

THIRD-PARTY BENEFICIARIES†

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INTRODUCTION

All common law rules are or should be based on applicable social propositions—that is, on those propositions of morality, policy, and experience that it is proper for the courts to take into account. Accordingly, one ideal for the common law is that every rule should be the rule that would be arrived at by taking into account all applicable social propositions, and making the best choices when such propositions collide. Call this ideal the standard of social congruence, and call a rule that meets that standard a socially congruent rule.

A second ideal for the common law is that every rule should be consistently followed. This ideal reflects such important social values as predictability and evenhandedness. Call this ideal the standard of doctrinal stability.

Any given rule that has been stated by a court may have been socially incongruent when adopted, or may have later become so. In such cases, the standards of social congruence and doctrinal stability point in different directions, and some accommodation must be made between them. In the common law, the two standards are accommodated by an institutional principle that once a rule has been stated by a court, it will be followed even if it is not the *most* socially congruent rule, as long as it does not lack *substantial* social congruence. Because small differences in the social congruence of competing rules are likely to be highly debatable, difficult to perceive, or both, stated rules would lose all reliability if the courts failed to apply a stated rule just because it was modestly less socially congruent than some alternative. In such cases, the social values underlying the standard of doctrinal stability outweigh the social values underlying the standard of social congruence. If, however, a stated rule lacks substantial social congruence, the social values underlying the standard of social congruence will outweigh the social values underlying the standard of doctrinal stability, and the rule will be overturned through overruling, inconsistently distinguishing, or radically reconstructing the precedents in which it was announced.¹

Because the rhetoric of judicial opinions heavily emphasizes rules that have been stated in the past, it is easy to make the mistake of believing that common law rules are relatively autonomous of social prop-

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1. See Melvin A. Eisenberg, *The Nature of the Common Law* 50–76, 104–145 (1988).

sitions. Reasoning that reflects this mistake is sometimes called formal, but might better be called *doctrinal*. In its extreme form, this type of reasoning first takes certain legal propositions as axiomatic in the sense that the propositions are regarded as self-evident, and then purports to derive other legal propositions by logical deduction from these axioms and to justify those other propositions by that derivation. As Holmes once put it, "I sometimes tell students that the law schools pursue an inspirational combined with a logical method, that is, the postulates are taken for granted upon authority without inquiry into their worth, and then logic is used as the only tool to develop the results."²

Doctrinal and axiomatic reasoning has often been particularly prominent in the law of contracts, and indeed was a central feature of classical contract law, as exemplified by the following passage from one of that school's leading texts, Langdell's *A Summary of the Law of Contracts*:

[An] acceptance . . . must be communicated to the original offerer, and until such communication the contract is not made. . . . It has been claimed that [in the case of contracts by mail] the purposes of substantial justice, and the interests of contracting parties as understood by themselves, will be best served by holding that the contract is complete the moment the letter of acceptance is mailed; and cases have been put to show that the contrary view would produce not only unjust but absurd results. The true answer to this argument is, that it is irrelevant. . . .³

For Langdell, then, "the purposes of substantial justice" and "the interests of the contracting parties as understood by themselves" were as irrelevant to contract law as they were to geometry.

Modern contract law is generally a much more open and supple instrument than classical contract law, but even in modern contract law certain doctrines seem to be treated as if they were autonomous, if not axiomatic. This problem has been especially salient in the law governing third-party beneficiaries, which for a long period undervalued the rights of third parties, and was eventually turned on its head to overvalue those rights. In this Article, I examine that body of law historically and analytically, with a view both to illustrating the history of a legal idea and to developing the principles that should govern this important area.

Nomenclature is important here. I will use the term *third-party beneficiary* to mean a person who is not a party to a contract but who would benefit from its performance; the term *promisor* to mean a person who

2. Oliver W. Holmes, *Law in Science and Science in Law*, 12 Harv. L. Rev. 443, 460 (1899), reprinted in Oliver W. Holmes, *Collected Legal Papers* 210, 238 (1920).

3. Christopher C. Langdell, *A Summary of the Law of Contracts* 15, 20-21 (2d ed. 1880).

has made a legally enforceable promise the performance of which would benefit a third-party beneficiary; and the term *promisee* to mean the person to whom this promise is made.⁴ Finally, I will use the term *contract* to mean an enforceable agreement between a promisor and a promisee the performance of which would benefit a third party, and the term *contracting parties* to refer to the promisor and the promisee, taken together.

In Part I of this Article, I examine the law of third-party beneficiaries as the history of an idea. I show in this Part that the concept of enforceability by third parties gradually flowed forward until the rise of the school of classical contract law in the mid-eighteenth century; then ebbed under the force of doctrinal objections raised by that school; and then flowed forward once again as the force of social propositions broke through the doctrinal barriers. In Part II, I develop the principle that should determine whether any given third-party beneficiary should be allowed to enforce a contract. In Part III, I illustrate that principle and develop its implications by examining its application to some recurring third-party-beneficiary problems. Finally, in Part IV, I examine the defenses that a promisor should be able to raise against a third-party beneficiary who would have power to enforce the contract in the absence of a defense.

I. THE DEVELOPMENT OF THE LAW GOVERNING THE ENFORCEABILITY OF CONTRACTS BY THIRD-PARTY BENEFICIARIES

A. *Early English and American Law*

The modern law of third-party beneficiaries did not arise until early in this century and did not begin to mature until the early 1930s. It took much time for contract law to emerge as a body of coherent principles, as opposed to a collection of discrete rules, and it is not surprising that coherent principles concerning the rights of third parties were especially late in coming. Nevertheless, in retrospect it appears that principles to govern those rights were ready to emerge in the mid-eighteenth century, until the rise of classical contract law put a

4. This nomenclature is somewhat artificial, because in bilateral contracts each party is both a promisor and a promisee. Typically, however, a third-party beneficiary would be benefited only by the performance of one of the parties—the party I call the promisor.

The term *third-party beneficiary* is sometimes used by courts to mean a third party who can enforce a contract, as opposed to one who cannot. See, e.g., *Dravo Corp. v. Robert R. Kerris, Inc.*, 655 F.2d 503, 510 (3d Cir. 1981) (“[T]he parties did not intend Dravo to be a third-party beneficiary to the . . . contract.”). However, the definition of the term in this Article to include all third parties who would benefit from the performance of a contract, whether or not they can enforce the contract, parallels the usage of other courts and of the Restatements. See Restatement of Contracts § 133 (1932) [hereinafter Restatement First]; Restatement (Second) of Contracts § 302 (1979) [hereinafter Restatement Second].

temporary end to their development. In England, for example, the tendency up to the early eighteenth century had been to allow suit by a third party.⁵ *Dutton v. Poole*,⁶ decided in 1677, was an important case illustrating this tendency. Father was preparing to sell a wood to raise marriage portions for his younger children, including Daughter.⁷ Eldest Son, who stood to inherit the wood as Father's heir, promised Father that he would pay £1000 to Daughter if Father would forbear from selling the wood.⁸ The court held that Daughter could enforce the contract.⁹

Dutton v. Poole was somewhat ambiguous. Chief Justice Scroggs suggested that because of the close relationship of father and child the promise to Father might be treated as a promise to Daughter.¹⁰ However, in *Martyn v. Hind*,¹¹ decided a century later in 1776, Lord Mansfield said that "[a]s to the case of *Dutton v. Poole*, it is [a] matter of surprise, how a doubt could have arisen in that case."¹² In *Pigott v. Thompson*,¹³ decided in 1802, a note (apparently by the reporter) said:

With respect to the right of a third person to sue upon a parol promise made to another for his benefit, there is great contradiction among the older cases. . . . But in *Dutton v. Poole*, the point seems to have been very fully considered and very solemnly decided. . . . In that case, indeed, some stress was laid upon the nearness of relationship between the Plaintiff's wife and her father, to whom the promise was made; but another case [*Martyn v. Hind*] has since occurred to which that reason does not apply.¹⁴

American courts tended to follow a similar course. New York was

5. See Peter Karsten, The "Discovery" of Law by English and American Jurists of the Seventeenth, Eighteenth, and Nineteenth Centuries: Third-Party Beneficiary Contracts as a Test Case, 9 *Law & Hist. Rev.* 327, 334-35 (1991).

6. 83 Eng. Rep. 523 (K.B. 1677).

7. See *id.* at 523.

8. See *id.*

9. See *id.* at 524.

10. See *id.*

11. 98 Eng. Rep. 1174 (K.B. 1776).

12. *Id.* at 1177.

13. 127 Eng. Rep. 80 (C.P. 1802).

