

CHAPTER TWO

Doctrine of Privity and Theoretical Justification for Third Party Rights

I. Introduction

This chapter examines the (i) development, role, principles and legal consequences of the doctrine of privity in England, (ii) concept of ‘parties to the contract’, (iii) rationale behind the doctrine, (iv) problems created by the doctrine in relation to contracts made for the benefit of third parties and (v) theoretical justification for third party rights. Discussion on part (i) and (ii) is necessary as the current doctrine of privity applicable in Malaysia is inherited from the English common law. Discussion on parts (iii), (iv) and (v) is important to evaluate the need and feasibility of reform of the doctrine. Specifically, discussion on part (iii) determines whether the application of the doctrine to contracts made for the benefit of third parties is justified. Discussion on part (iv) highlights the necessities to reform the doctrine in relation to contracts made for the benefit of third parties. Discussion on part (v) dispels concerns that third party rights undermine the theoretical justification behind contract law.

The importance of giving effect to the contracting parties’ intention is highlighted and discussed a number of times in this chapter from different perspectives. Firstly, it is used to show that the rationale behind the doctrine is not applicable in relation to contracts made for the benefit of third parties. Secondly, the frustration of the contracting parties’ intention is one of the major problems created by the doctrine. Thirdly, it will be shown that giving effect to the contracting parties’ intention is accommodated by contract theory.

II. Development, Role and Principles of Doctrine of Privity

The history of the privity doctrine is discussed briefly. From the 17th century till early 19th century, cases have not been decisive as to the status of this doctrine in English law. There are conflicting decisions as to whether the right to enforce a contract is strictly limited to parties to the contract only.¹ However, subsequent judicial development has become a testament that this doctrine is part and parcel of English law. Such confirmation begins with *Tweddle v Atkinson*² in 1861 where Crompton J disapproved the older cases which allowed a third party to enforce a contract made for his benefit.³ The learned judge supported his decision based on the ground that at the time the older cases were decided, the principles of contract law was not fully developed. As such, these cases should not be applicable due to the inconsistencies with the modern law of contract. The entrenchment of the doctrine is later seen in numerous House of Lords decisions.⁴ This begins with *Dunlop Pneumatic Tyre v Selfridge*.⁵ Subsequent entrenchment of the doctrine is seen in *Scruttons Ltd v Midland Silicones*⁶ *Beswick v Beswick*⁷ and *Woodar v Wimpey Construction*.⁸

¹ See Palmer, Vernon V., *The Paths to Privity: The History of Third Party Beneficiary Contracts* (San Francisco: Austin & Winfield, 1992) (hereinafter referred to as 'Palmer'), Flannigan, Robert, "Privity The End of an Era (Error)" in Kincaid, Peter, ed., *Privity: Private Justice or Public Regulation*, (Ashgate Publishing Company, 2001) (hereinafter referred to as '*Privity: Private Justice*'), at 29-32; E.J.P., "Privity of Contract" (1954) 70 *LQR* 467-469.

² (1861-73) All ER 369. See a contrasting view in Palmer, Chapter 4.

³ One of the older cases disapproved was *Dutton v Poole* (1678) 22 ER 1041, where the third party was allowed to enforce the contract on the basis that the contract was made in account of natural love and affection.

⁴ Lord Denning launched an unsuccessful attack against the validity of the doctrine of privity in *Smith & Snipes Hall Farm Ltd v River Douglas Catchment Board* [1949] 2 KB 500; *Drive Yourself Hire Co. (London) Ltd v Strutt* [1954] 1 QB 250 and *Adler v Dickson* [1955] 1 QB 158.

⁵ [1915] AC 847.

⁶ [1962] AC 446.

⁷ [1968] AC 58.

⁸ [1980] 1 WLR 277.

The doctrine of privity⁹ plays an important role in contract law to determine the scope of rights and liabilities arising from a contract and who is legally affected by the contract. One of the most best-known judgments explaining this legal principle is by Viscount Haldane L.C. in *Dunlop Pneumatic Tyre Co. Ltd. v Selfridge & Co. Ltd* where his Lordship stated that:

One is that only a person who is a party to a contract can sue on it. Our law knows nothing of *jus quaesitum tertio* arising by way of contract as a right to enforce the contract *in personam*.¹⁰

In the subsequent House of Lords decision in *Scruttons Ltd v Midland Silicones Ltd*, Lord Reid stated that:

. . . I find it impossible to deny the existence of the general rule that a stranger to a contract cannot in question with either of the contracting parties take advantage of provisions of the contract, even where it is clear from the contract that some provision in it was intended for him.¹¹

There are two legal consequences of the rule that no benefit can pass to a third party to a contract. Firstly, the third party cannot enforce the contract. He also cannot rely on any terms of the contract (exclusion or limitation clauses) to defend a claim brought by the promisor. Secondly, the contracting parties are free to revoke the contract made for the benefit of a third party. The third party cannot prevent the contracting parties from revoking or varying the contract despite the fact that he suffers losses as a result of the revocation or variation.

⁹ It is now widely acceptable that the doctrine of privity is a separate concept from the doctrine of consideration.

¹⁰ At 853 (*Dunlop*).

¹¹ At 473 (*Midland Silicones*).

Nonetheless, both parties to the contract must consent to the revocation or variation of a contract. If the promisee informs the promisor that he no longer wish to benefit the third party, the promisor has a choice whether to agree with the promisee or otherwise. If the promisor chooses to continue with the contract, performance of the contract amounts to valid discharge of his duty under the contract. Any interception of the promisee to prevent the promisor from performing his obligation under the contract will be unlawful.

A case example on this issue is *Re Schebsman*.¹² In this case, A contracted with B, a company for whom he worked for to provide a sum of money to his wife and family in the event of his (A) death. After A's death, B did in fact make the payment to C, A's wife and family. However, an issue arose as to whether A's trustee in bankruptcy (A's estate was insolvent) was entitled to claim the money from C or whether C was entitled to keep the money. The trustee in bankruptcy argued that since A provided the consideration for the contract with B, A could determine the destination of the payment of money under the contract. The Court of Appeal rejected the trustee in bankruptcy's argument. Payment to C by B was in accordance to the terms of the contract between A and B. As such, A has no right to attempt to vary the contract so that payment is made to A instead. Thus, C was entitled to keep the money.

¹² [1944] Ch 42.

III. Concept of 'Parties to a Contract'

Since only contracting parties can enforce a contract, it is vital to examine the criteria identifying the parties to the contract and the possible difficulties in determining this matter in relation to contracts made for the benefit of third parties. Two ways in which a person can be a party to the contract are (i) playing an active role in forming a contract¹³ and (ii) through express terms of the contract.

A contract is made from an agreement between two or more persons. Accordingly, parties to a contract consist of persons who negotiate the contract, who makes an offer and accepts the offer. Simply put, parties to the contract are those who undertake obligations which arise under the contract.¹⁴ If the agreement is reduced in writing, construction of the agreement will determine who is a party to a contract. Contracting parties are also free to expressly name additional persons as parties to the contract.¹⁵ The person named becomes a party to a contract without any participation in the formation of the contract or knowledge of the existence of such contract.¹⁶

In *Tweddle v Atkinson*, a contract was made to make payments of money to the plaintiff, who was not privy to the contract. It was stated in the agreement that the plaintiff "has full power to sue the said parties in any court of law or equity for aforesaid sums hereby promised and specified." Both the original parties had passed away and the defendant's

¹³ It is undoubtedly true that a person can become a party to the contract through the appointment of an agent. In this situation, the active role of the contracting party is taken by the agent on his behalf.

¹⁴ In Malaysia, s.2(b) Contracts Act 1950 (Revised 1974) (Act 136) states that a contract is created when a promisee accepts the proposal (offer) of the promisor.

¹⁵ Collins, Hugh, *The Law of Contract*, (Butterworths London, 4th Edition 2003) (hereinafter referred to as 'Collins'), at 308 and Treitel, Guentel, *Some Landmarks of 20th Century Contract Law*, (OUP, 2002) (hereinafter referred to as '*20th Century*'), at 85.

¹⁶ An analogy can be drawn from the situation of a deed.

administrator of estate did not fulfill the contractual obligation of paying a sum of money to the plaintiff. The plaintiff brought an action to claim payment intended for him under the contract. He stated that he had ratified and assented to the agreement shortly after the agreement was created.

The court held that the plaintiff's action must fail because he was not a party to the contract and consideration of the contract did not move from him. He was also not the person who made any offer or accepted any offer. The plaintiff was a stranger to the contract although he was expressly named in the agreement, given the right to enforce the agreement and the sole purpose of the agreement was to benefit the plaintiff. The fact that the plaintiff was the recipient of the performance of the contract bears no importance in the determination of the issue as to who is a party to the contract.

