

**C**hartered Secretaries often have responsibility for negotiating the documentation on major contracts. Equally they may become involved in considering the position of their company in contract-based litigation. The legal doctrine of privity of contract is one which has often proved problematic. This article considers what privity of contract means; what practical problems it has given rise to; and the sig-

is no privity between X and Z. Z is a 'stranger' to the contract. Alternatively, X may agree to cause Z to do a specified thing. Whether or not Y has the capacity to compel Z to perform the obligation, Z is not bound by the contract. The parties to the contract are X and Y alone, and only they may sue on it.

The absence of privity will often be only one factor which prevents Z from enforcing the contract. Usually no offer will have been made to Z, and Z will not have communicated any acceptance of

which certain benefits will be conferred by XYZ plc upon subsidiaries of ABC plc. In order to give those subsidiaries enforceable rights either they should become parties to the contract, or the rights should be set out in a deed in their favour made by XYZ plc. Otherwise the benefits might be unenforceable, and the transfer of the rights should the subsidiary subsequently be sold to a new owner may be more complex. Perhaps more importantly, the requirement to make all companies affected by a contract parties to the contract in



nificance of the *Contracts (Rights of Third Parties) Bill* which is now before Parliament.

### **The requirement for privity**

Privity of contract is the term used to denote the legal relationship between the parties to a contract. As a matter of law, for a contract to be enforceable by a person there must be privity of contract between that person and the party against whom enforcement is sought. This restriction of the rights and benefits of the contract to those persons who have privity with it is a rule of law and cannot be excluded by the parties.

A person enjoys privity of contract only where he is a party to the contract. For instance, in a typical contract X will promise to do a specified thing for Y, while Y will make a reciprocal promise to do some different specified thing for X. X and Y are the parties to the contract, and in privity with each other. Should X break the promise it is quite reasonable for the law to insist that only Y can enforce it and not some third party, Z. Indeed, in such a simplified example it would be unclear why Z should even wish to enforce the promise. Suppose, however, that X undertakes (in a contract with Y) to do something for Z rather than for Y. In such a case X and Y remain in privity, but there

any offer; moreover, Z will usually have given no consideration. Thus there is no 'agreement' on which to found a contract. Likewise there is a complete absence of reciprocity.

Although the requirement for privity is generally applied strictly, there are a number of important exceptions which may assist. These exceptions in general terms include: banker's commercial credits (or letters of credit); life insurance, novation, assignment; trust; agency; implied contract; restrictive covenants relating to land; tort; and where provided by statute.

### **Practical problems arising from the privity requirement**

Despite the range of exceptions available, the requirement for privity still presents practical problems. These are surprisingly broad. One example cited by Lord Boreic in the House of Lords debate on the Bill, was the inability of an employee to enforce medical expenses insurance taken out by an employer for the benefit of employees. Two particularly problematic areas relate to corporate groups and subcontractors.

#### **Corporate groups**

Suppose ABC plc intends to enter into a contract with XYZ plc, under the terms of

their own right is often not appreciated until efforts are initiated to enforce the contract. By that time, the privity problem is almost certain to be beyond correction.

#### **Subcontractors**

The privity requirement also presents difficulties in subcontracting situations, where the contractor and employer wish to confer enforceable benefits under the head contract upon subcontractors and workers, but have no desire for the subcontractors and workers to become parties to the main contract. These difficulties are indefensible when the contract has been made, or specific provisions have been included within it, solely to confer a benefit on the third party.

#### **Proposals to reform the requirement for privity**

The origins of the doctrine can be traced back at least to the early years of the nineteenth century. The most extreme applications of the privity requirement have been subject to a great deal of judicial, academic and professional criticism. In 1937, the Law Revision Committee (*6th Interim Report, Cmnd. 5449*) proposed that the law be changed to permit a third party to enforce a term of a contract that by its express terms seeks to confer a benefit

upon him. In 1996, the Law Commission (Report No. 242, 1996) *Report on Privity of Contract: Contracts for the Benefit of Third Parties* set out detailed proposals to reform the doctrine, including a draft Bill, to enable rights to be conferred upon someone not party to a contract but to retain the general rule that burdens cannot be imposed on a third party.