14. *Id.* at 81-82 n.(a). The note cited a statement of Justice Buller to the effect that "[i]f one person makes a promise to another for the benefit of a third, that third [person] may maintain an action upon it." The Master, Wardens and Commonalty of Feltmakers v. Davis, 126 Eng. Rep. 799, 801 n.(c) (C.P. 1797) (quoting *Marchington v. Vernon*, Trin. 27 G. 3, B.R. (1787) ("[person]" appears in *Davis*, but not in *Pigott* citing *Davis*)).

Some English cases decided during this early period reached a different result. See, e.g., *Bourne v. Mason*, 86 Eng. Rep. 5 (K.B. 1669). Parrie owed money to both the plaintiff and the defendants. X owed money to Parrie. Parrie allowed the defendants to sue X in his name in exchange for the defendants' promise to pay Parrie's debt to the plaintiff. Plaintiff then sued the defendants on their promise to Parrie. The court held for the defendants, on the ground that the plaintiff was "a stranger to the consideration." *Id.* at 6; accord *Crow v. Rogers*, 93 Eng. Rep. 719 (K.B. 1723).

fairly typical. In 1806, a New York court, citing *Dutton v. Poole* and *Pigott v. Thompson*, stated, "[W]e are of [the] opinion, that where one person makes a promise to another for the benefit of a third person, that third person may maintain an action on such promise."¹⁵ *Farley v. Cleveland*,¹⁶ decided in 1825, was for many years the leading New York case. A had given T a promissory note for \$100 plus interest. Later, A sold to B fifteen tons of hay in exchange for B's promise to pay A's debt to T. Apparently, B also promised T that he would pay A's debt. The court permitted T to sue B.¹⁷ A strong majority of other states,¹⁸ including Massachusetts,¹⁹ generally followed the same course as New York during this period.

B. Lawrence v. Fox

The general approach of the American courts through the mid-nineteenth century is reflected in the now-famous case of *Lawrence v. Fox*,²⁰ decided in 1859 by the New York Court of Appeals. This case falls into the category now known as creditor-beneficiary cases, in which the promisee owed the third party a legal obligation prior to the con-

15. *Schermerhorn v. Vanderheyden*, 1 Johns. 139, 140 (N.Y. Sup. Ct. 1806).

16. 4 Cow. 432 (N.Y. Sup. Ct. 1825), aff'd without opinion, 9 Cow. 639, 640 (N.Y. 1827).

17. See id. at 432, 439. Similarly, in *Ellwood v. Monk*, 5 Wend. 235 (N.Y. Sup. Ct. 1830), B promised A to pay, on A's behalf, various claims that A owed, including a debt A owed to T. See id. at 235-36. The court relied on *Farley* to hold that T could sue B. See id. at 236-37. In *Barker v. Bucklin*, 2 Denio 45 (N.Y. Sup. Ct. 1846), the court said, "It is now well settled [by this court], as a general rule, that in cases of simple contracts, if one person makes a promise to another, for the benefit of a third, the third may maintain an action upon it, though the consideration does not move from him." Id. at 53. In *Delaware & Hudson Canal Co. v. Westchester County Bank*, 4 Denio 97, 98 (N.Y. Sup. Ct. 1847), the court reiterated this rule almost verbatim.

18. See *Karsten*, supra note 5, at 340.

19. See, e.g., *Brewer v. Dyer*, 61 Mass. (7 Cush.) 337, 340 (1851) ("[U]pon the principle of law, long recognized and clearly established in this commonwealth, that when one person, for a valuable consideration, engages with another, by simple contract, to do some act for the benefit of a third, the latter, who would enjoy the benefit of the act, may maintain an action for the breach of such engagement."); *Hall v. Marston*, 17 Mass. 574, 579 (1822) ("It seems to have been well settled heretofore that if A promises B, for a valuable consideration, to pay to C, the latter may maintain *assumpsit* for the money."); *Arnold v. Lyman*, 17 Mass. 400, 404 (1821) ("Generally he for whose interest a promise is made may maintain an action upon it, although the promise be made to another . . ."); *Felton v. Dickinson*, 10 Mass. 287, 290 (1813) ("[W]hen a promise is made to one, for the benefit of another, he for whose benefit it is made may bring an action for the breach."); see also *Crocker v. Higgins*, 7 Conn. 342, 347 (1829) (citing cases from England, New York, and Massachusetts); *Bohanan v. Pope*, 42 Me. 93, 96 (1856) (citing with approval the Massachusetts cases cited supra); *M'Carty v. Blevins*, 13 Tenn. (5 Yer.) 195, 196 (1833) (holding third-party beneficiary could enforce contract between two horse owners where third party was to receive the foal of the breeding). But see *Butterfield v. Hartshorn*, 7 N.H. 345 (1834) (holding that third-party beneficiary may not recover due to lack of privity).

20. 20 N.Y. 268 (1859).

tract, and a performance objective of the contracting parties is to arrange for the discharge of that obligation by the promisor.²¹ The contracting parties were Holly and Fox.²² Under the contract, Holly loaned \$300 to Fox, and Fox in turn agreed to pay \$300 to Lawrence in satisfaction of a preexisting debt that Holly owed to Lawrence.²³ The court held that Lawrence could enforce the contract against Fox.²⁴

Although *Lawrence v. Fox* is often celebrated today as a landmark case that established the power of a third-party beneficiary to bring suit,²⁵ in reality the case was not very remarkable for its time. The cases considered so far show that *Lawrence v. Fox* broke little or no new ground in New York. The picture nationwide was little different. In an exhaustive survey of appellate decisions, Peter Karsten found that American courts had allowed third-party beneficiaries to enforce contracts in seventy-two percent of the cases decided prior to *Lawrence v. Fox*.²⁶

Indeed, *Lawrence v. Fox* was not very influential in its time.²⁷ On the contrary, the holding of the case was drastically limited in New York almost immediately after the case was decided, and for some time thereafter.²⁸

The modern celebrity of *Lawrence v. Fox* therefore results neither from its novelty nor its immediate impact, both of which were minimal. Instead, that celebrity results partly from the relative clarity of the several opinions in the case in staking out contrasting positions; partly because, as a result of that relative clarity, when the tide began turning back some years later, the courts began treating *Lawrence v. Fox* as a leading case; and partly because, due both to its relative clarity and its later-acquired status as a leading case, *Lawrence v. Fox* has become a standard with casebook authors. In historical context, however, what is striking about *Lawrence v. Fox* is not how far it advanced the law, which was very little, but how this now-celebrated case was almost drowned by the rising tide of classical contract law only ten or fifteen years after it was decided.

21. See generally *infra* part III.B.

22. See 20 N.Y. at 269.

23. See *id.*

24. See *id.*

25. See, e.g., Lawrence M. Friedman, *History of American Law* 534-35 (1985); Anthony J. Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 Harv. L. Rev. 1111, 1112, 1115 (1985).

26. See Karsten, *supra* note 5, at 331, 333.

27. A footnote in the first edition of Williston on Contracts listed chronologically, within jurisdictions, the cases that had recognized a direct action by third-party beneficiaries. *Lawrence v. Fox* was given an undistinguished mention in the middle of the New York cases. See I Samuel Williston, *Contracts* § 381, at 712-17 n.27 (1920) [hereinafter *Williston on Contracts*]. Corbin remarked that "[t]he decision in *Lawrence v. Fox* can hardly . . . be said to have created a new rule of law." 4 Arthur L. Corbin, *Corbin on Contracts*, § 827, at 303 (1951) [hereinafter *Corbin on Contracts*].

28. See *infra* text accompanying notes 44-53.

From the perspective of a casebook author, one of the virtues of *Lawrence v. Fox* is that the court split three ways, and the three opinions taken together put many of the relevant doctrinal issues on the table in a fairly explicit way. Eight judges participated in the Court of Appeals decision. Judge Comstock, joined by Judge Grover, took the position that Lawrence could not enforce the contract against Fox, on the doctrinal grounds that a third party is not in privity with the promisor and has given no consideration for the promise. The plaintiff, Judge Comstock said,

had nothing to do with the promise on which he brought this action. It was not made to him, nor did the consideration proceed from him In general, there must be privity of contract. The party who sues upon a promise must be the promisee, or he must have some legal interest in the undertaking.²⁹

The other six judges all took the position that Lawrence could enforce the contract, but had difficulty in meeting Judge Comstock's doctrinal arguments. Judges Johnson and Denio held for Lawrence on the untenable ground that in making the contract with Fox, Holly had acted as Lawrence's agent.³⁰ Judge Gray, joined by three colleagues, held for Lawrence without employing agency theory, but was unable to say exactly why. "[I]f . . . it could be shown," Judge Gray concluded, "that a more strict and technically accurate application of the rules applied, would lead to a different result (which I by no means concede), the effort should not be made in the face of manifest justice."³¹

The inability of Judges Johnson and Gray to clear the doctrinal hurdles set by Judge Comstock was not unusual. Like Judge Johnson, other courts that held for third-party beneficiaries during this period often resorted to justifications based on clumsy fictions, such as presumed assent or a unity of interest between the third party and the promisee.³² That even judges sympathetic to third-party beneficiaries

29. *Lawrence v. Fox*, 20 N.Y. 268, 275 (1859) (Comstock, J., dissenting).