The difficulty in determining who is a party to the contract arises in contracts made for the benefit of third parties. This is seen in the Australian case of *Coulls v Bagot's Executor and Trustee Co. Ltd.*¹⁷ In this case, the respondent's husband had entered into an agreement with a company to grant mining rights to the latter. In return, the company agreed to pay royalties to the respondent's husband. In the agreement, there was a term which read as follows:

I authorize the above Company to pay all money connected with this agreement to my wife, Doris Sophia Coulls and myself, Arthur Leopold Coulls as joint tenants (or tenants in common?) (the one which goes to a living partner).

¹⁷ (1967) 119 CLR 460. This case stated that in relation to the doctrine of joint-promisee (where a contract involves more than one promisee), it is not necessary for every joint-promisee to provide consideration. It is sufficient if one of them provides the consideration.

This agreement was prepared by the respondent and duly signed by the respondent's husband, the company and the respondent. No legal advice was sought in relation to the drafting of the agreement.

The issue which arose in *Coulls* was whether upon the respondent's husband's death, the company was bound to pay the agreed royalties to the deceased's executor or the respondent, and if the royalties were paid to the executor, whether the executor held the royalties on trust for the respondent. The answers to these question depended on whether the respondent was a party to the agreement between her husband and the company. The High Court was divided over this issue. It was held by a majority of 3-2 that the respondent was not a party to the contract due to the construction of the agreement. The heading of the agreement stated that the agreement was between the deceased and the company. The deceased was the person who owned the quarry and negotiated the contract with the company. The need to put in the term as quoted earlier in the agreement showed that the respondent was not a party to the contract. If she was a party to the contract, she was equally entitled to the royalties. There was no need to put in the term to stipulate her right to the money.

By contrast, the minority (Barwick CJ and Windeyer J) held that the respondent was a party to the contract. They adopted a wider approach in determining this issue. Barwick CJ stated that in construing a document, judges must search for the real meaning behind the words used as intended by the contracting parties rather than merely adopting the legal meaning of the words.¹⁸

¹⁸ At 474 (*Coulls*).

The minority held that from the construction of the agreement, the respondent, the deceased and the company intended that the respondent was to participate in the royalties. The term included provided clear evidence as to the intention of the deceased. He intended the respondent to have a right to the royalties during their joint lifetime and after he died. The only possible reason behind the respondent's signature could be that she was intended to be a party to the contract. The company's acquiescence to this matter showed that it was willing to be bound by the term. The fact that the parties did not use the correct legal term to signify their intention was no bar to the respondent's claim. To decide otherwise would defeat the intention of the deceased.¹⁹ The narrow majority in *Coull* signifies a possibility that in the future, judges may adopt the reasoning of the minority. The willingness of judges to adopt the minority's approach will ensure that the intention of the contracting parties to benefit the third party is respected.

¹⁹ Taylor and Owen JJ who were part of the majority judgment in *Coulls*, at 401 stated that they reached their decision with regret as this would defeat the clear intention of the deceased.

IV. Rationale of Doctrine of Privity

This part (i) analyses the various rationale put forward to justify the development and entrenchment of the doctrine of privity and (ii) explains how the rationale do not support the doctrine in relation to contracts made for the benefit of third parties.

The following are the rationale behind the doctrine:²⁰

(a) Respect individual autonomy

There are two aspects of this rationale. Firstly, the contracting parties do not wish to be bound and liable to a third party. They also want to reserve their right to rescind and vary the contract created as and when they wish. Secondly, a third party does not wish to be bound to any obligation which he may not have any knowledge and has not given consent to his involvement in the contract.

(b) Avoid indeterminate liability

There is always fear that the abrogation of the doctrine of privity will result in more onerous burden on the contracting parties. They may be liable to others who may not be known to them at the time the contract is entered into. The potential of wide ranging liability will hamper the thriving of economy activities as society is discouraged from entering into contracts. Limiting the right to sue in contract to contracting parties only will reduce or contain liability arises from a contract.

²⁰ See Collins, at 314-318.

(c) Maintain distinction between contract, tort and restitution

The doctrine serves as a filter to distinguish contractual, restitutionary and tortious claims.²¹ Such distinction is maintained as obligations arising from contracts are created voluntarily according to the wishes of the contracting parties. On the other hand, for tortious or restitutionary claim, these obligations are imposed by law.

(d) Maintain distinction between personal and proprietary interest

The doctrine ensures a line to be drawn between personal and proprietary rights. Personal rights arising from contract do not allow rights and obligations under the contract to pass on to a third party. The converse is allowed in relation to proprietary rights. In land law, benefits and burdens of a specified property can pass to a third party.

(e) Consistent with the bargain theory of consideration (This is discussed in Part VI)

Rationale (a) is clearly a sound justification for contracts which are intended to benefit the contracting parties only. The rationale is also valid in relation to contracts which pass burden to a third party. No person shall be forced to accept any obligation that he has not given his consent to. The same cannot be said for contracts which are intended to benefit a third party. These contracts do not involve any compulsion on the third party to be subject to any obligation.²² The third party is not obliged to do anything to his disadvantage.

²¹ Although there are arguments on whether contract, tort and restitution should fall under a general law of obligations, at present, the courts continue to separate these three branches of the law.

²² It is possible for obligations to be attached to the benefit. However, the third party can choose to reject the benefit and thus, would not be bound by the obligations.

Rather, acceptance of the benefit is in the third party's favour. If the third party does not wish to accept the benefit, he can always reject it.

Hence, for contracts made for the benefit of third parties, rationale (a) is working in favour of eroding the doctrine of privity rather than supporting it. If the promisor decides to be liable to a third party, this should be given effect to. Otherwise, the contracting parties' intention is defeated and this will unduly restrict their freedom to decide the scope of their rights and liabilities under a contract. Allowing contracting parties to create third party rights does not necessarily hamper their right to rescind or vary the contract. They can actually make the contract to be alterable without the third party's consent. In the absence of reservation of this right, a proper balance can be struck between the interest of the contracting parties and the third party.²³

Similarly, rationale (b) on the fear of unlimited liability of the promisor in relation to contracts made for the benefit of third parties is exaggerated. It is submitted that the flexibility resulted from loosening the doctrine will not lead to indeterminate liability. Not every third party who benefits from the contract is able to sue. Only the 'chosen one or ones' picked by the contracting parties is or are able to sue. In relation to contracts made for the benefit of third parties, the promisor has an option whether he wants to undertake extra liability to a third party. If he does not want such liability, all he is required to do is to negotiate with the promisee to include a term stating that no third parties are entitled to enforce the contract. A promisor who allows a wider class of third parties to benefit may suffer from a more onerous burden but this is in accordance with the obligation which he voluntarily undertakes. It is not appropriate to blame the law if he does not exercise care to

²³ This is covered in Part VI(D)(3) of this chapter in relation to the responsive bargain theory.

estimate the amount of liability which he subjects himself to. The principle against double recovery also helps to guard against imposition of onerous liability on the promisor to the promisee and the third party.

Rationale (c) and (d) are not sufficiently strong to support the application of the doctrine to contracts made for the benefit of third parties. Third party rights are only found in limited situations. Even before relaxing the doctrine, there is considerable overlapping between the different types of civil liability arising from contracts, torts and restitution. Such overlapping may increase after the relaxation of the doctrine but this increase should not be over exaggerated. Third party rights can only arise if the contract is created in accordance with contract law. As such, the distinction between the different types of liability is maintained as the requirements to prove liability under each type of laws are different. Thus, rationale (c) and (d) will not be overthrown if the law allows third parties to enforce these contracts.

V. Problems Created by Doctrine of Privity in relation to Contracts Made for Benefit of Third Parties

The problems created by the privity doctrine are widely accepted and are laid down in detail by the Law Commission in its 1996 Report entitled *Privity of Contract: Contracts for the Benefit of Third Parties* (hereinafter referred to as ‘LCR’).²⁴ However, there has been academic opinion on the sufficiency of these problems to justify reform of the doctrine.²⁵ This necessitates a thorough discussion on the five major problems caused by the doctrine.

A. Frustration of Contracting Parties’ Intention

The inherent problem of the doctrine of privity is that it frustrates the intention of the contracting parties to provide benefit to a third party.²⁶ An examination of this problem consists of (i) whose intention is being frustrated? and (ii) the extent of this problem.

1. Whose Intention is Frustrated?

According to Stevens, if a promisor breaks the contract, the doctrine does not frustrate the intention of both the contracting parties.²⁷ Only the intention of the promisee is defeated. It is usually the promisee who intends the third party to benefit from the contract. In relation to the promisor, in most situations, it may not matter to him as to who will benefit from the

²⁴ Section B: Preliminary Issues - Part III.

