

CHAPTER ONE

Context Setting

I. Introduction

This thesis examines the doctrine of privity in Malaysia and argues that its application to contracts made for the benefit of third parties is inadequate and is in need of statutory reform. This introductory chapter explains the (i) background of study, (ii) objectives, (iii) justifications, (iv) scope, (v) outline, (vi) research methodology and (vii) terminology used in this thesis.

II. Background of Study

This part explains the (i) two main concepts of research in this thesis, doctrine of privity and contracts made for the benefit of third parties, (ii) growth of contracts made for the benefit of third parties, (iii) difficulties created by the doctrine in its application to contracts made for the benefit of third parties, (iv) judicial and statutory developments relating to the doctrine in selected countries¹ and (v) concerns arising from the statutory reform of the doctrine.

¹ In relation to the judicial development of the doctrine of privity, this study examines the developments in England, Australia and Canada. In relation to statutory reform, the reform in England, Australia and New Zealand will be examined. The legal position in the United States and the Principles of European Contract Law is also discussed in this thesis.

A. Two Main Concepts

The privity doctrine provides that only parties to a contract can sue or be sued under the contract. Two distinct principles can be summed up from the doctrine. Firstly, a person who is not a party to the contract cannot enforce the contract. Secondly, a person is not bound by a contract to which he is not a party.

This thesis focuses on contracts made for the benefit of third parties. This refers to contracts made with an intention to benefit other person(s) who are not parties to the contract. At the time the contracting parties make the contract, they have the third party in contemplation with a view to benefit him. There must be some express reference to the third party in the contract to indicate the contracting parties' intention to benefit him. The promisee provides consideration for the contract and yet the performance of the contract is to be rendered to the third party. The third party may or may not be aware of the existence of the contract when it is created. These contracts are created in all aspects of life involving different types of contract and involving all parties, whether commercial or private parties.

B. Growth of Contracts Made for the Benefit of Third Parties

The growth of contracts made for the benefit of third parties necessitates a thorough investigation on whether the present state of law in Malaysia is able to deal with these contracts satisfactorily. The economic development that has taken place since the last century has brought many changes to society, both as to how businesses are conducted as well as to the private lifestyles of individuals.

The number of business opportunities grows due to the development of modern technology in communication and transportation which render it easier for individuals in different countries to deal with one another. This has led to an era of globalisation in the trade of goods and services where many legal conventions such as the Vienna Convention and the UNCITRAL Convention have been introduced to encourage international trade. The setting up of subsidiaries and branches of companies in different countries is a norm in today's business world. The amount of money involved in business projects, the level of complexities and the volume of such projects have vastly increased. The amount of profit at stake has led to a very competitive commercial world. Efficiency and reduction in cost are factors that ensure that businessmen continue to remain in the competition for businesses.² This results in specialisations of expertise. Hence, in business projects, many parties are involved as a single contractor may not be able to provide all the services required.³ As a consequence, different types of arrangements have been developed by businessmen assisted by their legal advisers to carry out their business activities. Such arrangements often involve third parties who will benefit from the contracts created.⁴

² For eg., it is a usual practice of the property owner and the general contractor of a construction project to take out an insurance policy which provides protection to the sub-contractors. This practice is not only cheaper but it also acts as an assurance to the owner and the general contractor that losses will be compensated rather than to rely on the sub-contractor to insure the losses; Swan, John, "The Rights of Third Parties to Contracts: A Suggested Basis for Recognition" in Kincaid, Peter, ed., *Privity: Private Justice or Public Regulation*, (Ashgate Publishing Company, 2001) (hereinafter referred to as '*Privity: Private Justice*'), at 236.

³ For eg., in a construction contract to build a factory, the main contractor will have the expertise to build the structure of the factory. He will enter into contracts with sub-contractors for laying the floor of the factory or for the wiring of the factory in order to ensure that the factory is ready for operation. Usually, the main contract contains terms which are beneficial to the sub-contractors which they (sub-contractors) rely on in the event of a dispute between the sub-contractors and the employer who hired the main contractor.

⁴ Different types of contracts have been introduced to cater for the growth in the commercial world brought by globalisation and advancement of technology. These include outsourcing contracts, contracts for mass market supply of software, contracts involving provision of web services. Another important development of the law that has also generated interest in the privity rule is the growth of arbitration as a means of resolving disputes. Particularly, it is important for the third party to know whether he is entitled to rely on an arbitration clause in the main contract and conversely, whether he is bound by it to pursue a claim or defend a claim brought by the contracting parties.