30. "[T]he promise was to be regarded as made to the plaintiff [Lawrence] through the medium of his agent [Holly], whose action he could ratify when it came to his knowledge, though taken without his being privy thereto." *Id.* at 275.

31. *Id.*

32. For example, in *Arnold v. Lyman*, 17 Mass. 400 (1821), the Massachusetts court allowed suit by a third-party beneficiary on the ground that "the assent of the [third party] creditors made them parties to the promise; and this assent is sufficiently proved, as respects the plaintiffs, by their bringing an action upon the contract." *Id.* at 404.

A few opinions, however, did break through the doctrinal barrier to a lesser or greater extent. For example, in *Brewer v. Dyer*, 61 Mass. (7 Cush.) 337 (1851), the court said that the right of a third-party beneficiary

does not rest upon the ground of any actual or supposed relationship between the parties, as some of the earlier cases would seem to indicate [citing *Dutton v. Poole*]; nor upon the reason that the defendant, by entering into such an agreement, has impliedly made himself the agent of the plaintiff; but upon the broader and more satisfactory basis, that the law, operating on the act of the

had difficulty in meeting the doctrinal objections raised by Judge Comstock soon became telling, because almost immediately after *Lawrence v. Fox* was decided, contract law became dominated by the doctrinal reasoning of the classical contract school, as exemplified both in the cases and in the commentaries of figures like Langdell, Holmes, and Williston.

C. *The School of Classical Contract Law*

One tacit premise of the classical contract school was that contract law could be developed in axiomatic fashion. Another was that persons would not readily engage in contracting if they faced the threat of high liability. A third was that standardized rules, the application of which is unrelated to the intentions of the parties or the particular circumstances of the transaction, were preferable to individualized rules, the application of which depends on situation-specific variables that are concerned with intention and circumstances.³³

Given these premises, it is not surprising that classical contract law would be hostile to third-party beneficiaries. The classical school regarded the doctrines of privity and consideration as axiomatic and was unable to reconcile suits by third-party beneficiaries with these doctrines. Furthermore, allowing third-party beneficiaries to bring suit seemed to threaten a significant expansion of promisors' liability. Finally, if there was no general barrier to suits by third-party beneficiaries, an individualized inquiry would often be required to determine whether any given third party could enforce a contract.

With the rise of classical contract law, the doctrinal objections to suits by third-party beneficiaries soon began to dominate the field. So, for example, Langdell concluded axiomatically that "[the proposition] that a person for whose benefit a promise was made, if not related to the promisee, could not sue upon the promise . . . is so plain upon its face that it is difficult to make it plainer by argument."³⁴ Holmes reached the same result by the same axiomatic method:

parties, creates the duty, establishes the privity, and implies the promise and obligation, on which the action is founded.

Id. at 340 (citations omitted). In *Bohanan v. Pope*, 42 Me. 93 (1856), the court said, simply and directly, that

where a party for a valuable consideration stipulates with another, by simple contract, to pay money or do some other act for the benefit of a third person, the latter, for whose benefit the promise is made, if there be no other objection to his recovery than a want of privity between the parties, may maintain an action for a breach of such engagement.

Id. at 96.

33. See generally Melvin A. Eisenberg, *The Responsive Model of Contract Law*, 36 *Stan. L. Rev.* 1107, 1112-17 (1984) (describing classical contract law as standardized and rigorously objective); Melvin A. Eisenberg, *The Principles of Consideration*, 67 *Cornell L. Rev.* 640 (1982) (describing the axiomatic nature of classical contract law).

34. Langdell, *supra* note 3, at 79.

The fact that a consideration was given yesterday by A to B, and a promise received in return, cannot be laid hold of by X, and transferred from A to himself. The only thing which can be transferred is the benefit or burden of the promise, and how can they be separated from the facts which gave rise to them? How, in short, can a man sue or be sued on a promise in which he had no part?³⁵

The third great American commentator of the classical school, Williston, appreciated "that justice requires some remedy to be given" to at least certain third-party beneficiaries,³⁶ but had enormous difficulty in reconciling that conclusion with the axioms of contract law as he held them to be. In his treatise, Williston tried to reconcile this conflict by concluding that because a third-party beneficiary is not a party to the contract, as a matter of legal principle the third party could not bring suit in a court of *law*, but on grounds of justice in appropriate cases a third-party beneficiary should be allowed to bring suit in a court of *equity*.³⁷

The case law proceeded in a generally parallel fashion. In England the law had begun to shift in the early nineteenth century,³⁸ and *Tweddle v. Atkinson*,³⁹ decided in 1861, rejected *Dutton v. Poole* in all but form. In *Tweddle*, A and B were the fathers of a newlywed couple, Husband and Wife. A and B promised each other to pay certain sums to Husband and expressly agreed that Husband should have a right enforceable at law. A, Wife's father, died without paying the promised amount, and Husband sued A's executor to enforce the contract. The court held for the executor on the ground of lack of privity.⁴⁰ *Dutton v. Poole*, Justice Blackburn said, "cannot be supported."⁴¹

35. Oliver W. Holmes, *The Common Law* 265 (Mark Howe ed., 1963).

36. 1 Williston on Contracts, *supra* note 27, § 354, at 683. *Williston on Contracts* is now in its fourth edition. The first edition, cited here, was published in the early 1920s. The second edition, known as the "revised edition," by Williston and George J. Thompson, was published in the 1930s. The third edition, edited by Walter H.E. Jaeger, was published from the late 1950s to the late 1970s. Publication of a fourth edition, edited by Richard A. Lord, began in 1990. The first three volumes of that edition have now been issued. Unless otherwise indicated, references to Williston are to the first edition.

37. See 1 Williston on Contracts, *supra* note 27, § 354, at 682-89. Later, as the Reporter for Restatement (First) of Contracts (1932), Williston included in the Restatement a rule that allowed third-party beneficiaries to bring suit even in courts of law, see *infra* text accompanying notes 68-75, but he regarded the rule as "an anomaly." See 5 A.L.I. Proc. 385 (1927) (remarks of Reporter Williston).

38. See Karsten, *supra* note 5, at 337.

39. 121 Eng. Rep. 762 (K.B. 1861).

40. See *id.* at 763-64.

41. *Id.* at 764; accord *Price v. Easton*, 110 Eng. Rep. 518, 519 (K.B. 1833) (action for breach of contract must be brought by the person from whom the consideration moved). Similarly, in *Gandy v. Gandy*, 30 Ch. D. 57 (C.A. 1885), Justice Bowen said that although it

was supposed at one time in the history of our common law, that there was an

During the latter half of the nineteenth century, some American states also reversed course.⁴² The most notable of these states was Massachusetts, which, like England, began a holdout against third-party beneficiaries that persisted long after the tide had turned back elsewhere.⁴³

exceptional class of cases, in which where a contract was made for the benefit of a person who was not a contracting party, that is to say, a stranger, it could be enforced by that person at law,

it would be "mere pedantry now to go through the history of that idea," because the "true common law doctrine" was that laid down in *Tweddle v. Atkinson*. *Id.* at 69.

The picture was somewhat mixed, because the common law rule was partially undercut by the equity courts. Corbin describes this development as follows:

It came to be recognized that, by means of a trust, A and B could create enforceable rights in C, even though he gave no consideration and took no part whatever in the operative transaction. Usually, however, this result was reached with respect to the enjoyment of "property." The trustee was said to hold some subject matter in trust for the benefit of another. This invention was capable of great extension in its application. . . . Not only could a trustee be required to hold land or goods for the benefit of another, he could also be required to hold a "fund" in trust for another, even though the fund included no specific physical object; and he could be required to hold "rights" and "powers" in trust, even though they had no relation to the use and enjoyment of any specific physical object.