²⁵ The attack on the sufficiency of the justification provided by the LCR to reform the doctrine is led by Peter Kincaid and Stevens, Robert, “The Contracts (Rights of Third Parties) Act 1999” (2004) 120 *LQR* 292–323. Kincaid’s attack is on the theoretical aspect of third party rights which is discussed in Part VI of this Chapter.

²⁶ LCR, at para 3.15.

²⁷ Stevens (2004) 120 *LQR* 292–323, at 293.

contract. He is happy that he is able to close another deal for his business. Therefore, it is inaccurate to argue that the doctrine frustrates the intention of both the contracting parties. Stevens' argument does not weaken the need for reform. Since the promisor is willing to perform the obligations in the contract for the benefit of the third party from the very beginning, his assent is construed as being joined to the intention of the promisee to benefit the third party. Hence, the problem of frustration of the contracting parties' intention is a valid argument.

2. Extent of Frustration of Contracting Parties' Intention

In order to determine the extent of the frustration of contracting parties' intention, this part examines the (i) types of the contracting parties' intention in relation to contracts made for benefit of third parties and (ii) availability of legal mechanisms to avoid the doctrine and promisee's remedies for breach of contract which alleviate the difficulties created by the privity doctrine.

(i) Types of Contracting Parties' Intention

Intention of the contracting parties may consist of two different types of intention to benefit the third party. Firstly, they intend the third party to benefit from the performance of the contract but without the right to enforce the contract.²⁸ Any dispute that arises is intended to concern them only. In this situation, the contracting parties' intention will not be frustrated by the doctrine of privity as they do not intend the third party to sue. As long as the

²⁸ This is important as statutory reform undertaken in Australia (Queensland and Northern Territory), New Zealand and England stresses on the difference between these two intentions.

promisee can obtain a remedy that compensates the thwarting of his intention, the end result will be satisfactory. Secondly, the contracting parties can intend the third party to benefit from the contract as well as able to enforce any terms in the contract that benefits him. The doctrine defeats the second type of intention.

A good example is *Tweddle v Atkinson* where the contract in dispute granted the plaintiff with a right to enforce the contract. In rejecting the plaintiff's claim, Crompton J stated that:

It would be a monstrous proposition to say that a person was a party to the contract for the purpose of suing upon it for his own advantage, and not a party to it for the purpose of it being sued.²⁹

With respect, it is submitted that in dismissing the plaintiff's claim, the intention of the contracting parties was defeated. This too is equally monstrous and cruel to them, who arguably had made a less effective contract as the term of contract allowing the third party to sue is not given effect to. However, in real life situations, the contracting parties may have never given thought to the exact scope of their 'intention' whether they intend the third party to enforce the contract. Arguably, this oversight happens in many situations where they do not receive legal advice which is most acute in situations involving domestic agreements or simple commercial contracts. The issue arises in these situations is whether the intention of the contracting parties is frustrated by the application of the doctrine of privity.

Stoljar³⁰ argues that if the contracting parties intend the third party to receive a specified benefit, the proper inference to be made is that they intend the third party to have rights to

²⁹ (1861-73) All ER 369, at 370.

³⁰Stoljar, Samuel, "Contracts for Third Parties: In Search of the Problems" (1988) 13 *NZULR* 68-96, at 71.

the benefit. Otherwise, it would seem that they create a contract without intending the contract to be accomplished. The same sentiment is shared by Adams, Beyleveld and Brownsword³¹ who opine that it does not make sense that contracting parties are able to exclude the right of the third party to enforce the contract. The exclusion of third party rights will destroy the constitutive purpose of the contract to benefit the third party.³²

Stoljar, Adams, Beyleveld and Brownsword take the view that the intention to benefit the third party impliedly includes the intention to allow him to sue. This thesis adopts this view in situations where the contracting parties do not give thought as to whether they intend the third party to enforce the contract. Seen in this light, the doctrine of privity is problematic as the third party is not entitled to claim the benefit intended for him. However, it is submitted that the contracting parties should be given the freedom to decide whether they want to provide the third party with a right to sue. This will be consistent with the basis of reform, to give effect to the intention of the contracting parties. Accordingly, the third party should not have any enforceable rights over the contract if the contracting parties expressly intend that he should not have such rights.

(ii) Availability of Legal Mechanisms and Promisee's Remedies for Breach of Contract

The contracting parties' intention to allow the third party to enforce the contract is not something that is impossible to attain. There are common law mechanisms available to

³¹ Adams, J.N., Deryck Beyleveld and Roger Brownsword, "Privity of Contract – the Benefits and the Burdens of Law Reform" (1997) 60 *MLR* 238–264, at 241.

³² Adams, Beyleveld and Brownsword (1997) 60 *MLR* 238–264, at 241. For incidental beneficiaries, it is justified that they do not have the right to sue as the constitutive purpose is not to benefit them.

assist the contracting parties to give effect to this intention. The use of collateral contract/warranty, deed, assignment, agency and trust equips the third party with the right to enforce the contract. Even if these methods are not utilised, Stevens questions whether the doctrine of privity frustrates the contracting parties' intention.³³ In the event of breach of contract by the promisor, the promisee is entitled to claim remedies such as damages and specific performance to ensure that his original intention to benefit the third party will be given effect to. For example, the granting of specific performance on the nephew to perform the contract to pay his aunt (third party) in *Beswick v Beswick*³⁴ ensured that the purpose of the contract to benefit the aunt was upheld. Alternatively, the promisee can claim damages which can be used to provide the benefit to the third party.³⁵ As a result, Stevens argues that it is unjustified to state that the doctrine frustrates the promisee's intention if he decides not to enforce the contract to obtain these remedies.³⁶ The inability of the third party to acquire any benefit from the contract is simply the consequence of the promisee's own choice.

The availability of common law mechanisms to circumvent the doctrine and the promisee's remedies for breach of contract is not sufficiently wide enough to cover all deserving cases. A detailed discussion on this issue is carried out in Chapters 4 and 5. Moreover, unless the contracting parties are well aware of the law, they may miss the opportunity to utilise the common law mechanisms to create an enforceable right for the third party. Not everyone receives legal assistance before they enter into a contract. A good example is the case of *Coulls* where the contract was prepared without legal advice and in the end, the intention of the deceased was not upheld by the High Court. In simple transactions, contracting parties

³³ Stevens (2004) 120 *LQR* 292–323, at 293.

³⁴ The facts and decision of this case is discussed in Chapter 4 Part II(A).

³⁵ This is discussed in Chapter 4 Part IV.

³⁶ Stevens (2004) 120 *LQR* 292–323, at 293.

should not be burdened with the need to hire a legal expert to supervise the making of their transaction.³⁷

There could be circumstances where the promisee could not take any action to enforce his rights to benefit the third party.³⁸ This could be due to the fact that the promisee has passed away or has gone into bankruptcy. Some of the major decisions in relation to the doctrine involved this kind of situation which illustrates the severity of this problem. These include *Tweddle v Atkinson*, *Re Schebman*, *Beswick v Beswick* and *Coulls v Bagots* where the promisee in these cases had passed away before breach of contract occurred or that the personal representative of the promisee decided to revoke the benefit to the third party. In *Beswick*, Mrs. Beswick was lucky as she was the administratrix of her husband's estate. Otherwise, she would have suffered the same fate as Mrs. Coulls in *Coulls*.

More fundamentally, these mechanisms do not solve the inability of contract law to provide power to contracting parties to create third party rights. Thus, the cause of problems created regarding contracts made for benefit of third parties still lies with the doctrine.

B. Third Party's Loss Uncompensated

The next problem created by the doctrine of privity is the inability of a third party to recover losses suffered due to the breach of contract made for his benefit. There are two types of losses here, actual and expectation loss. The Law Commission was of the opinion

³⁷ LCR, at para 1.8.

³⁸ LCR, at para 3.4. Stevens (2004) 120 *LQR* 292–323, at 293 acknowledges that there may be situations where the promisee could not enforce the contract (he may be ill, becomes a bankrupt or have died) but he argues that this is an insufficient justification to allow the third party to enforce the contract. With respect, to allow the third party to enforce the contract in these circumstances is consistent with the need to give effect to the intention of the contracting parties.

that it is unjust to the third party if he does not have a cause of action against the promisor if the contract “engendered in the third party reasonable expectations of having a legal right to enforce the contract **particularly where the third party has relied on the contract to regulate his or her affairs.**”³⁹ (emphasis added) The basis offered by the Law Commission for allowing a third party to enforce a contract is the loss of “reasonable expectation” created in his mind. Reliance on the contract is not required. However, the existence of reliance will strengthen the third party’s claim to enforce the contract.

There are two difficulties in accepting ‘reasonable expectation’ as a sufficient basis to allow a third party to sue on a contract. Firstly, mere ‘reasonable expectation’ without more seems a weak justification for the third party to enforce a contract. It is inconsistent with the conventional understanding of the basis of enforcement of a contract as the third party is entitled to sue even though he does not comply with the basic requirements to create a valid contract such as making or accepting an offer. Secondly, there may be conflict between the ‘reasonable expectation’ of the third party and the contracting parties’ intention. Conflict will arise where the contracting parties wish to revoke the benefit to the third party. To protect the third party’s interest requires a restriction on the contracting parties’ right to revoke or vary the contract.