The development of economy also has an impact on private relationships of individuals. Economic growth improves the spending power of individuals. Today, individuals have more resources to provide for their loved ones or indulge in charitable work. This increases the number of contracts whose purpose is to benefit third parties⁵ and which are now very common in modern societies.⁶

C. Difficulties Created by Doctrine of Privity

The application of the doctrine of privity, particularly the rule prohibiting the conferment of benefit to third parties causes a number of difficulties to contracts made for their benefit. The following is the list of the major problems of the privity doctrine which are discussed in Chapter 2 Part V.

- (a) Frustration of contracting parties' intention,
- (b) Third party suffers losses as a result of promisor's breach of contract but no satisfactory remedy is provided,
- (c) Lacuna in the law,
- (d) Complexity, artificiality and uncertainty in the law, and
- (e) Inefficiency and inconvenience.

⁵ For eg., a parent may enter into a contract to buy a laptop as a gift to be delivered to their child or a rich person may enter into a contract with a supplier to deliver stationeries to a foster home.

⁶ As per Lord Goff in *McAlpine Construction v Panatown* [2001] 1 AC 518, at 538-539.

D. Judicial and Statutory Developments in Selected Countries

The courts in Australia and Canada have undertaken the task of creating new exceptions to the doctrine of privity as seen in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd*⁷ and *London Drugs Ltd v Kuehne & Nagel International Ltd*.⁸ In addition, other Australian courts have innovatively applied existing principles of the law such as promissory estoppel and restitution (unjust enrichment) to evade the doctrine.

In recent years, to overcome the problems created by the doctrine of privity, a number of the Commonwealth countries have undertaken legislative reform to create statutory exceptions to the doctrine. New Zealand has enacted the Contracts (Privity) Act 1982. England has also enacted the Contracts (Rights of Third Parties) Act 1999 (hereinafter referred to as '1999 Act (E&W)'). The Northern Territory of Australia too has enacted the Law of Property Act 2000.⁹ These Acts allow contracting parties to confer a right to the third party to enforce the contract without the need to fulfill specific formalities such as that required by assignment of contractual rights. The third party is able to bring an action for breach of contract if it is expressly provided that he has such right or where the contract purports to benefit him.

Particularly, the reform undertaken in England has attracted much academic writing. Perhaps, this is due to the fact that the English doctrine of privity has been so entrenched in contract law and is followed in the Commonwealth countries. Thus, a change in the English position will prompt other Commonwealth countries to review their law in this area. This is

⁷ [1988] 165 CLR 107 (hereinafter referred to as '*Trident* exception').

⁸ [1992] 3 SCR 299 (hereinafter referred to as '*London Drugs* exception').

⁹ This Act deals with the reform and consolidation of property, conveyancing and contract law.

directly seen in the Singaporean legislative changes to the doctrine of privity with a new Act of Parliament similarly named and modelled on the 1999 Act (E&W).¹⁰ The Law Commission in Nova Scotia,¹¹ Hong Kong¹² and Ireland¹³ have come out with their reports in 2004, 2005 and 2008 respectively and recommended legislative changes to the doctrine of privity.

E. Reform of Doctrine of Privity

There are three main concerns of reform of the doctrine of privity. These include (i) consistency of third party rights with contract theory, (ii) necessity of reform and (iii) mode of reform.

Firstly, some legal writers opine that reform of the doctrine will adversely affect the foundation of the law of contract beyond recognition.¹⁴ In brief, the concern is whether allowing third party rights under contract law will undermine the coherency of contract law. Any reform to contract law must be consistent with the contract theory which moulds the characteristics of a contract. If the reform does not fit into the mould of contract, it cannot fall within the realm of contract. This issue arises because it is widely assumed that the bargain theory of consideration is the justifying theory which explains the principles of contract law. As such, only those who participate in the making of a bargain are entitled to bring an action in contract law. Such reciprocity leads to the requirement that in order for a

¹⁰ Contracts (Rights of Third Parties) Act 2001.

¹¹ The Law Commission of Nova Scotia's report is entitled 'Discussion Paper – Privity of Contract (Third Party Rights)' and Final Report – 'Privity of Contract (Third Party Rights)' respectively.

¹² The Law Commission of Hong Kong's Consultation Paper is entitled 'Privity of Contract'.

¹³ The Law Commission of Ireland's report is entitled 'Privity of Contract and Third Party'.

