electric Co. v. City of Toledo* 13 F. 2d 98.

³⁰ 73 P. 2d 1163.

³¹ *Ibid.*, 1170. (emphasis mine).

³² 219 N.W. 287 (1928).

sideration of property conveyed by him to them. The Court held that the plaintiff's creditors (the beneficiaries) could recover on such a contract. However, the promisee was claiming, and the Court also held that he could recover from the defendant promisors upon their failure to pay his debts, even though he had not paid them himself in the meantime; the measure of his damage was the amount of the debt.

Dibell J. stated:

It is sometimes suggested that this rule may work a hardship by compelling one in the position of the defendants to pay twice; See 3 Willistone, §1408. 2 Sedwick Damages (9th ed.) §790. . . . It may be that the defendants could require the money paid to the plaintiff to be applied on the bank debt; or, if judgment is obtained against them, could obtain relief giving them equivalent protection; or before judgment could adopt such procedure as would prevent double payment. *The danger of being subject to double payment is not great.*³³

The American experience shows that there is very little risk of double liability. It appears to be a problem of little or no moment and it is significant that the American text books have little or nothing to say on the matter. If double liability was a danger, its presence would have been felt in the highly sophisticated commercial society that America is and would have been written about forcibly, but it has not.

Where a promisor fails to perform a promise and both the promisee and beneficiary are going to bring an action against him, the proper procedure for the promisor will be to have both joined in one action so that all claims against the promisor in respect of that promise can be decided in the one action. It will be quite crucial in some situations, especially where a number of beneficiaries have enforcement rights and are going to sue, that the promisor does have all the interested parties joined. Otherwise he could be involved in several actions in respect of a breach of only one promise—an easily avoidable waste of time and money.

Where it is uncertain (i.e. unclear on the fact of the contracting parties' contract) whether or not third parties are in fact "beneficiaries" (and hence have status to sue) it will be a matter of tactics on the promisor's part as to whether or not to join them if the promisee brings an action on the promise.

E. Section 9—Defences Available to a Promisor in an Action by a Beneficiary

The final question to consider is to what extent defences available to the promisor in an action between the promisor and promisee will be available against the beneficiary.

It is useful in this respect to consider the American position. The following two passages from Williston on Contracts³⁴ accurately sum up the U.S. position:

³³ *Ibid.*, 288.

³⁴ Williston, *Law of Contracts*, (3rd ed., 1961, Jaeger Ed.), 2.

. . . the foundation of any right the third person may have . . . is the promisor's contract. It follows that any defense arising in connection with the formation of the contract, such as lack of capacity or want of mutual assent or consideration, is available to the promisor against the beneficiary. Further, if there is a contract valid at law, but subject to some equitable defense—as fraud, mistake, or failure of consideration—the defense may be set up against the third person.³⁵

And:

. . . if a contract is conditional, voidable, or unenforceable at the time of its formation, or subsequently ceases to be binding in whole or in part because of impossibility, illegality or the present or prospective failure of the promisee to perform a return promise which was the consideration for the promisor's promise, the right of a . . . beneficiary . . . under the contract is subject to the same limitation.³⁶

It is important that such defences are available to the promisor in an action with the beneficiary, otherwise the beneficiary would have greater rights of enforcement in respect of the promise than the promisee would have, and that, in principle would be quite unacceptable, especially since the beneficiary's rights are dependent on the promisor's promise.

As a line of important American cases holds in enunciating an important principle³⁷, a beneficiary can acquire no better right to enforce the promise than that held by the promisee. This *must* be so in contract law for if such defences were not available to the promisor against the beneficiary the legislature would in effect be creating a new unimpeachable type of right in the beneficiary.

Section 9 addresses itself to the question of the availability of defences to the promisor and provides as follows:

- (1) This section applies only where, in proceedings brought in a Court or an arbitration, a claim is made in reliance on this Act by a beneficiary against a promisor.
- (2) Subject to subsections (3) and (4) of this section, the promisor shall have available to him, by way of defence, 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 in 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.

³⁵ *Ibid.*, 1063.

³⁶ *Ibid.*, 875.

³⁷ See for example *Simmons v. Western Assurance Co.* 205 F. 2d 815; *Re Connecticut Co.* 95 F. 2d 311.

This section appears to make available to the promisor, by way of defence, counterclaim, set-off, or otherwise, rights or claims that arise in connection with the formation of the contract, and go to the validity or enforceability of that contract³⁸ and any defences arising in the course of the performance (or lack of it) of the contract causing it to cease to be binding in whole or in part.³⁹ In all cases the beneficiary's rights will be subject to such defences raised by the promisor.

The most striking feature of section 9 is that a beneficiary can be liable on a counterclaim raised by a promisor.⁴⁰ However, section 9 (4)(b) ensures that a beneficiary's liability under a counterclaim cannot exceed the value of the benefit (if any) which has already been conferred on him under the promise. Therefore beyond having his action defeated, at most, a beneficiary can be liable to refund that benefit (if any) which has been conferred on him by the promisor.

III. CONCLUSION

It is laudable that the Act adopts a scheme built around the fundamental principle of freedom of contract and only limits the autonomy of contracting parties to discharge a beneficiary's rights in certain circumstances; as opposed to a scheme based on the inflexible notion of a trust whereby a beneficiary's rights would become irrevocable from the time they were created.

On the whole, the Act appears to be basically sound and brings about timely and much needed reform to the law on privity of contract. No longer will the courts be forced to resort to strained constructions of contracts in order to prevent the privity rule frustrating the intention of contracting parties to confer enforceable rights on third parties. However, one is left with a sense of some uneasiness as to the extent to which section 4 can be made to extend to contractual promises. Will it open the way for a host of tort claims to be pleaded in contract? Will the Act, in the hands of a Denning-minded judicial activist become more than just a measure to reform the law on privity of contract, expanding into a significant vehicle for social change,

³⁸ As, for example, where the contract can be set aside for mistake, misrepresentation, or because of duress, or undue influence, or where there is lack of capacity, or the failure of a condition precedent, or some other factor affecting the contract's enforceability.

³⁹ As, for example, where the promisor can cancel the contract, for breach by the promisee, because of illegality, or the occurrence of a condition subsequent, or where frustration, supervening impossibility, or other vitiating factors in the course of performance cause the contract to cease to be binding in whole or in part.

⁴⁰ The requirement in section 9 (4) (a) that a beneficiary must elect to proceed with his action in full knowledge of the counterclaim before he can be liable on it is clearly superfluous because a plaintiff always has the opportunity to elect to proceed no further with his action after he has received the statement of defence. Obviously if he decides not to proceed with his claim, he cannot be liable on the counterclaim.

blurring the important distinction between obligations imposed consensually (contract) and obligations imposed by law (tort)? Only time will tell. If such anxieties prove to be unfounded it will be because the judges who administer the Act do so in the spirit in which the legislation was intended and because, as is likely, standard form contracts and other contracts drawn up by solicitors, will make express provision as to whether or not the Act is to apply.