Privity of Contract

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The rule of privity of contract is the principle that a third party cannot sue for damages on a contract to which he is not a party. This rule has been strongly criticised in recent times, particularly where the contract is for the benefit of the third party. Indeed civil law systems of other members of the European Union recognise and enforce such contracts. Despite calls for statutory reform, the rule persists in English Law to prevent a third party enforcing contractual provisions made in their favour.

The existence of the rule is the reason behind the rise in the use of collateral warranties. Collateral warranties bypass the rule by creating separate independent contracts collateral to the consultancy or construction contract. It allows future owners of developments to sue consultants or contractors for defects in the design or construction under the collateral warranty. There would be no cause of action under the original consultancy or construction contract.

A further fundamental principle is that the assessment of damages for breach of contract is meant to be compensation for damage, loss or injury suffered through the breach. It therefore allows the party to the contract to sue for his loss but does not allow him to sue for the loss caused to a third party.

Two decisions establish an exception to these principles. The first of two court decisions to examine these principles was **St. Martin's Corporation Ltd v Sir Robert McAlpine (1993)**. McAlpine was the contractor for a development for the Corporation. After completion the Corporation passed the development to Investments, a sister company. The Corporation also assigned the full benefit of the construction contract to Investments, with the intent that Investments could sue McAlpine should any defects occur. Defects were found after the assignment which were alleged to be due to breaches of contract by McAlpine under the construction contract. It cost Investment £800,000 to put right the defects.

Investment sued under the above action. The House of Lords held that the action failed. The assignment of the benefit under the contract had no effect because McAlpine's consent to the assignment had not been obtained as required under the contract with the Corporation. It was considered that the reason for including the contractual prohibition from the contractor's point of view was that the contractor wished to ensure that he dealt, and dealt only, with the particular employer with whom he has chosen to enter into a contract.

"Building contracts are pregnant with disputes: some employers are much more reasonable than others in dealing with such disputes".

So the action failed under the first of the above principles, the privity of contract between the Corporation and McAlpine prevented Investments suing on the contract.

However the Corporation was also a party to the action. Since the assignment had failed the Corporation argued that it was entitled to judgment against McAlpine for any breach of contract.

The problem the Corporation faced was that they had parted with the property at full value and were not liable to their sister company for the defects. Where therefore was their loss? On the basis of the second principle above, the Corporation could not sue for the loss suffered by a third party, in this case £800,000 incurred by Investments. The Corporation was therefore entitled only to nominal damages under the above principles.

Having found that McAlpine were not liable to the extent of the loss of £800,000, the House of Lords then proceeded to find an exception to the second principle described above, namely that a plaintiff can only recover damages for his own loss. The basis of this exception was that it was known by McAlpine that the development would be occupied if not purchased by third parties and not the Corporation itself. It could be foreseen that the damage caused by a breach would cause loss to a later owner and not merely the original contracting party. Therefore on this basis the original contracting party could be entitled to recover damages for loss suffered by others. The prohibition on assignment was crucial to this exception. The exception did not apply where the third party could themselves sue for the loss.

The decision has made uncertain some of the boundaries of contract. Nor is it clear on what basis an original contracting party would hold damages won in such an action. In the above case the Corporation had already paid its sister company the £800,000 as part of the Group reorganisation, so that the problem did not arise.

Some answers are found in the Court of Appeal decision on 28 June 1994 **Darlington Borough Council v Wiltshier Northern Ltd (1994).** Darlington wished to create a recreational centre on land which it owned. Instead of borrowing and in order to provide private finance for the project, Darlington had Morgan Grenfell enter into a construction contract as employer, with Wiltshier as contractor. A collateral covenant between Darlington and Morgan Grenfell provided that Darlington would pay Morgan Grenfell all sums expended under the construction contract. The construction contract was therefore clearly a contract for the benefit of a third party. The covenant also provided for Morgan Grenfell to assign to Darlington all rights against Wiltshier.

In this case, when Darlington sued there was no problem with the assignment. However, they were faced with the two general principles above. In other words, Morgan Grenfell the party in contractual relationship with Wiltshier had suffered no loss and could transfer no claim for substantial damages. On the other hand, Darlington, who suffered the loss, was precluded by the privity rule from claiming the damages which it had suffered. The principles therefore combined to allow a contract-breaker to go scot-free.

The exception in **St. Martin's Corporation Ltd v Sir Robert McAlpine** was applied and Darlington was held to be entitled to recover. In an important judgment, the wider exception was recognised, namely that if a party engages a contractor to perform specified work, and the contractor fails to render the contractual service the party suffers a loss of bargain. That loss can be recovered on the basis of what it would cost to put right the defects. It was held that it was no pre-condition to recovery of substantial damages that the party should undertake to use the damages awarded to carry out the necessary repairs. It followed that if the party is sued for damages before assignment, then it would hold such damages for the third party and would be accountable to them for the sum

awarded.

These cases demonstrate a weakening of the rigid principles of contract at least in so far as the measure of damages are concerned. The full extent of the exception as it applies to construction contracts still needs to be worked out. What the above decisions mean is that even without collateral warranties, a consultant or contractor may find his is liable in damages for the loss to a third party due to defects in the design or construction.