¹⁴ Kincaid, Peter, "Privity and Private Justice in Contract" and Smith, Stephen A., "Contracts for the Benefit of Third Parties: In Defence of the Third-Party Rule" in *Privity: Private Justice* at 60-81 and 147-171 respectively.

valid contract to be created, an offer must be made and accepted. A third party who is not a party to the contract naturally will not have any rights on the contract. To decide otherwise would go against the bargain theory which may necessitate the need to find a new justification behind enforcement of contracts.

The second concern raised as to whether it is necessary to reform the privity doctrine is premised on two grounds. The first ground is that the problems created by the doctrine are not so serious as to justify reform. Accordingly, if the existing common law mechanisms are able to solve the problems created by the doctrine, there is no need to change the law.¹⁵ Stevens opines that if judges are willing to develop the law in relation to promisee's remedies for breach of contract, the problems created by the doctrine will 'largely disappear' sooner or later.¹⁶ The second ground is that the problems in relation to contracts made for the benefit of third parties are not created by the doctrine. Instead, these problems arise due to the inadequacy of the law in relation to the law on damages and the doctrine of promissory estoppel.¹⁷ Thus, reform should focus on these areas rather than the privity doctrine. It will be shown in this thesis that the problems created by the privity doctrine are more severe than argued by the writers above and also that the usefulness of the common law mechanisms is limited.

Thirdly, in reforming the privity doctrine, there are two options available, either to undertake statutory reform or judicial reform to allow for creation of third party rights in accordance to the contracting parties' intention. This thesis attempts to show that there are a

¹⁵ Stevens, Robert, "The Contracts (Rights of Third Parties) Act 1999 (2004) 120 *LQR* 292–323.

¹⁶ Stevens, (2004) 120 *LQR* 292–323, at 322.

¹⁷ Smith, Stephen A., "Contracts for the Benefit of Third Parties: In Defence of the Third-Party Rule" in *Privity: Private Justice*, at 147-171.

number of weaknesses in relation to judicial reform. The preferred solution to overcome the problems created by the privity doctrine is through statutory reform.

III. Objectives of Research

The following objectives are formulated pursuant to the thesis made in Part I of this chapter.

- (a) To examine whether there is a need to reform the doctrine of privity in Malaysia.
- (b) To examine the possibility of accommodating third party rights in contract law.
- (c) To analyse the judicial application of the doctrine and the common law mechanisms to avoid the doctrine.
- (d) To undertake a comparative study on the legal position and development of the law relating to the doctrine in selected countries.
- (e) To make recommendations to improve the law in relation to contracts made for the benefit of third parties in Malaysia.

This study aims to achieve its objectives in the following manner:

Firstly, this thesis sets out the legal consequences of the doctrine of privity, examines its problems and rationale as well as whether third party rights can be justified in contract theory.

Secondly, this thesis examines the recognition and how far the doctrine applies in Malaysia.

Thirdly, this thesis examines the various statutory exceptions available in Malaysia and the common law mechanisms utilised by Malaysian judges to evade the doctrine. This discussion is to identify the lacuna left by the present statutory exceptions and the ability of the present legal position in Malaysia to allow third parties to enforce contracts made for their benefit.

Fourthly, the judicial development in relation to common law mechanisms in England, Australia and Canada are analysed to determine the trend of the law in other countries in relation to contracts made for the benefits of third parties. The strengths and weaknesses of all the common law mechanisms are evaluated. This analysis provides insights as to the possible judicial development that can be adopted in Malaysia. It also highlights the disadvantages of common law mechanisms in dealing with the problems of the doctrine compared to a comprehensive statutory reform.

Fifthly, this thesis examines the statutory position in England, New Zealand, Australia, United States and the Principles of European Contract Law in relation to the doctrine. A comparative study of the various jurisdictions is undertaken to determine the preferable model of reform to be proposed for Malaysia.

IV. Justifications of Research

There are three main justifications for this research. Firstly, with the growth of contracts made for the benefit of third parties that are created daily by the business community or private individuals, there arises a need to ensure that the law is in a position to deal with these contracts satisfactorily. There is a need for the law to be consonant with the needs of

the contracting parties and the third party whom they intend to benefit. Besides, the current globalisation of trade in goods and services has encouraged cross-border businesses and the proliferation of multinational companies. In countries which have reformed the doctrine of privity, it is viewed as an anachronism in the law. As such, conformity to this doctrine will not assist Malaysia to attain the required level of competitiveness and attractiveness *vis-a-vis* these countries. This necessitates the reform of the doctrine of privity. For instance, the UNIDROIT Principles of International Commercial Contracts 2004 allows for the creation of third party rights.¹⁸

Secondly, the courts in England, Australia and Canada have applied judicial creativity in utilising the existing principles of the law in creating new exceptions in order to cater for the inadequacy of the law in dealing with contracts made for the benefit of third parties. There is a need to analyse these judicial developments of the various mechanisms to evade the doctrine of privity. Recent judicial initiatives include the '*Trident* exception', the '*London Drugs* exception' and a few others. A comparative analysis of the mechanisms to evade the doctrine would assist in the development of these mechanisms by judges and legal practitioners in Malaysia.