4 Corbin on Contracts, *supra* note 27, § 840, at 361.

However, the English courts of equity, while more flexible than the common law courts, were hardly committed to recognizing third-party rights. In 1883, Lindley, L.J. said, "an agreement between A. and B. that B. shall pay C., gives C. no right of action against B. I cannot see that there is in such a case any difference between Equity and Common Law, it is a mere question of contract." *In re Rotherham Aluminum & Chem. Co.*, 25 Ch. D. 103, 111 (C.A. 1883).

42. See *Meech v. Ensign*, 49 Conn. 191, 209 (1881); *Eichelberger v. Murdock*, 10 Md. 373, 379 (1857); *Karsten*, *supra* note 5, at 344-50.

43. As late as *Brewer v. Dyer*, 61 Mass. (7 Cush.) 337 (1851), the Massachusetts court had enforced

the principle of law, long recognized and clearly established in this commonwealth, that when one person, for a valuable consideration, engages with another, by simple contract, to do some act for the benefit of a third, the latter, who would enjoy the benefit of the act, may maintain an action for the breach of such engagement.

Id. at 340. However, in *Mellen v. Whipple*, 67 Mass. (1 Gray) 317 (1854), the Massachusetts court held that a mortgagee could not sue the grantee of a mortgagor who had assumed the mortgagor's debt. The court stated that the general rule was that no action may be brought by a person who is not a promisee and distinguished previous Massachusetts cases as exceptions to that rule. See *id.* at 321. The early leading case of *Felton v. Dickinson*, 10 Mass. 287 (1813), was essentially overruled in 1889 by *Marston v. Bigelow*, 22 N.E. 71 (Mass. 1889):

The [*Felton*] court, in its opinion, puts the decision upon the broad ground, that, 'when a promise is made to one, for the benefit of another, he for whose benefit it is made may bring an action for the breach.' But, as we have seen, this is not the law as established by the later decisions.

While the case of *Felton v. Dickinson* was rightly decided upon its peculiar circumstances, we think it cannot be fairly regarded as establishing a general rule that a son may sue upon a promise made for his benefit to his father. The

Unlike England and Massachusetts, New York did not completely turn its back on third-party beneficiaries in the latter part of the nineteenth century, but it did severely limit the ambit of *Lawrence v. Fox*. Judge Gray's opinion in that case, although uncertain in its reasoning, clearly took the position that lack of privity and consideration was not a barrier to suits by third-party beneficiaries. Subsequent New York cases dramatically cut back on that position. Although the New York courts continued to allow suit by creditor beneficiaries, with only very limited exceptions they refused to allow suit by any other third-party beneficiaries and pared the holding of *Lawrence v. Fox* down to a bare minimum.⁴⁴ For example, in the important case of *Vrooman v. Turner*,⁴⁵ A owned property that had been mortgaged to T, but A was not personally liable on the mortgage. A sold the property to B, who promised to pay the mortgage. The court held that T could not enforce B's promise. The requirements of consideration and privity with the promisor, the court said, could be dropped only when there was an obligation or duty previously owed by the promisee to the third party.⁴⁶ This preexisting legal obligation would create "a privity by substitution" with the promisor,⁴⁷ which in turn would permit the transaction to be characterized as one of either agency ("the [promisee] being regarded as the agent for the third party, who, by bringing his action adopts his acts"⁴⁸) or of trust ("the promisor being regarded as having received money or other things for the third party"⁴⁹).

Over the next twenty years, New York continued to reject the gen-

nearness of the relationship may be evidence that the promise to the father was made to him acting in behalf of, and as the agent of, the son, and therefore was a promise to the son; but when it appears that the promise was not made to the son, and that the consideration did not move from him, we can see no reason why the nearness of the relationship should change the general rule of law, that a man cannot sue upon a contract to which he is not a party or privy.

Id. at 73 (citations omitted).

Massachusetts held to this position until the end of the 1970s, when the state joined what had by then become the mainstream. See *Ayala v. Boston Hous. Auth.*, 536 N.E.2d 1082, 1088-90 (Mass. 1989); *Flattery v. Gregory*, 489 N.E.2d 1257, 1260-62 (Mass. 1986); *Rae v. Air-Speed, Inc.*, 435 N.E.2d 628, 632-33 (Mass. 1982); *Choate, Hall & Stewart v. SCA Servs., Inc.*, 392 N.E.2d 1045, 1050 (Mass. 1979).

44. For example, in *Garnsey v. Rodgers*, 47 N.Y. 233 (1872), the court said, "[A]ll that the case of *Lawrence v. Fox* decides is, that where one person loans money to another, upon his promise to pay it to a third party to whom the party so lending the money is indebted" the creditor can bring suit under the contract. Id. at 240.

45. 69 N.Y. 280 (1877).

46. See id. at 283-84.

47. Id. at 284.

48. Id. at 285.

49. Id. In *Vrooman*, the promisee-grantor, A, was not personally liable to pay the mortgage and therefore owed no legal duty to the mortgagee. The court suggested in dicta that if the grantor had been personally liable to pay the mortgage, the holding in *Lawrence v. Fox* would have applied, and the mortgagee could have enforced the promise against the assuming grantee. See id. The result in *Vrooman* may have been correct on

eral approach of *Lawrence v. Fox*, while accepting its narrow holding. In 1884, for example, in *Wheat v. Rice*⁵⁰ the court said, "We prefer to restrict the doctrine of *Lawrence v. Fox* within the precise limits of its original application."⁵¹ In 1892, the court said in *Durnherr v. Rau*,⁵²

There is lacking in this case the essential relation of debtor and creditor between the grantor and a third person seeking to enforce [a covenant in a deed], or such a relation as makes the performance of the covenant at the instance of such third person a satisfaction of some legal or equitable duty owing by the grantor to such person, which must exist according to the cases in order to entitle a stranger to the covenant to enforce it.⁵³

the facts. See *infra* part IV.C. What is striking about the case is not the result, but the very restrictive reasoning the court employed to reach that result.

During this period, some (but not all) other states also cut back on the power of third-party beneficiaries to enforce contracts. See generally Karsten, *supra* note 5, at 340-53 (tracking gradual movement of the common law in the nineteenth century away from allowing suits by third-party beneficiaries).

50. 97 N.Y. 296 (1884).

51. *Id.* at 302; accord *Lorillard v. Clyde*, 25 N.E. 917, 919 (N.Y. 1890) ("[T]he courts have repeatedly said that the principle of [*Lawrence v. Fox*] should be limited to the cases having the same essential facts.").

52. 32 N.E. 49 (N.Y. 1892).

53. *Id.* at 50. While *Lawrence v. Fox* was being strictly limited to its facts, the New York courts were forthcoming in allowing third-party beneficiaries to enforce contracts when the requisite preexisting legal duty was found. See *Hannigan v. Allen*, 27 N.E. 402, 403 (N.Y. 1891); *Arnold v. Nichols*, 64 N.Y. 117, 119 (1876); *Claffin v. Ostrom*, 54 N.Y. 581, 584 (1874).

Furthermore, despite the strictures of cases such as *Wheat* and *Durnherr*, the New York courts during this period allowed enforcement by third-party beneficiaries in at least two categories of cases that did not involve creditor beneficiaries. One of these categories involved the recurring leitmotif (going back to *Dutton v. Poole*) of a close familial relationship between the promisee and the beneficiary. For example, in *Todd v. Weber*, 95 N.Y. 181 (1884), Child was born out of wedlock, and the putative Father promised Child's relatives that he would provide for Child's care. The court allowed Child to enforce the contract. See *id.* at 193-95.

The second category involved cases in which a third-party beneficiary would benefit from performance of a contract made by a government entity. See *Rigney v. New York Cent. & H. R. R.R. Co.*, 111 N.E. 226 (N.Y. 1916); *Smyth v. City of New York*, 96 N.E. 409 (N.Y. 1911); *Pond v. New Rochelle Water Co.*, 76 N.E. 211 (N.Y. 1906); *Little v. Banks*, 85 N.Y. 258 (1881). Generally speaking, however, the New York courts tried to avoid conceptualizing government contracts as an independent category of third-party beneficiary law. In *Little*, the court rested its result on the ground of public policy and suggested that third-party-beneficiary reasoning might therefore be unnecessary:

The ground upon which these decisions [involving contractors with the state] are founded is a broad principle of public policy essential to the public welfare and we are unable to perceive why [that] doctrine . . . , without invoking the rule laid down in *Lawrence v. Fox*, is not applicable to a contract of the description of the one in controversy, where the officers enter into it for the advantage and the welfare of the public, and where such a provision constitutes a material portion of the agreement which is essential to carry it into effect.