It is submitted that the basis of ‘reasonable expectation’ must be subject to the basis of giving effect to the intention of the contracting parties. There is a need to give effect to ‘reasonable expectation’ of the third party only if it coincides with their intention. In situations where there is a conflict between the interest of the contracting parties and the third party, the law must strike a proper balance to achieve justice between the three parties.

³⁹ LCR, at para 3.2.

In order for a third party to trump the contracting parties' intention, something more than mere expectation should be required.

C. Creation of 'Legal Black Hole'

In relation to contracts made for the benefit of third parties, it is usually the third party who suffers losses as a result of the promisor's breach of contract. The promisee who suffers no loss is only entitled to claim nominal damages from the promisor. The inability of the third party to sue the promisor in contract may in some situations, allow the defendant to escape from paying compensation for losses created by his breach of contract.⁴⁰ This phenomenon is known as the 'legal black hole'⁴¹ where losses suffered by the third party are absorbed into the black hole and disappeared. This makes a mockery of the law. The extent of this problem has been reduced by judicial attempts to close this 'legal black hole' by adopting broad measures of damages or allowing the promisee to recover damages suffered by the third party.⁴²

D. Complexity, Artificiality and Uncertainty

Judges, through their innovativeness and desire for justice have allowed third party claims by (i) utilising the existing principles of the law or (ii) creating new exceptions to the doctrine of privity. As a consequence, there is a list of mechanisms available to override the doctrine. The development of these mechanisms on a case to case basis results in

⁴⁰ LCR, at para 3.3.

⁴¹ This phrase was used by Lord Stewart in *GUS Property Management Ltd v Littlewoods Mail Order Stores Ltd*, 1982 SC(HL) 157, at 166.

⁴² This is discussed in detail in Chapter 4 Part IV.

complexity and artificiality of the law.⁴³ Sometimes, reliance on these mechanisms has landed the parties in courts to determine whether the various requirements of the particular legal mechanism have been satisfied. Thus, a huge amount of money is spent on litigation. This is not beneficial to the public where legal aid is used and the sum claimed is only a small sum as seen in *Beswick v Beswick*.⁴⁴ Uncertainty in the law is also created as it may be unsure at the very beginning, when the contract is created as to whether the third party will ultimately be entitled to enforce the contract.

E. Inefficiency and Inconvenience

Another criticism of the doctrine of privity is that it causes difficulties in commercial life, particularly, construction and insurance contracts.⁴⁵ In relation to construction contracts, the building owner could not sue the sub-contractors for breach of contract due to defective performance. The sub-contractors could not enforce the contract created between the main contractor and the building owner for payment. For insurance contracts, the nominated beneficiaries are not entitled to enforce the policy insurance. It is submitted that similar problems also arise in the context of domestic contracts. As such, efficacy of contracts is reduced as the terms of the contract are not given effect to.⁴⁶

Although legal practitioners have been able to apply their ingenuity in drafting contracts and relying on legal mechanisms to assist their clients to achieve their intention, this results

⁴³ LCR, at para 3.6. This is particularly true in relation to Himalaya clauses which are discussed in Chapter 5 Part III(C).

⁴⁴ Treitel (*20th Century*), at 85.

⁴⁵ LCR, at para 3.9.

⁴⁶ There are situations where the promisor charges a higher price due to the possibility of liability to a third party who is intended to benefit from the contract. Thus, there is nothing unfair or prejudicial to the promisor to hold him liable to a third party.

in complicated agreements and extra cost to their clients. It will be beneficial if the present complicated agreements can be simplified.⁴⁷ In sum, the doctrine of privity is not user-friendly to both commercial and domestic arrangements.

VI. Theoretical Justification for Third Party Rights in Contract Law

One of the concerns of reform of the doctrine is whether third party rights are consistent with the existing contract theory justifying enforcement of contract. Consistency with contract theory is important as the law must be seen as a coherent whole. Coherency in contract law means that there must be a theory which ties all the principles of contract law together. The theory must be applied consistently in the development of contract law.⁴⁸

This part examines the (i) theoretical justification of privity doctrine, (ii) theoretical justification for third party rights in contract, (iii) whether contract law should accommodate third party rights and (iv) responsive bargain theory proposed in this thesis to justify third party rights.

A. Theoretical Justification for Doctrine of Privity

This part examines the (i) ideology of formalism and (ii) bargain theory of consideration adopted by judges in the 19th century, as well as (iii) how (i) and (ii) reject third party rights in contract law.

⁴⁷ LCR, at para 3.18. The Law Commission of England in its LCR, at para 3.28, explains that “Our basic philosophy for reform is that it should be straightforwardly possible for contracting parties to confer on third parties the right to enforce the contract.”

⁴⁸ Mitchell, Catherine, “Searching for the Principles Behind Privity Reform” in *Privity: Private Justice* 104-125, at 106. Mitchell relies on the work of N. MacCormick, *Legal Reasoning and Legal Theory* (Oxford: O.U.P. 1978) Chapters V and VII on this matter.

1. Formalism

The ideology adopted by judges for classical contract law is formalism.⁴⁹ The formalism ideology discussed here refers to the need of an ‘internally consistent body of doctrine.’⁵⁰ According to this ideology, judges pledge loyalty to the rule-book. The rule-book will be kept as thin as possible due to judges’ non-interventionist approach to respect individual freedom of contract.

Formalist judges accept the rules found in the rule-book uncritically.⁵¹ Judges in deciding cases will only apply the existing rules and principles of contract law. Any development of the law must be able to be accommodated by the existing rules and principles of contract law. Otherwise, any proposed development to the law will be rejected. Formalism also requires judges to be conservative in its interpretation and development of the law. Judicial discretion should be kept to the minimum. In applying the law, judges are not concerned with ‘sympathy and politics’⁵² unless the rule-book states otherwise. Individual justice or public policies will not be emphasised by judges in deciding cases. This gives rise to the phrase ‘Hard cases make bad law.’

The concept of formalism is important for a number of reasons.⁵³ The adoption of formalism ensures consistency in the law as like cases will be treated alike so that the law is certain and predictable. Judges will decide cases impartially and in a neutral manner. This

⁴⁹ The opposite ideology of formalism is realism. The ideology of realism is result-orientated. The emphasis placed by judges adopting realism is fairness. The adherence to the rules will be secondary; Adams, John N and Roger Brownsword, “The Ideologies of Contract” (1987) 7 *LS* 205-223, at 216.

⁵⁰ Coote, Brian, “The Essence of Contract (Part II)” (1988) 1 *JCL* 183–204, at 184.

⁵¹ Adams and Brownsword (1987) 7 *LS* 205-223, at 215.

⁵² Adams and Brownsword (1987) 7 *LS* 205-223, at 214.

⁵³ Collins, at 36.

preserves the integrity and legitimacy of the legal system as a coherent body of rules are created.

2. Bargain Theory of Consideration

It is submitted there are two approaches on the bargain theory of consideration, the strict or liberal approach towards this theory. This part deals with the strict bargain theory. The bargain theory of consideration is the product of judicial approach towards contract cases in the 19th century. The bargain theory is made up of two elements, the will theory and consideration.⁵⁴

According to the will theory, the basis of enforcement of contracts is to give effect to the will (intention) of the contracting parties. The law should give legal effect to an agreement intended by the parties to be binding. Consideration is the price paid to purchase a promise made by another. In English law, consideration must move from the promisee. Expectation, trust and confidence in the promisor are created because the promisor makes the promise to the promisee. There must be reciprocity in the sense that parties to the contract must provide consideration to the contract. The promise made coupled with consideration justifies why the promisee is entitled to enforce the promise. Therefore, contracts are seen as bargains. The purpose of contract law is to give effect to the bargain made by the contracting parties. The word 'bargain' itself indicates that contract is a private affair between two or more individuals who create the bargain. Naturally, only the private interests of those who make the bargain are protected. They are also free to revoke or vary their contract.

⁵⁴ Flannigan, Robert, "Privity – The End of an Era (Error)" in *Privity: Private Justice* 28-59, at 50.

3. Rejection of Third Party Rights

There are a number of legal writers who argue that the bargain theory of consideration rejects third party rights. One main proponent for this view is Kincaid.⁵⁵ The reasons behind this view are as follows.

Firstly, the third party does not participate in the making of the bargain. Although the contract is made for his benefit, it is not made with him. There are situations where he is not aware that a contract is made for his benefit. Since he is not the promisee to the bargain, no right is attached to him to enforce the contractual duty owed by the promisor.