Thirdly, in recent years, the Law Commission in England, Singapore, Nova Scotia (Canada), Hong Kong and Ireland undertook studies to determine whether it was necessary to reform the doctrine of privity in their respective countries. The work of these Commissions focused on the problems created by the doctrine, the reforms undertaken and the recommendations put forth in those countries. Reforming the doctrine would be very

¹⁸ Article 5.2.1–5.2.6. This is a result of the recommendations made by the Working Group for the Preparation of Principles of International Commercial Contracts 1998.

controversial. The scope of the promisor's liability to third parties must be defined properly. As a consequence, the concerns and effects brought by statutory reforms of the doctrine of privity must be examined. It is also vital to examine the judicial application of the rules of the statutory reforms. Any problems relating to statutory reforms that have been undertaken in these countries must be clarified and analysed so that Malaysia will not suffer from similar weaknesses in its own attempt to reform the doctrine. Accordingly, this study will be of assistance to the Attorney General's Chamber if they decide to review the doctrine in Malaysia. Lastly, it is hoped that the findings of this thesis will provide new insights as to the feasibility of undertaking statutory reform of the doctrine and will precipitate changes to the doctrine in Malaysia.

Furthermore, in Malaysia, there is a scarcity of research in relation to the doctrine of privity. The current local articles merely highlight the problems of the doctrine and comment on the 1999 Act (E&W). It is therefore necessary to undertake a comprehensive study on the application and circumvention of the doctrine of privity, whether third party rights can be justified in contract law and the preferred solution to suit the local conditions and circumstances in Malaysia.

V. Scope of Thesis

As stated earlier in this chapter, the doctrine of privity consists of two rules. The focus of this thesis is on the rule prohibiting the conferment of benefit to a third party to a contract. The other rule which prevents the passing of burden to a third party is not examined in this study because it does not create as many difficulties as the rule prohibiting the conferment

of benefit. The English position on the doctrine of privity is explained in Chapter 2 as its application in Malaysia is originated from the English common law.

The focus of this thesis is the law of contract and its related areas such as agency and the law of restitution. Thus, this thesis does not discuss the law of tort¹⁹ extensively. This study also does not cover restrictive covenants which are another common law mechanism to sidestep the doctrine in land law nor does it cover the effects of the doctrine on arbitration. Furthermore, the research in this study covers only civil law. Thus, the Islamic contract law is not examined as it would entail the study of a vastly different legal philosophy. An investigation on these extensive areas of the law is beyond the scope of this thesis.

For the comparative study on the legal position and development in other countries in relation to the doctrine of privity, a few particular Commonwealth countries are selected. England is selected as it is the source of the doctrine of privity. As for New Zealand and Australia, these countries are part of the Commonwealth which inherited the doctrine from England, thus there is commonality of position with Malaysia. The position in the United States is also chosen as it is one of the first countries which took a different approach from the strict English doctrine of privity and provides third parties with a direct right to enforce contracts made for their benefit. The Principles of European Contract Law which is applicable to the member states of the European Union is also selected as the approach taken in relation to third party rights differs in some aspects from the above mentioned jurisdictions.

¹⁹ This refers to the tort of negligence and the defence of *volenti non fit injuria* which are part of the common law mechanisms to overcome the privity doctrine.

VI. Chapter Outlines

This thesis is divided into seven chapters. Chapter 1, the present chapter is the introductory chapter.

Chapter 2 lays down the legal effects, rationale and problems of the doctrine of privity and examines whether third party rights can be justified in contract theory. In determining the theoretical justification of third party rights, this chapter will first examine the theoretical justification for the doctrine. This sheds light on the theoretical arguments against third party rights. This chapter goes on to explore theories which recognise third party rights to determine whether the theoretical arguments against third party rights can be overcome. This chapter goes on to propose the 'responsive bargain theory' to justify third party rights.