## The Contracts (Rights of Third Parties) Bill

*The Contracts (Rights of Third Parties) Bill*

now before the House of Lords, will at long last bring the English law regarding privity of contract in line with the law of Scotland, most members of the European Union, the United States and many Commonwealth jurisdictions. In general terms, the Bill implements the recommendations of the Law Commission in its 1996 Report.

### New approach

In effect, sub-clauses 1(1) and (2) provide that a third party may enforce a term of the contract if the contract expressly provides that he may, or the term purports to confer a benefit on him, and it does not appear on a proper construction of the contract that the parties did not intend the term to be enforceable by the third party. The double negative is of particular significance: it means that there is a presumption that the third party may enforce any provision that purports to confer a benefit upon him. However, in order to be entitled to enforce the contract, the third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description. For instance, in order to confer a benefit upon a subsidiary of ABC plc such as ABC Ltd, the contract may describe ABC Ltd either by name, or as a 'subsidiary of ABC plc' or as 'a subsidiary of

ABC plc yet to be incorporated'. The same remedies are accorded to the third party as if he had been a party to the contract. The remedies remain subject to their normal qualifications: for instance, a third party must mitigate his damages to the same extent as a party to the contract would be required to mitigate damage; equitable remedies such as specific performance remain discretionary.

One question this new approach gives rise to is: what happens if the original parties wish to cancel or vary their contract? This is dealt with by clause 2, a complex provision, which in effect, will make it prudent for contracting parties to insert a clause in the contract to ensure that they may cancel or vary without the consent of any third party.

### Defences and special considerations

It is fairly clear that while the Bill will limit the most severe applications of the doctrine of privity, it stops far short of its total abolition. Moreover, a range of defences and special considerations will govern the right of the third party to enforce the benefit conferred upon him. For instance, clause 3 provides in effect that, where proceedings are brought by a third party and the contract so provides, the promisor is entitled to any defence or set off which would have been available if the proceedings had been brought by the promisee. Accordingly, a third party may not enforce a contract conferring a benefit upon him where that contract is void, discharged or unenforceable. Similarly, if the obligation to the third party is contingent upon payments being made by the promisee, the obligation will not be enforceable by the third party unless those payments have been made. However, the parties may agree that the third party benefit shall be enforceable by the third party irrespective of the defences to which the promisor is entitled against the promisee. Conferring such rights may be attractive, for instance, in the case of covenants in favour of lenders and major suppliers.

### Enforcement

In some cases, it may be desirable for both the promisee and the third party to be allowed a separate right of enforcement. Clause 4 will permit the promisee to enforce the promise, but under clause 5 the promisor is protected against the risk of double liability. Surprisingly, however, while clause 5 reduces the amount recov-

erable by the third party where the promisee has recovered damages by reason of the promisor's breach of contract, no comparable relief is given against claims by the promisee where the third party has already enforced the claim against the promisee. It is therefore clear that the right conferred by the Bill is additional to any right the contracting party has in relation to the enforcement of a term of the contract which benefits the third party.

### Exclusions

By virtue of clause 6, the Bill will not apply to certain contracts. Exceptions include contracts deemed to exist under section 14(1) of the *Companies Act, 1985*; rights against an employee under an employment contract; certain contracts relating to the carriage of goods, particularly those covered by the *Carriage of Goods by Sea Act, 1924*.

### Commencement

The Bill will not come into force until six months after the day on which it is passed. It will not apply to contracts entered into before the expiration of that six month period. This delayed effect is intended first to allow a sufficient period of time for industry and commerce (and their professional advisers) to learn of the Bill's enactment, and secondly for them to assess the impact of the Bill upon their contracting practices.

### Conclusion

The Bill looks likely to have a major impact on the drafting of contracts. It could have unforeseen effects because of its general conceptual approach. For example, Lord Howe in the House of Lords debate queried whether the proposals would enable the general public to sue where a major public sector building project, such as an underground line, were delayed. As should be obvious from the above description, while the general gist of the Bill is clear it will be necessary for companies to obtain legal advice to determine its precise effect upon individual contracts. Chartered Secretaries must be careful to give close consideration to the legislation when enacted even if distracted by the volume of proposals for the reform of company law. ■

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