Secondly, allowing third party rights amounts to protecting public interest which is inconsistent with the basis of contract law to protect private interest. The third party is considered to be an outsider to the contract. He is suing the promisor seeking to realise his own expectation in the contract. Accordingly, his interest in the contract falls outside the realm of protection offered by the bargain theory. Society's views on the benefits (fairness, efficiency and convenience) of reform to the privity doctrine are disregarded.

The difficulty in justifying reform based on considerations of public justice is that if this is allowed too often and in a great extent, the theoretical foundation of contract will be affected. Thus, priority should be given to protection of private interest compared to public

⁵⁵ Kincaid views can be seen in his various works such as "Third Parties: Rationalising A Right To Sue" (1989) *C.L.J.* 243-270 and his edited work, *Privity: Private Justice*. Other academics which share similar views include John Gava in his article entitled "Is Privity Worth Defending?" in *Privity: Private Justice*, 199-232, Stephen Smith in his article entitled "In Defence of the Third Party Rule" in *Privity: Private Justice*, 147-171 and Tham, Chee Ho in his article 'Trust, not Contract: Restoring Trust in the Contracts (Rights of Third Parties) Act' (2002) *JCL LEXIS* 45.

interest in the development of contract law.⁵⁶ Although public interest does influence reform in some areas of contract law, such occasions are rare and only happen where there are good and strong justifications for private justice to give way to public interest.⁵⁷ If more emphasis is placed on the protection of public interest, this will spark the fear that contractual obligations are beyond the control of the contracting parties as the obligations are imposed by the State (legislature) in disregard of their intentions.

Thirdly, there is no reciprocity between the third party and the promisor. The third party does not provide consideration to the contract.

Fourthly, rejection of third party rights is consistent with the position of a gratuitous donee. The latter has no right to enforce the promise made to him as he does not furnish any consideration to the promise made to him.

Fifthly, the contracting parties' intention is not the basis used to determine whether a third party can enforce the contract. In contract law, intention of the contracting parties is vital for two purposes only, to determine whether there is intention to create legal relations and to determine the contents of contract.

Sixthly, due to adherence to the concept of formalism, a third party is not entitled to enforce a contract made for his benefit as this is not provided by the rule-book of contract law.

⁵⁶ *Privity: Private Justice*, at 76.

⁵⁷ *Privity: Private Justice*, at 76.

B. Theoretical Arguments for Third Party Rights in Contract Law

At the same time, there are also a number of contract theories which support the reform of privity to be based in contract law.⁵⁸ These include (i) bargain theory of consideration, (ii) will theory, (iii) business efficacy theory, and (iv) other alternative contract theories.

1. Bargain Theory of Consideration

A more liberal bargain theory can be used to justify third party rights in contract law. The main proponents for this view are Flannigan⁵⁹ and Phang.⁶⁰ The main gist of their argument is that to give effect to the bargain created effectively entails the need to recognise third party rights. The third party should be entitled to enforce the contract if this is in accordance with the will of the contracting parties.⁶¹

As stated by Phang:

It could be argued that by giving effect to the intentions of the parties (to confer a benefit on the third party), the legislature (under the 1999 Act) is **simultaneously giving effect to the bargain between the said parties**, which constitutes the basis of the Act itself. **The fact that the third party benefits**

⁵⁸ In relation to third party rights generated by the English Contracts (Rights of Third Parties) Act 1999, the Court of Appeal in *WPP Holdings Italy SRL v Benatti* [2007] 2 All ER (Comm) 525 held that these rights are contractual rights for the purposes of applying the Council Regulation (EC) 44/2001.

⁵⁹ Flannigan (*Privity: Private Justice*, 28-59). He propounds the view that all the possible theories of contract law can accommodate third party rights. This includes among other the will theory, promise theory, economic theory, relational contract theory and detrimental reliance.

⁶⁰ Phang, Boon Leong, "On Justification and Method in Law Reform – The Contracts (Rights of Third Parties) Act 1999" (2002) 18 *JCL* 32-51.

⁶¹ As such, third party rights can also be justified by the will theory. The proponents for this argument are Flannigan (*Privity: Private Justice*, 28-59), Phang (2002) 18 *JCL* 32-51 and Mason, "Privity – A Rule in Search of Decent Burial?" in *Privity: Private Justice*, 88-103. Charles Fried's promise theory which bears a close resemblance to the will theory can also justify third party rights. In Fried's book entitled *Contract as Promise: a theory of contractual obligation*, (Harvard University Press, 1981), at 44-45, the learned author justifies third party right by recognising that there are situations where the contracting parties want to create enforceable rights for the third party.

may be viewed as the consequence of giving effect to the said bargain between original parties.
(emphasis added)⁶²

As such, third party rights in contract are remedial in nature. A new remedy is necessary in order to give effect to the bargain effected by the contracting parties. This is hardly surprising nor offensive as this is the outcome the promisee wishes for when he enters into the contract. In most situations, the promisee will not complain about the third party's right to enforce the contract. Besides, since contracts are to assist the contracting parties to arrange their everyday affairs, it may not be objectionable that the law is changed to give effect to their intention. It may be true that, traditionally, intention of the contracting parties is not used to determine as to who can sue. This is a question to be answered by the law. Yet, there is an element of circularity in this argument. Society's wishes play a great role in influencing the contents of the law. This is evident from our legal system. The society chooses the members of the legislature who undertakes the role of making law for the society as promised to the public before the elections.

Arguments have been put forward to displace the contention that the third party does not furnish consideration. Phang argues that the essence of bargain theory should be the price paid for the promise rather than the 'source of the price.'⁶³ Thus, as long as the promisee has provided consideration, the contract should be given effect to allow the third party to enforce the contract.⁶⁴ Similarly, Mitchell⁶⁵ argues that the third party's claim is 'parasitic' on the contract made for his benefit. Thus, it is not necessary for him to provide independent consideration from that provided by the promisee. This argument justifies why

⁶² Phang (2002) 18 *JCL* 32-51, at 37.

⁶³ Phang (2002) 18 *JCL* 32-51, at 39 citing Samuels, G, "Contracts for the Benefits of Third Parties" (1968) 8 *UWALR* 378-401, at 400.

⁶⁴ Phang (2002) 18 *JCL* 32-51, at 39.

⁶⁵ "Searching for the Principles Behind Privity Reform" in *Privity: Private Justice*, 104-125, at 104.

a third party intended to benefit under a contract is treated differently from a gratuitous promisee.⁶⁶ The third party is enforcing a valid contract where consideration has been provided. By contrast, a gratuitous promisee is enforcing a promise which does not amount to a valid contract as no consideration is provided by the gratuitous promisee.

In addition, Coote⁶⁷ highlights that too much emphasis has been placed on the importance of the doctrine of consideration in contract law. There are situations where legal obligation is owed to persons who do not give consideration.⁶⁸ Coote points out that the requirement of consideration is not necessary in civil law. Moreover, the requirement of consideration in the common law systems has been relaxed in recent years by the judges in England as well as in other Commonwealth countries.

2. Business Efficacy Theory

The business efficacy theory subscribes to the idea that contract law is to ‘facilitates the growth of the social practice of making economic transactions’.⁶⁹ To enable commercial men to reduce costs and increase business efficiency, the law should be open to change to accommodate commercial realities.

⁶⁶ Phang (2002) 18 *JCL* 32-51, at 39.

⁶⁷ “Contract not Trust: Some Questions About the Contracts (Rights of Third Parties) Act From Another Perspective” 2006 *JCL LEXIS* 5 obtained from *Lexis.com Research System*, at 9 according to the pagination provided by *Lexis.com Research System*.

⁶⁸ This arises in situations involving letters of credit and deeds to create binding contractual obligations.

⁶⁹ Collins, at 9.

Swan⁷⁰ has come up with the ‘enterprise theory’ to justify giving protection to third parties. Judges are allowed to take into account the relationship of the parties in a contractual dispute in deciding cases and developing the law. Judges will determine whether the promisee and the third party constitute one entity in receiving the promise made by the promisor. If this is answered affirmatively, the third party is entitled to enforce the contract. It does not matter that the third party does not provide consideration as long as one party of the entity furnishes consideration to the promisee.⁷¹ In determining whether the promisee and the third party constitute an entity, emphasis is placed on the purpose and the type of transaction created by the parties. There must be a connection between the promisee and the third party which justifies the latter to enforce the contract. This amounts to a principled approach taken to justify protection of third parties.