85 N.Y. at 263-64 (citations omitted). In *Pond*, the court analogized government-

The submergence of third-party-beneficiary law under the doctrinal wave of classical contract law in the last part of the nineteenth century was mistaken on both the substantive and technical levels. A central vice of the classical contract school was that as between the values of doctrinal stability and social congruence, the classical school placed almost all of its chips on the former and few or none on the latter. This vice was particularly apparent in the third-party-beneficiary area, in which courts under the influence of classical contract law applied the doctrines of consideration and privity as objections to enforcement by third parties without even attempting to provide a social underpinning for that result.

These doctrinal objections were mistaken on the substantive level, because, as I show in Part III, there are strong social reasons why at least some third-party beneficiaries should be allowed to enforce contracts.

The objections were also mistaken on the technical level, because the doctrines of privity and consideration were virtually irrelevant on their face to the third-party-beneficiary problem.

The objection based on privity—that the plaintiff “must have some legal interest in the undertaking”—was circular, because the very question was *whether* a third-party beneficiary had a legal interest in the undertaking.

The objection based on lack of consideration was also wide of the mark. The purpose of the requirement of consideration in contract law is to screen out those promises that are legally enforceable from those that are not. A suit by a third-party beneficiary, however, *assumes* the

contract cases to close-relationship cases: “While there is not presented a domestic relation like that of father and child or husband and wife, yet it cannot be said that this contract was made for the benefit of a stranger.” 76 N.E. at 214. In *Smyth*, the court analogized the government-contract cases to the creditor-beneficiary cases on the basis of the government entity’s preexisting obligations to its citizens:

[T]hough the city might not be liable for injuries occasioned by [the negligence of a contractor with the city], it was entirely proper, if not morally obligatory upon the part of the rapid transit commissioners to secure the abutting owners from loss or damage occasioned by negligence and improper conduct of the work.

96 N.E. at 412. This approach was also taken in *Rigney*. See 111 N.E. at 228 (quoting passage from *Smyth*).

The New York courts also allowed suit by a third-party beneficiary to whom the promise was directly made, see *Rector v. Teed*, 24 N.E. 1014 (N.Y. 1890), but in this kind of case the privity objection arguably did not apply.

As these cases suggest, the close-relationship and creditor-beneficiary theories are at least loosely related, because a close relationship can give rise to some sort of preexisting duty. Insofar as the government-contract cases rested on an analogy to the close-relationship and creditor-beneficiary cases, therefore, they both presaged and were part of the next important development in New York, which was to open up the concept of preexisting duty to include moral as well as legal duties. See *infra* text accompanying notes 55–61.

existence of a legally enforceable contract. The question therefore is not whether an enforceable promise has been made—it has—but who can enforce the promise. That question may often be very difficult to answer, but it is not a question of consideration.⁵⁴ Finally, on a technical level, if the privity and consideration objections were well taken, they would have barred actions by all third-party beneficiaries. Although England and Massachusetts did take this approach, New York and most other states allowed at least some types of third-party beneficiaries to bring suit.

D. *The Beginnings of Modern Contract Law*

Given the double mistake of the classical school's doctrinal objections to enforcement of contracts by third-party beneficiaries, it was only a matter of time until those objections eroded and then collapsed.

In New York, the erosion was marked most sharply by *Buchanan v. Tilden*,⁵⁵ decided in 1899. T made a contract with A under which T agreed to pay \$50,000 to A's wife in exchange for A's obtaining a loan for T. The court held that A's wife could bring an action against T, partly on the ground that there was a unity of interest between husband and wife, but also on the ground that the moral duty owed by a husband to a wife would satisfy the preexisting-obligation requirement of cases such as *Vrooman*.⁵⁶

In 1918, the New York Court of Appeals decided the pivotal case of *Seaver v. Ransom*.⁵⁷ This case involved the category now known as donee-beneficiary cases, in which a performance objective of the contracting parties, as manifested in the contract read in the light of surrounding circumstances, is to give effect to a donative intention of the promisee by obliging the promisor to render a performance that will benefit the third party.⁵⁸ The contracting parties were Mrs. Beman and her husband, Judge Beman. Judge Beman had drawn a will for Mrs. Beman when she was about to die. The will left a house owned by Mrs. Beman to Judge Beman for life, with the remainder to a charity. When the will was read to Mrs. Beman, she said she wanted to leave the house to her niece, Marion. Mrs. Beman's strength was waning, and although Judge Beman offered to write another will, she was afraid she would not hold out long enough to sign it. Judge Beman therefore promised that

54. Even Williston, who took the position that enforcement of contracts by third-party beneficiaries was not justified in principle because of the privity objection, see supra text accompanying notes 36–37, admitted that consideration was not a problem: “[I]n a developed system of contract law there seems to be no good reason why A should not be able for a consideration received from B to make an effective promise to C.” 1 Williston on Contracts, supra note 27, § 354, at 682.

55. 52 N.E. 724 (N.Y. 1899).

56. See id. at 727–28.

57. 120 N.E. 639 (N.Y. 1918).

58. See infra part III.A.

if Mrs. Beman would sign the original will, he would leave Marion enough in his own will to make up the difference. When Judge Beman died, it was found that his will made no provision for Marion, and Marion brought suit against Judge Beman's executors. The court held that Marion could enforce the contract.⁵⁹

Unlike *Buchanan v. Tilden*, the court in *Seaver* could not easily rely on a unity of interest between the promisee-aunt and the beneficiary-niece. The court therefore based its holding, more squarely than it had in *Buchanan*, on the ground that a preexisting moral obligation owed by the promisee to the third-party beneficiary sufficed to allow enforcement of the contract by the third party:

The constraining power of conscience is not regulated by the degree of relationship alone. The dependent or faithful niece may have a stronger claim than the affluent or unworthy son. No sensible theory of moral obligation denies arbitrarily to the former what would be conceded to the latter. We might consistently either refuse or allow the claim of both, but I cannot reconcile a decision in favor of the wife in *Buchanan v. Tilden*, based on the moral obligations arising out of near relationship, with a decision against the niece here on the ground that the relationship is too remote for equity's ken.⁶⁰

As in *Lawrence v. Fox*, however, the court was not certain precisely how to support its result as a doctrinal matter:

If Mrs. Beman had left her husband the house on condition that he pay the plaintiff \$6,000, and he had accepted the devise, he would have become personally liable to pay the legacy, and plaintiff could have recovered in an action at law against him, whatever the value of the house. That would be because the testatrix had in substance bequeathed the promise to plaintiff The distinction between an implied promise to a testator for the benefit of a third party to pay a legacy and an unqualified promise on a valuable consideration to make provision for the third party by will is discernible, but not obvious. . . . The equities are with the plaintiff, and they may be enforced in this action⁶¹

Notwithstanding its doctrinal hesitation, *Seaver* represents a crucial transition between the restrictive rules of classical contract law that governed third-party beneficiaries in the late nineteenth and early twentieth centuries and the general principle of modern contract law that began to emerge around the 1920s and has steadily evolved since that time.

In form, *Seaver* looked backward to classical contract law. Classical contract law tended either to deny the right of a third-party beneficiary to enforce a contract, or, at best, to allow enforcement only by third

59. See *infra* part III.A for further discussion of *Seaver*.

60. 120 N.E. at 641.

61. *Id.* at 641-42 (citations omitted).

parties who fell within specific, well-defined, and standardized categories—most prominently, third parties to whom the promisee owed a preexisting legal obligation. *Seaver*, too, only allowed enforcement by a third-party beneficiary to whom the promisee owed a preexisting obligation, although the concept of obligation was expanded to include moral obligation.

In substance, however, *Seaver* looked forward to modern contract law. The recognition of prior *moral* obligations as a basis for enforceability was inherently much more expansive, less standardized, and more openly dependent on social propositions than was the earlier restriction to preexisting legal obligations. And recognition of this large new class set the stage for the creation of a general principle that could both explain and go beyond the specific instances. Thus, the ruling in *Seaver*, although tied to classical contract law in form, in substance bore the seeds of the modern expansion of the law governing third-party beneficiaries.