Chapter 3 focuses on the Malaysian position in relation to the privity doctrine. The beginning of Chapter 3 deals with the hierarchy of courts and the reception of English law in Malaysia. Cases decided by the Privy Council, Federal Court, Court of Appeal and the High Court are examined to analyse the approach taken by the courts in relation to the doctrine. This chapter also shows that the responsive bargain theory is applicable in Malaysia. This chapter proceeds to set out the statutory exceptions to the doctrine as well as the cases applying these exceptions to gauge whether judges adopt a benevolent approach towards the application of these exceptions to third parties. Lastly, this chapter evaluates the inadequacies of the statutory exceptions in solving the problems created by the doctrine.

Chapter 4 examines the remedies for breach of contract which a promisee can utilise to ensure that his intention to benefit the third party is achieved. The remedies discussed are

specific relief (specific performance and injunction), stay of proceedings and damages. This chapter investigates the development of the law in England in relation to remedies for breach of contract and whether similar development is found in Malaysia. The last part of this chapter examines the weaknesses of the remedies for breach of contract to solve the injustices created by the doctrine of privity.

Chapter 5 examines the common law mechanisms which provide a direct right to a third party to enforce a contract. This chapter is divided into three parts. The first part looks into the conventional mechanisms applicable in Malaysia to evade the doctrine such as liberal construction as to party to a contract, collateral contract, agency, trust and tort of negligence. The second part examines the mechanisms available to assist a third party to rely on the exclusion, limitation and waiver of subrogation clause in a contract which he is not privy to. These mechanisms include vicarious immunity, bailment on terms, Himalaya clauses, tortious analysis of exclusion clauses and the '*London Drugs* exception'. The third part discusses new conceptual ideas utilised by judges to circumvent the harshness of the doctrine such as '*Trident* exception', the doctrine of promissory estoppel and restitution. In relation to the second and third parts, this chapter also examines whether similar development is found in Malaysia.

Chapter 6 examines the legal position of the doctrine of privity in the selected countries. The reform of the doctrine and the cases applying the rules of reform in these jurisdictions are discussed and analysed. A comparative study is undertaken on these jurisdictions to highlight the strengths and weaknesses of the various statutory reforms and propose solutions to deal with these weaknesses.

Chapter 7 is the concluding chapter which explains the findings of this research and the recommendations to solve the problems created by the doctrine in Malaysia.

VII. Research Methodology

This thesis undertakes a qualitative research to answer the fundamental questions laid down in Chapter 1 Part III. This includes analysis and evaluation of various legal materials. The principal source of the materials is the conventional legal materials such as Acts of Parliaments and case law from Malaysia, India, England, Australia, Canada, New Zealand and the United States.

Other sources of materials include the Law Commission Reports and Consultation Papers (of England, Canada, Hong Kong, India and Ireland), Hansards, Explanatory Notes to the 1999 Act (E&W), Halsbury's Law, Annotated Statutes, books, chapters in books, articles found in academic journals and on the Internet as well as Conference Papers.²⁰

The thesis is based on the law as at 1 September 2008.

²⁰ There are a number of articles and cases obtained from <<http://www.lexisnexis.com>>, <www.cljlaw.com>, <www.austlii.edu.au> <www.bailii.org>, <www.canlii.org>, <www.blackwellpublishing.com>, and <www.jstor.org> which are very useful for discussion in this thesis.

VIII. Terminology

This part explains the various terms which are used in the specific context of discussing the doctrine of privity and its related topics in this thesis. The definitions provided below are by no means exhaustive.

- (i) 'crystallisation' refers to the process where the third party's right under the contract becomes fixed and cannot be revoked or varied without his consent. The general perception on the third party's right is that it is created the moment the contract is entered into. However, at this stage, it is an inchoate right subject to change by the contracting parties.
- (ii) 'legal mechanisms' or 'common law mechanisms' refers to the legal principles which judges utilise in order to overcome the doctrine of privity. Strictly speaking, these alternatives do indeed comply with the doctrine of privity. Sometimes, they are referred to as 'exceptions' due to convenience and simplicity. These mechanisms include among others, trust, agency, collateral contracts and promisee's remedies for breach of contract.
- (iii) 'incidental beneficiaries' refers to third parties who are not intended by the contracting parties to benefit from the contract.
- (iv) 'promisee' refers to the party who enters into a contract with the promisor to provide benefit to the third party.
- (v) 'promisor' refers to the party who receives consideration from the promisee to provide benefit to the third party.
- (vi) 'third party' refers to a single individual or entity and to a group of individuals or entities whom the contracting parties intend to benefit.
- (vii) 'third party rights' – refers to the third party's right to enforce a contract.