In *Coulls v Bagot’s Executor and Trustee Co Ltd*, the transaction was to benefit both husband and wife. Thus, they constituted an entity and the wife was not required to provide consideration as the husband had done so.⁷² Similarly, the owner, contractor and sub-contractors in a construction project also constitute an “entity”.⁷³ So too are the situations where the promisee and the third party are ‘engaged in a common enterprise’.⁷⁴ In *London Drugs Ltd. v Kuehne & Nagel International Ltd*,⁷⁵ the employer and employees are part of an organisation to earn profit. As such, the employees were entitled to rely on the limitation clause found in the contract entered into between the employer and the customer. The same argument can be used to justify the decision of *Fraser River Pile & Dredge Ltd. v Can-*

⁷⁰ His article entitled “The Rights of Third Parties to Contracts: A Suggested Basis for Recognition” is found in *Privity: Private Justice*, 233-258.

⁷² Swan relied on Windeyer’s J’s judgment (minority) in *Coulls* which treated the wife as a party to the contract.

⁷³ *Privity: Private Justice*, at 253.

⁷⁴ *Privity: Private Justice*, at 253.

⁷⁵ [1992] 3 SCR 299.

Dive Services Ltd,⁷⁶ where it is possible to regard the owner of the barge and its charterer “as having a relation to the enterprise, that was the profitable exploitation of the barge”.⁷⁷ As such, it is justified for the charterer to be regarded as one of the parties to the insurance contract in relation to the barge created between the owner of the barge and the insurer. Thus, the charterer was allowed to rely on the waiver of subrogation clause found in the insurance contract that the insurer would waive any right of subrogation against any charterer.

3. Other Alternative Contract Theories

Another theory to support reform of the doctrine of privity is the legitimate or reasonable expectation theory.⁷⁸ Expectation refers to “a forecast, belief or anticipation that something will happen or be the case”.⁷⁹ Legitimate and reasonable expectation differs from one another.⁸⁰ The third party is entitled to enforce the contract as an expectation is engendered on the third party that the contract will be performed for his benefit. This occurs where the contracting parties inform the third party that a contract is created for his benefit.⁸¹

⁷⁶ [1999] 3 SCR 108. The cases of *London Drugs* and *Fraser River Pile* are discussed in Chapter 5 Part III(E).

⁷⁷ *Privity: Private Justice*, at 253.

⁷⁸ The main proponents for this theory are Mitchell (*Privity: Private Justice*, 104-125), Brownsword and Hutchinson in “Beyond Promissory Principle and Protective Pragmatism” in *Privity: Private Justice*, 126-146.

⁷⁹ Mitchell, Catherine, “Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law” (2003) 23 *OJLS* 639-665, at 642.

⁸⁰ Reasonable expectation refers to an “objectively justified belief in the likelihood of some future event or entitlement”. By contrast, legitimate expectation consists of “further justificatory argument for recognising the expectation, whether remedying arbitrariness, protecting detrimental reliance or upholding other requirement of morality or fairness, such as promise-keeping or maintaining equality”; Mitchell (2003) 23 *OJLS* 639-665, at 644.

⁸¹ In fact, this is one of the grounds provided by the Law Commission of England to reform the privity doctrine as mentioned earlier in this chapter at Part V(B).

Third party rights can be justified on reliance theory. The third party who has relied on the contract is entitled to enforce the promise. Unconscionability also supports third party rights. Unconscionability arises due to the creation of the 'legal black hole' which enables the promisor to escape from liability caused by his own breach of contract. In these circumstances, the law should intervene to redress any injustice caused by the doctrine. The common law mechanisms (promissory estoppel and restitution) incorporating these three theories to allow third parties to sue the promisor are discussed in Chapter 5.

C. Evaluation

Part VI(A) and (B) of this chapter examine the various contract theories which oppose or support reform of the doctrine of privity in contract law. The examination shows that whether third party rights are consistent with contract theory depends on (i) the impact of reform on the foundation of contract law and (ii) whether a wider or stricter approach should be given to contract theory.

1. Impact of Third Party Rights on Foundation of Contract Law

As seen in Part VI(A) of this chapter, the main concern arising from reform of the privity doctrine is that there will be a shift in the foundation of contract law from protecting private interest to public interest. This part examines (i) whether contract law is to protect private or public interest and (ii) whether reform of the doctrine protects private interest of contracting parties.

(i) Private Interest versus Public Interest

Legal writers are divided on the issue whether contract law is to protect private or public interest. Kincaid, the proponent for strict bargain theory, supports the view that contract law is to protect private interest. In contrast, Flannigan argues that protection of public interest is implicit in the will theory whose purpose is to ensure that agreements are enforced “to maintain the integrity of the contracting process”.⁸² However, there may be a thin line distinguishing private and public justice.⁸³ Whatever the contracting parties’ desire may be, these are similar to the desire of other individuals in the society.⁸⁴ Accordingly, reform of the doctrine of privity may serve both private and public justice. As such, the drive behind reform, whether private or public justice should not be differentiated so clearly as this seems to be an impossible goal to attain. RA Hillman also comes to the same conclusion. He states that:

Much recent contract theory constitutes a debate over whether contract law facilitates the exercise of private preferences or, instead, whether freedom of contract defers to principles legitimizing state control of the contracting process, ranging from fairness, equality, and morality to efficiency. However, neither vision adequately portrays contract law because each focuses on one perspective at the expense of the other. In reality, freedom of contract and interventionist principles share the contract law spotlight. The debate among theorists therefore diverts our focus from the reality that freedom of contract and outside principles are all important. Expending resources in an attempt to determine which set of principles “wins” hardly seems to worth the effort.⁸⁵

⁸² *Privity: Private Justice*, at 49. Mason also reaches the same opinion; *Privity: Private Justice*, at 100.

⁸³ Phang (2002) 18 *JCL* 32-51, at 76. Protecting private interest amounts to private justice and protecting public interest amounts to public justice.

⁸⁴ In relation to contracts made for the benefit of third parties, the contracting parties wish to grant third party rights. Similarly, other individuals in the society may intend for third party rights to be created in relation to that particular contract so that in the future, any similar contract made by them will be given effect to.

⁸⁵ Hillman, RA, *The Richness of Contract Law: An Analysis & Critique of Contemporary Theories of Contract Law*, (Springer, 1997) (hereinafter referred to as ‘Hillman’), at 267-268.

In addition, Coote states that contract is regarded as the tool provided by the state to give legal effect to the assumption undertaken by the contracting parties.⁸⁶ The state can therefore intervene to make changes to the orthodox principles of contract to give legal effect to the assumption undertaken. A good example to illustrate the state's intervention in the law of contract is the use of deeds which is usually prescribed by legislation. This must necessarily mean that it is possible for the legislature to provide 'a new additional facility' to allow contractual obligations to be assumed.⁸⁷ Coote justifies the power of the state to make changes to the law as follows:

If it is asked why society and the state should have intervened to provide such a facility, the answer would be the same as for conventional contracts: that in general they serve the classic governance objectives of peace, order and good government and in addition, that the new facility helps to plug a gap identified as such by a succession of practitioners, judges and legal academics.⁸⁸

Hence, any development to contract law should not be defeated merely because it appears to protect public interest. It must also be considered whether it furthers the protection of private interest of the contracting parties. What is more important is to ensure that there is a principled development of the law and that a right balance is struck between private and public interest to maximise the benefits of reform to be enjoyed by the society. Reform should be encouraged if it produces more advantages to the society than harm to the basis of enforcement of contract that has been developed along the years. This issue is covered in the discussion in relation to the responsive bargain theory in Part VI(D) of this chapter.

(ii) Third Party Rights Protect Private Interest

⁸⁶ Coote (Contract not Trust) 2006 *JCL LEXIS* 5, at 10. Coote opines that the essence of a contract is the voluntary assumption of obligations; "The Essence of Contract" (1988) 1 *JCL* 91-112 (Part I) and 182-205 (Part II).

⁸⁷ Coote (Contract not Trust) 2006 *JCL LEXIS* 5, at 9.

⁸⁸ Coote (Contract not Trust) 2006 *JCL LEXIS* 5, at 10-11.

The arguments that reform protect public interest can equally be used to show that reform protect private interest. Reforming the privity doctrine is necessary to give effect to the will of the contracting parties. They are in full determination on whether to grant rights to the third party. Reform of the doctrine also balances their rights and interests. The promisor has promised the promisee to allow the third party to sue in exchange for payment made by the promisee. It is therefore fair to the promisee that the third party is given a right to enforce the contract. Accordingly, reform is to protect the private interests of contracting parties.

In addition, reform of the doctrine will not lead to a proliferation of the number of claimants against the promisor. Contract remains a private affair as not everybody in the society is able take a contractual action against the promisor.⁸⁹ Moreover, to improve the law to ensure greater convenience and efficiency can also be justified on account of private justice. It is in the interest of the contracting parties for the law to be simple and efficient in giving effect to the arrangements which they have undertaken.⁹⁰ On balance, it is submitted that reform to the doctrine would protect private interest more than public interest. Accordingly, allowing third party rights will not destroy the foundation of contract law.

2. Liberal Approach towards Contract Theory

⁸⁹ As discussed in Part IV of this Chapter.