This expansion received its single most important expression fifteen years after *Seaver v. Ransom* was decided, when *Restatement (First) of Contracts (Restatement First)* was published in 1932.⁶² *Restatement First* Section 133 provided:

- (1) Where performance of a promise in a contract will benefit a person other than the promisee, that person is . . . :
- (a) a donee beneficiary if it appears from the terms of the promise in view of the accompanying circumstances that the purpose of the promisee in obtaining the promise of all or part of the performance thereof is [i] to make a gift to the beneficiary or [ii] to confer upon him a right against the promisor to some performance neither due nor supposed or asserted to be due from the promisee to the beneficiary;
 - (b) a creditor beneficiary if no purpose to make a gift appears from the terms of the promise in view of the accompanying circumstances and performance of the promise will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary . . . ;
 - (c) an incidental beneficiary if neither the facts stated in Clause (a) nor those stated in Clause (b) exist.⁶³

Sections 135 and 136 of *Restatement First* then went on to provide that a donee or creditor beneficiary had legally enforceable rights under a contract, but an incidental beneficiary did not.⁶⁴

The nomenclature of *Restatement First* can be reformulated in the following terms. There are two well-established basic categories of third-party beneficiaries who can enforce contracts. One basic category consists of cases in which the object of the promisee is to bring about

62. See *Restatement First*, supra note 4.

63. *Id.* § 133 (bracketed numbers added).

64. See *id.* §§ 135–136.

the payment of a legal obligation he owes to the beneficiary. This category is covered in Section 133(1)(b), and in such cases the third party is labeled a creditor beneficiary. The second basic category consists of cases in which the object of the promisee is to make a gift to the beneficiary. This category is covered in Section 133(1)(a)[i], and in such cases the third party is labeled a donee beneficiary. In cases falling outside these two well-established categories, sometimes it is appropriate to allow the beneficiary to enforce the contract, and sometimes it is not. When the purpose of the promisee is to confer a right on the beneficiary, enforcement is appropriate, and Section 133(1)(a)[ii] labels the beneficiary a donee beneficiary in these cases as well. In other cases enforcement is inappropriate, and Section 133(1)(c) labels the beneficiary an incidental beneficiary.

The terminology of *Restatement First* was very awkward, because the term donee beneficiary was used to describe both true donees and beneficiaries who, by hypothesis, were not true donees.⁶⁵ For ease of exposition, in the balance of this Article I will refer to Section 133(1)(a)[i] beneficiaries as true donee beneficiaries and to Section 133(1)(a)[ii] beneficiaries as constructive donee beneficiaries.

Despite the awkward nature of its nomenclature, *Restatement First* initiated the modern law of third-party beneficiaries by taking two critical steps. First, it pushed aside by brute force the doctrinal objections to enforcement by third-party beneficiaries. Second, it set the stage for movement away from a rule-based body of third-party-beneficiary law, comprised of a collection of specific categories, toward a body of law in which enforceability by third-party beneficiaries would be determined by a general principle. But what is that principle?

II. THE PRINCIPLE GOVERNING ENFORCEABILITY OF CONTRACTS BY THIRD-PARTY BENEFICIARIES

It is easy to see why not every third-party beneficiary should be allowed to enforce a contract. The reasons for enforcing bargain promises are complex, but the most important is that bargains enhance the wealth of the contracting parties by creating value through exchange and allowing the contracting parties to make reliable plans.⁶⁶ At its core, therefore, contract law seeks to facilitate the power of self-governing parties to further their own interests by contracting. Allowing enforcement of contracts by third-party beneficiaries often conflicts with those interests.

For example, suppose Martial is a manufacturer of specialty toy

65. "By hypothesis," because if the promisee had an intent to make a gift to the beneficiary, the beneficiary would fall under *Restatement First*, *supra* note 4, § 133(1)(a)[i].

66. See Robert Cooter & Melvin A. Eisenberg, *Damages for Breach of Contract*, 73 *Cal. L. Rev.* 1434, 1459-64 (1985); Melvin A. Eisenberg, *The Bargain Principle and Its Limits*, 95 *Harv. L. Rev.* 741, 743-44 (1982).

soldiers, and Access is a toy distributor. Martial purchases special paint for her soldiers from Color, and employs skilled workers on an hourly basis. At a time when Martial would have otherwise had to idle her plant for lack of business, Access places a large order for highly detailed Civil War toy soldiers to take advantage of a special surge of interest in that war. Access plans to resell the toy soldiers to large retailers, including Toys "R" We. Martial designs the soldiers and draws engineering plans for the necessary dies and then enters into a contract with Diemaker, who agrees to produce the dies. At the time the contract is made, Diemaker knows that Martial requires the dies to fill her contract with Access, that Access plans to resell to Toys "R" We and other retailers, and that Martial has no other business in prospect.

In breach of his contract, Diemaker fails to deliver the dies. As a result, Martial, in turn, is in breach of her contract with Access and also is forced to idle her plant for six weeks, until new orders begin to come in. Access and Toys "R" We sue Diemaker for their lost profits on resale of the toy soldiers. Color sues Diemaker for lost profits on sales of paint. Martial's workers sue Diemaker for their lost wages. Access, Toys "R" We, Color, and the workers are all third-party beneficiaries of the contract between Diemaker and Martial, but intuitively it seems clear that none of these beneficiaries should be able to bring suit against Diemaker.⁶⁷

The source of the intuition lies in considerations that might be thought of as remedial, that is, considerations concerning the promisor's liability and the impact of that liability on the contracting parties. In the hypothetical, Martial is entitled to expectation damages against Diemaker as a result of Diemaker's breach, and these damages would be measured in large part by Martial's lost profits. It can be assumed that the prospect of such damages affected the price Diemaker charged. If Martial had initially agreed to forgo expectation damages in the event of Diemaker's breach, Diemaker presumably would have agreed to a lower price. If Martial did not agree to forgo those damages, presumably that was partly because she wanted full compensation if Diemaker breached, and partly because she would have viewed the contract with Diemaker as unreliable if the contract was not backed by the sanction of expectation damages.

Suppose now that the parties had directly addressed the issue of the third parties' rights. If Diemaker was to be exposed to liability to the third parties, as well as liability to Martial, Diemaker would certainly

67. See Restatement Second, *supra* note 4, § 302 illus. 16, 19:

16. B contracts with A to erect an expensive building on A's land. C's adjoining land would be enhanced in value by the performance of the contract. C [cannot bring suit under the contract].

19. A contracts to erect a building for C. B then contracts with A to supply lumber needed for the building. C . . . and B [cannot bring suit under each other's contract]

have demanded a higher price from Martial. Martial, however, would almost certainly have been unwilling to pay that higher price, because she would receive little or no corresponding benefit in return. We can therefore be fairly confident that if Martial and Diemaker had directly addressed the issue, they would have agreed that the third parties should not be able to enforce the contract. Accordingly, if the interests of the contracting parties, Martial and Diemaker, are measured by what they would have agreed to if they had addressed the issue, allowing the third parties in the hypothetical to enforce the contract would conflict with those interests.

In short, although, as I show in Part III, social propositions do not support a rule that no third-party beneficiaries should be allowed to enforce contracts in their favor, neither do they support a rule that all third-party beneficiaries should be allowed to enforce contracts in their favor. Therefore, when *Restatement First* swept aside the doctrinal barriers to enforcement by third-party beneficiaries as a class, it not only cleared the way for the formulation of a general principle to determine when enforcement by third-party beneficiaries should be permitted, but also created an urgent need for such a formulation.

A. *The Restatement First Test*

Restatement First itself did not formulate a general principle to cover all third-party beneficiary cases, but instead adopted three separate rules to cover three separate categories of beneficiaries—a type of scheme often referred to as a categorization or categorical approach. The three categorical rules were: (1) Creditor beneficiaries could enforce contracts. (2) True donee beneficiaries could enforce contracts. (3) Third-party beneficiaries who were neither creditor beneficiaries nor true donee beneficiaries could enforce contracts if, but only if, “the purpose of the promisee in obtaining the promise [was] . . . to confer on [the beneficiary] a right against the promisor.”⁶⁸ The beneficiaries who qualified under the third rule are those I call constructive donee beneficiaries.

By adopting separate rules for creditor beneficiaries, true donee beneficiaries, and constructive donee beneficiaries, *Restatement First* treated creditor beneficiaries and true donee beneficiaries as special cases, rather than instances of a general principle that applied to all third-party beneficiaries. *Restatement First* here followed the view of Williston, its principal draftsman, who believed that “[a]ny attempt to reduce to a single governing principle the case of the donee beneficiary and that of the creditor beneficiary is not only doomed to failure but is an inevitable source of confusion.”⁶⁹ It is not surprising that Williston

68. *Restatement First*, supra note 4, § 133.

69. Samuel Williston & George J. Thompson, *A Treatise on the Law of Contracts* § 356A, at 331 (rev. ed. 1938) [hereinafter *Williston on Contracts Revised Edition*].

should arrive at this conclusion, given his view that the power of a third-party beneficiary to enforce a contract was supported by justice but not by contract principles.⁷⁰ It would be very surprising, however, if it were true that the two paradigmatic third-party beneficiary categories could not be explained by some general principle.

Furthermore, the rule of *Restatement First* that governed constructive donee beneficiaries—which as a residual rule was crucial to the enterprise—was seriously defective. By labeling all third-party beneficiaries who could enforce contracts (other than creditor beneficiaries) “donee beneficiaries,” *Restatement First* infected the treatment of residual cases by inviting an inquiry centered on whether a *gift* of a right was intended⁷¹—an unlikely finding in a context that by hypothesis does not involve true donative intent. The focus of the *Restatement First* residual rule solely on the promisee’s purpose, here reflecting the views of both Williston⁷² and Corbin,⁷³ was also inappropriate. In determining whether a third-party beneficiary should be allowed to enforce a contract, the objectives of both contracting parties, not merely the promisee, should be determinative. After all, the contract sought to be enforced is that of both parties, not merely of the promisee.⁷⁴

Last and most important, *Restatement First*’s residual rule provided no guidance concerning the critical question of how a court was to determine whether the relevant purpose was present. In the end, therefore, *Restatement First*’s crucial residual test was both wrongly focused and largely empty.⁷⁵

70. See *supra* note 37.

71. See, e.g., *King v. National Indus., Inc.*, 512 F.2d 29, 33 (6th Cir. 1975); *Isbrandtsen Co. v. Local 1291, Int’l Longshoremen’s Ass’n*, 204 F.2d 495, 497–98 (3d Cir. 1953); *McCall v. Towne Square, Inc.*, 503 S.W.2d 180, 184 (Tenn. 1973).

In *Isbrandtsen*, the time-charterer of a vessel, *Isbrandtsen*, had chartered the vessel to *Scott*. While the vessel was under charter to *Scott*, *Scott* hired *Lavino*, a stevedore, to unload the vessel. *Lavino* was a member of a stevedore’s association that had a contract with *Local 1291*. *Local 1291* delayed unloading the vessel in breach of that contract. *Isbrandtsen* sued the union as a third-party beneficiary of the contract. The court, in holding that *Isbrandtsen* could not enforce the contract, reasoned:

[W]e think that the whole setting of this fact situation . . . is one which completely negatives a gift transaction under any possible interpretation of that term. . . . We cannot think that *Lavino* was making a gift to *Scott* or that *Scott* was making a gift to *Isbrandtsen*. In other words, all the transactions were usual business transactions in which parties were agreeing to do things for and pay money to each other.

204 F.2d at 497–98. This was all perfectly true, and all perfectly irrelevant.

72. See Williston on Contracts Revised Edition, *supra* note 69, § 356A, at 330–31.

73. See 4 Corbin on Contracts, *supra* note 27, § 776, at 14–24.

74. See *American Fin. Corp. v. Computer Sciences Corp.*, 558 F. Supp. 1182, 1184–85 (D. Del. 1983); *Manor Junior College v. Kaller’s Inc.*, 507 A.2d 1245, 1246–48 (Pa. Super. Ct. 1986).

75. See David M. Summers, Note, *Third Party Beneficiaries and the Restatement (Second) of Contracts*, 67 *Coruelli L. Rev.* 880, 884 (1982).

B. *The Intent-to-Benefit Test*

For this or other reasons, although the courts have made wide use of the *Restatement First* terminology, they have tended to adopt a variation of the *Restatement First* residual test. The test in most common use has been whether the promisee—or, in some formulations, the parties to the contract—intended to benefit the third-party beneficiary.⁷⁶ This test is also defective.

The term “intent” is deeply ambiguous along at least three axes.

First, “intent” can refer either to the parties’ actual subjective intent or to an intent that is objectively manifested.⁷⁷

Second, “intent” can refer either to acting with a motive to achieve a given result, or to choosing a course of action with knowledge that a given result is likely to follow from the action, even if the actor is indifferent about achieving the result or indeed would prefer to avoid it. This point is exemplified in Illustration 1 to *Restatement (Second) of Torts Section 8A*:

A throws a bomb into B’s office for the purpose of killing B. A knows that C, B’s stenographer, is in the office. A has no desire to injure C, but knows that his act is substantially certain to do so. C is injured by the explosion. A is subject to liability to C for an intentional tort.⁷⁸

Third, “intent” can refer either to the end an actor seeks to achieve or to the means that an actor uses to achieve an end. For example, suppose that A, a country at war, stages a bombing raid on the civilian population of its enemy, B. The end that A seeks to achieve by the raid may be to kill B’s civilians (perhaps in retribution for the killing of A’s civilians) or to induce B’s surrender. Although in the first case killing civilians is intended as an end, and in the second it is intended as a means, in both cases it could be said that A intended to kill civilians.

Courts that use the intent-to-benefit test often fail to make clear what they mean by “intent” in the context of this test.⁷⁹ Certainly, the test could not be satisfied merely by knowledge that performance of the contract will benefit the third party. By definition, in every case involving a third-party beneficiary the third party will benefit from perform-

76. See, e.g., *Buchman Plumbing Co. v. Regents of the Univ. of Minn.*, 215 N.W.2d 479, 483 (Minn. 1974); *Snyder Plumbing & Heating Corp. v. Purcell*, 195 N.Y.S.2d 780, 783 (App. Div. 1960); *Vogel v. Reed Supply Co.*, 177 S.E.2d 273, 279 (N.C. 1970); Harry G. Prince, *Perfecting the Third Party Beneficiary Standing Rule Under Section 302 of the Restatement (Second) of Contracts*, 25 B.C. L. Rev. 919, 923 (1984); Note, *The Third Party Beneficiary Concept: A Proposal*, 57 Colum. L. Rev. 406, 408–09 (1957).

77. See 4 Corbin on Contracts, *supra* note 27, § 776, at 14–15, 18–20; 2 Samuel Williston, *A Treatise on the Law of Contracts* § 356A, at 835–42 (Walter H.E. Jaeger ed., 3d ed. 1959) [hereinafter *Williston on Contracts Third Edition*].

78. *Restatement (Second) of Torts* § 8A illus. 1 (1979).

79. See, e.g., *State v. Osborne*, 607 P.2d 369, 371 (Alaska 1980); *Little v. Union Trnst Co. of Maryland*, 412 A.2d 1251, 1253 (Md. 1980); cases cited *infra* note 129.

ance of the contract, and normally the contracting parties will know with substantial certainty that this benefit will result. Accordingly, if the intent-to-benefit test was satisfied merely by knowledge that performance would benefit the third party, every third-party beneficiary could enforce a contract. Many or most courts that use the test avoid this problem by effectively treating the issue as whether the contracting parties, or the promisee, had a subjective motive to confer a benefit on the third party as an end.

Indeed, unless the intent-to-benefit test has this meaning, it is largely empty. If the intent-to-benefit test is satisfied by objective intent, it provides no guidance on the issue the test, as so formulated, makes critical: How is it to be determined, as an objective matter, why in some contracts whose performance will benefit a third party, the benefit is objectively "intended" within the meaning of the test, while in other contracts whose performance will benefit a third party, the benefit is not so "intended"?

Perhaps to ameliorate these difficulties, some courts patch additional formal requirements onto the intent-to-benefit test. For example, some cases impose a requirement that an intent to benefit the third party be "clear," "express," or "definite,"⁸⁰ and some require that an intent to benefit the third party be found in the language of the contract itself, and cannot be established on the basis of surrounding circumstances.⁸¹ The former type of requirement is based on the erroneous assumption that contracting parties normally have a "clear," "express," or "definite" intent on benefiting the third party. Both types of requirement are inconsistent with modern principles of contract interpretation, which do not place a thumb on the interpretative scale and do allow courts to look to surrounding circumstances. And both types of requirement are difficult or impossible to apply meaningfully and consistently, and are not so applied in fact.⁸² The better-reasoned cases reject these formal requirements,⁸³ and so does *Restatement (Second) of*

80. See, e.g., *Security Mut. Casualty Co. v. Pacura*, 402 So. 2d 1266, 1267 (Fla. Dist. Ct. App. 1981) (clear); *Donalson v. Coca-Cola Co.*, 298 S.E.2d 25, 27 (Ga. Ct. App. 1982) (clear); *Khabbaz v. Swartz*, 319 N.W.2d 279, 285 (Iowa 1982) (express); *Snyder Plumbing*, 195 N.Y.S.2d at 783 (clear); *Keel v. Titan Constr. Corp.*, 639 P.2d 1228, 1231 (Okla. 1981) (express); *Kelly Health Care, Inc. v. Prudential Ins. Co. of Am.*, 309 S.E.2d 305, 307 (Va. 1983) (clear and definite); Prince, *supra* note 76, at 926.