⁹⁰ These arguments do not go against the principle of formalism which is held dearly in the law. Williston holds the view that formalism can be advocated on pragmatic grounds. The benefits of formalism entail 'simplicity, predictability and comprehensibility'; Movsesian, Mark L., "Rediscovering Williston" (2005) 62 *Wash & Lee L Rev* 207-275, at 214.

The validity of the problems created by the privity doctrine supports the adoption of a liberal approach towards contract theory. There are a number of additional arguments which support this approach.

(i) Logic and Practicalities

Since problems are created by the privity doctrine which is found in contract law, it is therefore only logical that these problems are solved within contract law. This is consistent with the approach taken by judges too. Judges in deciding disputes involving contracts made for the benefit of third parties will first look to contractual principles for a solution to provide a fair outcome. Hence, the principles of collateral or implied contracts, joint promisee as well as allowing recovery of damages on behalf of third parties have been utilised by judges to circumvent the harshness of the doctrine. If no alternatives are available in contract law, then only will judges turn to other areas of the law to seek a solution.

Secondly, the existing recognised common law mechanisms to ameliorate the harshness of the doctrine may not apply to all situations regarding contracts made for the benefit of third parties. These mechanisms also cause artificiality in the law. For example, although trust is a favourite solution to the problems created by the doctrine of privity, contracting parties who intend the third party to benefit from the contract, may not necessarily intend to create a trust. In fact, they may not even know or give thought to the possibility of creating a trust

relationship at the time they create the contract. Thus, trust is only applicable in limited situations. It is still preferable to justify reform of the doctrine in contract law which can apply to all contracts made for the benefit of third parties. This also preserves the simplicity of the transactions to benefit third parties especially in relation to domestic agreements.

(ii) Due Recognition to Contracts Made for Benefit of Third Parties

Contract law governs the relationship between parties to a contract. The majority of contracts created are for the benefit of the contracting parties only. Accordingly, development of contractual rules caters for these contracts. There are two major differences between these contracts and contracts made for the benefit of third parties. Firstly, for the latter contracts, the contracting parties specifically intends to allow the third party to seek benefit from the contract. Secondly, the third party is the recipient of the performance of the contract.

These differences were ignored in *Tweddle v Atkinson*. In this case, Crompton J stated that a stranger to the contract cannot sue or be sued on the contract. But the third party is not a total stranger to the contract. Due to the will of the contracting parties, he is the recipient of the benefit of the contract. He is directly involved in the performance of the contract as intended by the contracting parties.⁹¹ As a result, the application of the doctrine of privity is more appropriate in relation to contracts made for the benefit of the contracting parties only. Such justification is lacking in contracts made for the benefit of third parties.

⁹¹ Stoljar, Samuel, "Contracts for Third Parties: In Search of the Problems", (1988) 13 *NZULR* 68-96, at 71.

Unfortunately, the classical contract law applies the doctrine of privity to all types of contracts regardless of the differences between the different types of contracts and the motives of the contracting parties. This is the outcome of the classical contract law which supports simplification of the law and a minimum rule-book. Such a Procrustean approach leads to rigidity in the application of the law of contract. Reform to the doctrine will ensure that contract law is responsive to the differences between these two different types of contract.

(iii) Expand Freedom of Contract

The function of contract law to assist members of society to arrange their affairs or to allow them to undertake obligations to one another necessitates that individuals should enjoy freedom of contract. According to Coote, this comprises of three kinds of freedoms, the freedom to determine whether to create a contract, the freedom to determine the terms of the contract and the freedom to exclude or limit the obligations arising from the contract.⁹²

The importance of freedom of contract is enunciated clearly in *Printing and Numerical Registering Co v Sampson* where Sir George Jessel stated that:

If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the **utmost liberty of contracting**, and that their contracts when entered into freely and voluntarily shall be held **sacred** and shall be enforced by Courts of Justice. (emphasis added)⁹³

⁹² Coote (Essence of Contract Part I) (1988) 1 *JCL* 91–112, at 187.

⁹³ (1875) LR 19 Eq 462, at 465.

In order to achieve greater freedom of contract, reform to the doctrine of privity must be undertaken. The law should allow the contracting parties with a choice to state in their contract as to whether they intend to give enforceable rights to the third party. At present, contracts can contain whatever terms the parties wish as long as the terms are not illegal or against public policy. To include a benefit for the third party or to provide a right for the third party to sue is neither illegal nor against public policy.

D. Responsive Bargain Theory

Following the discussion above, contract law can accommodate third party rights. This thesis proposes the responsive⁹⁴ bargain theory to justify third party rights in contract theory. The possibility of applying this theory in Malaysia is discussed in Chapter 3. This part examines the (i) elements of responsive bargain theory, (ii) reasons for adopting this theory and (iii) how this theory can justify third party rights.

1. Elements of Responsive Bargain Theory

The responsive bargain theory consists of the following elements:

- (a) strict bargain theory
- (b) responsiveness to the needs of the society and fairness

⁹⁴ The word 'responsive' is adopted from the title of M.A. Eisenberg's article, "The Responsive Model of Contract Law" (1984) *Stan LR* 1107–1167.

The basic elements of the strict bargain theory remain intact. However, more flexibility is injected into the bargain theory where the need arises to ensure that the law reflects the needs of the society and that the application of contract law leads to fairness.

2. Reasons for Responsive Bargain Theory

This part examines the reasons why reliance is placed on strict bargain theory despite the criticisms levelled against it. Two reasons are discussed, the (i) continuing importance of bargain theory and (ii) changing trend in modern contract law which necessitates a broader bargain theory to be adopted.

(i) Continuing Importance of Bargain Theory

Firstly, contracts are tools used by the society to plan their day-to-day affairs. It is vital for the society to understand the rationale behind contract law. In this respect, enforceability of contract is best understood as based on the creation of a bargain. A promisee has a right to secure performance of the contract by suing the promisor because the promisor makes a promise and consideration is provided for the promise. Consideration provided shows the seriousness of the promisee which justifies the imposition of a legal obligation on the promisor.

Secondly, the chief criticism of the privity doctrine is the failure to give effect to the bargain struck between the contracting parties. This shows that bargain remains the central concern of the law. Accordingly, the bargain theory continues to be relevant. Although the strict bargain theory denies third party rights, this defect can be corrected by reinventing the

bargain theory to be more responsive. Many legal writers are of the opinion that the bargain theory allows a third party to have a right against the promisor. These include Flannigan, Phang, Mason⁹⁵ and Law Commission of England. This again justifies the contention that there can be more than one perspective in analysing the bargain theory, a stricter or wider perspective. A wider perspective of the bargain theory, in terms of a responsive bargain theory can justify reform to the doctrine and give effect to the needs of the business community and private individuals by upholding the agreement reached by them. The term 'responsive' is chosen as it is a more specific term compared to 'liberal' or 'broad' to limit the criteria to justify reform in contract law. Reform can only be undertaken in response to the needs of the society.

Thirdly, although other alternative legal theories are introduced, none of the theories is free from criticisms and weaknesses. As such, there is no recognition for any of the alternative theories as a valid replacement of the bargain theory. Moreover, the alternative theories are not adequately suited to apply to all contracts made for the benefit of third parties. The dominant purpose behind reform is centred on the contracting parties rather than the third party. As a general rule, the contracting parties' intention is given priority over the third party's interest. As such, the legitimate expectation theory which emphasises on protecting third party is unsuitable to be the principal justification behind reform.⁹⁶ Besides, the concept of legitimate expectation is vague. The scope of this concept and the situations which will give rise to a legitimate expectation have not been ascertained. Reliance and unconscionability are applicable only in certain situations and could not be the general

⁹⁵ Although Anthony Mason and the Law Commission of England relied on the will theory to justify the right of the third party to enforce the contract, their argument is included here as the will theory is also part of the bargain theory.

⁹⁶ The problem associated with the responsive bargain theory on the possible conflict between protecting the intention of the contracting parties' and legitimate expectation of the third party is covered in Part V(B) of this chapter.

theory allowing third party rights. Since bargain theory can justify reform, it is also unnecessary to rely on the business efficacy theory.

(ii) Changing Trend in Modern Contract Law

The responsive bargain theory is also proffered as a result of the changing trend in today's contract law. This is based on the developments that have taken place in the commercial world and in the various areas of contract law such as consideration and the development of the requirement of good faith and unconscionability where a more liberal application of the existing rules is adopted to promote a fair and just outcome. Hence, a persistent application of the strict bargain theory is inapt today. Support can be found in Atiyah's work where he states that:

. . . our basic conceptual apparatus, the fundamental characterisations and divisions which we impose on the phenomena with which we deal, reflect not the values of our times, but those of the last century.⁹⁷

As a consequence, Atiyah argues that the bargain theory in its strict form has failed. One of its failures is that it fails to give recognition to third party rights.⁹⁸

Coote also opines that the traditional contract theories fail to provide a satisfactory justification behind enforcement of contracts due to the following reason:

None of the traditional theories can be said to indicate precisely what a contract is. All of them are wide enough to include relationships which have not been regarded as contracts. Equally, all of them

⁹⁷ Atiyah, P.S., *Essays on Contract*, (Oxford University Press, 1988) (hereinafter referred to as 'Atiyah-Essays'), at 11.

⁹⁸ Atiyah, PS, *The Rise and Fall of Freedom of Contract*, Clarendon Press. Oxford (1979), at 412–414.

(unless the will theory is dissociated from agreement) exclude relationships which have been so regarded. **In every case the problem has been the result of generalising from too narrow a base.**

. . . **The notion of a general theory, for example, reinforces trends towards generalization and away from the ‘technical’ requirements of classical contract law.** (emphasis added)⁹⁹

Coote views that the essence of a contract is “a promise or undertaking in respect of which legal contractual obligation has been assumed by means which the law recognises”.¹⁰⁰

Undoubtedly, this represents a more liberal approach towards defining contractual obligation as it dilutes the importance of certain requirements to create a valid contract such as the principle that consideration must be provided in creating a valid contract.

Eisenberg states that the rigidities brought by the classical contract law have waned and concedes that the reaction against the classical contract is proper.¹⁰¹ He also opines that:

The task . . . is to reconceptualize contract law so that it consists of a body of principles that are both intellectually coherent and sufficiently open-textured to encompass the complex and evolving realities of contract as a social institution.¹⁰²

The considerations which Eisenberg views as important in reconceptualising contract law are “consideration of fairness, as determined principally by conventional morality, and of policy, as determined principally by efficiency and administrability”.¹⁰³ The issue as to when it is ‘necessary’ to loosen the rigidities of contract law will ‘depend on a functional analysis of the relevant issue in terms of fairness and policy’.¹⁰⁴ Eisenberg concludes that:

⁹⁹ “The Essence of Contract (Part 1)” (1988) 1 *JCL* 91–112, at 111.

¹⁰⁰ “The Essence of Contract (Part II)” (1988) 1 *JCL* 183–204, at 195.

¹⁰¹ Eisenberg (1984) 36 *Stan LR* 1107–1167, at 1110.

¹⁰² Eisenberg (1984) 36 *Stan LR* 1107–1167, at 1111.

¹⁰³ Eisenberg (1984) 36 *Stan LR* 1107–1167, at 1111.

¹⁰⁴ Eisenberg (1984) 36 *Stan LR* 1107–1167, at 1111.

. . . it seems fair to say in modern times, contract theory has evolved away from the rigidities of the classical model, into a supple instrument consisting of principles that are intellectually coherent but also responsive to intentions and circumstances.¹⁰⁵

The understanding of the bargain theory as it is in the 19th century may be outmoded today due to changes in the society in the 21st century.¹⁰⁶ Today, the number of contracts created is way larger than that in the 19th century. The nature of contracts entered into by businessmen is also more complex nowadays and involve many participants. The amount of money involved in these contracts is also very large. Changes in conducting businesses also lead to new business patterns which are getting more popular in recent years such as outsourcing contracts. This proves the doctrine of privity devised in the 19th century may not reflect commercial practices in modern times.

The modern contract law is perceived to incorporate elements of flexibility and justice in an individual case to avoid rigid rules even if stability and predictability of the law are compromised. The law adopts a pragmatic approach to solve problems created by the strict bargain theory. The judicial decisions in the 20th century display a pragmatic approach bringing the law closer to commercial reality. Commercial expediency surface many times in the law reports as grounds to support judicial decisions.¹⁰⁷

Hence, although the bargain theory is chosen for the purposes of this thesis to justify third party rights, the theory has to be looked at from a wider perspective as compared to the strict bargain theory. This approach is valid as it must be remembered that the law is not a static concept. Rather it is an evolving concept, changing to suit the ever moving society.

¹⁰⁵ Eisenberg (1984) 36 *Stan LR* 1107–1167, at 1167.

¹⁰⁶ See Collins, at 7.

¹⁰⁷ This pragmatic approach is seen in cases involving third party's reliance on exclusion clauses discussed in Chapter 5 Part III.

Thus, the legal theory used to justify liability should have the same characteristic. Once the revised bargain theory is placed in the 21st century, many of the arguments by academics against the reform of the doctrine of privity can be displaced. Such revision works closely with the changes in contract law and the needs of the society in modern times. The basis behind imposing contractual liability may have been widened but this is necessary to cure the deficiencies of the bargain theory so that it continues to become relevant in modern times.

(iii) Responsive Bargain Theory and Doctrine of Privity

This part discusses how the responsive bargain theory can justify third party rights. Due to the problems created by the privity doctrine, contract law should be responsive to the needs of the society and allow third party rights. Reform of the privity doctrine brings the following benefits. Firstly, reform solves to a large extent the problems created by the doctrine. Reform ensures that equality and justice are achieved in the society.

Secondly, reform upholds the moral value that people should be bound by their promises.¹⁰⁸

Atiyah states that:

The purpose of contract law is to encourage people to pay their debts, keep their promises, and generally be truthful in their dealings with each other. The enforcement of contracts, like the protection of property and the punishment of crime, is thus, perceived as important primarily for its deterrent or hortatory purpose.¹⁰⁹

¹⁰⁸ Hillman, at 272.

¹⁰⁹ "Contracts, Promises, Obligations", at 15 in Atiyah-Essays.

Allowing the third party to sue provides an additional motivation to the promisor to keep his promise to avoid being liable to the third party.

Thirdly, reform increases security of contract. According to Coote,¹¹⁰ to increase security of contract, the sanctions provided for breach of contract must be “the close equivalent”¹¹¹ of the obligations undertaken. With regards to contracts made for the benefit of third parties, the contracting parties’ intention is to allow the third party to acquire a benefit from the contract which may necessarily include the right to enforce the contract. The process to achieve security of these contracts must entail the right of the third party to enforce the contract since the existing contractual remedies cannot fully give effect to the intention to benefit the third party.

Fourthly, reform encourages the activity of contracting in the society as it allows greater freedom to individuals to determine the scope of contracts. Larger number of contracts will be created as the promisee knows that his intention to allow the third party to enforce the contract will be given effect to. This facilitates the making of business arrangements and assists the flourishing of the economy. Individual rights can be enhanced if the economy improves.

Accordingly, a general exception to the privity doctrine is created to allow third party to sue. The legal principles proposed for reform must ensure that the will of the contracting parties is given effect to. However, in situations where the interest of the contracting parties

¹¹⁰ “Security of Contract and the New Zealand Contract Statutes” 2000 *JCL LEXIS* 7 obtained from *Lexis.com Research System*, at 5 according to the pagination provided by *Lexis.com Research System*.

¹¹¹ Coote [2000] *JCL LEXIS* 7 (Security of Contract), at 2.

conflicts with the interest of the third party, the former will prevail unless the third party suffers or would suffer actual monetary loss or loss of amenities.¹¹²

VII. Conclusion

Various concerns have been raised in relation to the appropriateness of reform of the privity doctrine to be undertaken in contract law. Discussion in this chapter shows that contract law can accommodate third party rights. Firstly, the rationale behind the doctrine could not justify its application to contracts made for the benefit of third parties.

Secondly, the application of the doctrine to contracts made for the benefit of third parties causes problems which justify a reform to be undertaken. In summary, the main criticism against the doctrine is its inability to give full recognition to the contracting parties' intention to benefit the third party in a simpler, more convenient and cost effective manner. The availability of legal mechanisms to evade the doctrine does not solve its main problems. However, the law cannot give absolute effect to the intention of the contracting

¹¹² This is proposed by drawing an analogy with the existing law allowing promisee to claim damages on behalf of the third party in certain situations discussed in Chapter 4 Part IV(A). The justification behind this exception to the general law of damages is to ensure that the third party is compensated for his losses. Similarly, in reforming the privity doctrine, the justification behind the ability of a third party to trump over the interest of the contracting parties is where he suffers or would suffer actual losses as a result of change of intention of the contracting parties.

parties as this may cause detriment to the third party.¹¹³ In these situations, the law has to draw a sufficient balance between the interests of all the three parties.

Thirdly, the main argument against reform is that it will alter the foundation of enforceability of contracts which rests heavily on the bargain theory. However, in light of the changing trend in contract law today, the bargain theory requires a make over in order to accommodate the needs of the modern society. One such need is to give effect to the contracts made for the benefit of third parties by allowing the third party to enforce the contract. The responsive bargain theory is able to perform this role to ensure a principled development of the law.

¹¹³ This issue is discussed in detail in Chapter 6 where the effects of the statutory reform of the doctrine of privity are analysed.