81. See, e.g., *Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co.*, 542 F. Supp. 323, 329 (N.D. Ill. 1982).

Some cases that take this position make an exception that extrinsic circumstances can be utilized where the contract discloses that it was entered into for the benefit of a third-party beneficiary, but the beneficiary is not specifically identified. See *Hylte Bruks Aktiebolag v. Babcock & Wilcox Co.*, 399 F.2d 289, 292 (2d Cir. 1968); *American Fin. Corp. v. Computer Sciences Corp.*, 558 F. Supp. 1182, 1186 (D. Del. 1983).

82. See Prince, *supra* note 76, at 927-30.

83. See *E.B. Roberts Constr. Co. v. Concrete Contractors, Inc.*, 704 P.2d 859 (Colo. 1985); *J. Louis Crum Corp. v. Alfred Lindgren, Inc.*, 564 S.W.2d 544, 547 (Mo.

Contracts (Restatement Second).⁸⁴

Other courts patch an additional substantive test onto the intent-to-benefit test. Some authorities require the performance to be rendered directly to the beneficiary.⁸⁵ This requirement, however, has no rational connection with the intent-to-benefit test or, for that matter, with anything else. Not surprisingly, therefore, the direct-performance test is both over- and under-inclusive.

The direct-performance test is over-inclusive because there are many cases in which a contracted-for performance is to be rendered to a designated third person, but that person should not be given the right to enforce the contract. For example, suppose that A, a computer manufacturer, and B, a software producer, enter into a contract to stage a joint demonstration of their products at the San Francisco Hilton. A is to pay Hilton; B is to pay any other third parties whose services will be required.⁸⁶ Before any promise is made to Hilton, A breaks the contract with B. Here, Hilton is a third-party beneficiary, Hilton is named in the contract, and A is to render a performance (payment) directly to Hilton, but it seems clear that Hilton should not be able to enforce the contract. A *Restatement Second* illustration takes just this position on comparable facts: "B contracts with A to buy a new car manufactured by C. C [cannot bring suit under contract], even though the promise can only be performed if money is paid to C."⁸⁷

The direct-performance test is under-inclusive because it would exclude enforcement by third-party beneficiaries in certain cases in which enforcement should be and now commonly is permitted. For example, when an attorney has broken a contract with a client to draft a will in favor of a designated legatee, the attorney's performance is ren-

Ct. App. 1978); *Black & White Cabs of St. Louis, Inc. v. Smith*, 370 S.W.2d 669, 675 & (Mo. Ct. App. 1963); *Prince*, supra note 76, at 928-29.

84. See *Restatement Second*, supra note 4, § 302(1)(b).

85. See *Fidelity & Deposit Co. v. Rainer*, 125 So. 55, 58-59 (Ala. 1929); *Carson Pirie Scott & Co. v. Parrett*, 178 N.E. 498, 501-04 (Ill. 1931); Laurence P. Simpson, *Handbook of the Law of Contracts* § 117, at 246-48 (2d ed. 1965); Note, supra note 76, at 425-28.

86. This is a variant of a hypothetical posed in Gary T. Schwartz, *Economic Loss in American Tort Law: The Examples of *J'Air* and of Products Liability*, 23 *San Diego L. Rev.* 37, 42 (1986).

87. *Restatement Second*, supra note 4, § 302 illus. 17; see also *Dravo Corp. v. Robert B. Kerris, Inc.*, 655 F.2d 503, 510-11 (3d Cir. 1981) (holding that Dravo could not enforce a subcontract in which A agreed to construct a plant for X, A subcontracted to B the installation of ventilation systems, and the subcontract between A and B provided that B would use only Dravo ventilation units).

The direct-performance test would not necessarily be over-inclusive if it really did supplement the intent test and if the intent test could screen out those cases in which rendering direct performance was relevant from those cases in which it was not. However, because the reason for the direct-performance test is to answer the question how to determine intent—a question the intent test makes critical but leaves open—in fact the direct-performance test supplants rather than supplements the intent test.

dered to the client, but the would-be legatee should be and now generally is entitled to enforce the contract.⁸⁸

A variation of the direct-performance test is that there must be an intent to confer a "direct" benefit on the third-party beneficiary.⁸⁹ This requirement, however, is just as empty as the intent-to-benefit test itself and leads to the same kind of conclusory reasoning.

The failure of the formal and substantive add-ons to the intent-to-benefit test only serves to illustrate that this test, like the *Restatement First* residual test to which it is intimately related, is either unjustifiable or largely empty. If the test is construed to rest on a subjective motive to benefit the third party as an end, or to require that the contract clearly, expressly, or definitely state an intent to benefit the third party, the test unjustifiably departs from normal principles of contract interpretation. If, in contrast, the test is construed to rest on an objective intent to confer a benefit on the third party as an end, and the courts are allowed to find the requisite intent even if it is not clearly, definitely, or expressly stated in the contract, then the test provides no guideline for resolving the critical question how to determine objectively whether the contract was made with that end.

Finally, the entire enterprise of finding an intent to benefit the third party as an end is misguided. Except in some cases involving true donee beneficiaries, the intent of the contracting parties is typically to further their own interests, not the interests of a third party. Accordingly, the question whether there is an intent to benefit the third party as an end normally cannot generate a meaningful answer.

In sum, the intent-to-benefit test—and its variations, like the *Restatement First* test—is difficult or impossible to apply in a meaningful and consistent way,⁹⁰ and, without an elaboration that has so far been missing, is essentially an empty test that asks a non-question. As a result, the test is characteristically applied by the courts in a conclusory fashion, with no real analysis of the case at hand and, indeed, often without even an attempt at analysis.⁹¹

C. *The Restatement Second Test*

Restatement Second makes still another attempt to formulate a princi-

88. See *infra* part III.D.

89. See, e.g., *Holley v. St. Paul Fire & Marine Ins. Co.*, 396 So. 2d 75, 80 (Ala. 1981); *Reidy v. Macauley*, 290 S.E.2d 746, 747 (N.C. Ct. App. 1982); *Prince*, *supra* note 76, at 933–34, 990–91.

90. See *Prince*, *supra* note 76, at 923.

91. See, e.g., *Buchman Plumbing Co. v. Regents of the Univ. of Minn.*, 215 N.W.2d 479, 483–84 (Minn. 1974); *Vogel v. Reed Supply Co.*, 177 S.E.2d 273, 279 (N.C. 1970). See generally Note, *Third Party Beneficiaries and the Intention Standard: A Search for Rational Contract Decision-Making*, 54 Va. L. Rev. 1166, 1170–74 (1968) (intent-to-benefit test offers little guidance); Note, *supra* note 76, at 408–09 ("It is apparent that the imprecision of the intent to benefit approach prohibits clear analysis and predictability.").

ple to determine which third-party beneficiaries should be allowed to enforce a contract. Preliminarily, *Restatement Second* breaks with *Restatement First* by substituting, for the awkward nomenclature of *Restatement First*, a single term, "intended beneficiaries," to describe all third-party beneficiaries who are entitled to enforce contracts.

However, *Restatement Second* fails to follow up on the concept of a unified nomenclature by adopting a unified principle of enforceability; and the principles it does adopt are seriously flawed. These principles are set out in Section 302(1):

Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties *and* either

(a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or

(b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.⁹²

Basically, Section 302 is a conjunctive test that combines elements of the intent-to-benefit test articulated by the courts and the categorical tests of *Restatement First*. Under Section 302, to enforce a contract a third-party beneficiary must satisfy the requirements of the introductory clause and either Subsection 1(a) or 1(b). The introductory clause has the look and feel of an intent-to-benefit test (although it is susceptible to a better interpretation),⁹³ while Subsections (1)(a) and (b) are essentially counterparts of the *Restatement First* tests for creditor and donee beneficiaries.⁹⁴

It is not easy to determine exactly how the drafters of *Restatement Second* thought Section 302 would work, but whatever the thought, the text is relentless in its focus on intent. The introductory clause de-

92. *Restatement Second*, supra note 4, § 302(1) (emphasis added).

93. See *infra* text accompanying notes 106-109.

94. That *Restatement Second* § 302(1)(a) is essentially a variation of the creditor-beneficiary test of *Restatement First* is recognized in Comment *b*, which notes that "[t]he type of beneficiary covered by Subsection (1)(a) is often referred to as a creditor beneficiary." *Restatement Second*, supra note 4, § 302 cmt. b. That *Restatement Second* § 302(1)(b) is essentially a variation of the donee-beneficiary test of *Restatement First* is recognized by Comment *c*, which states: "Where the promised performance is not paid for by the recipient, discharges no right that he has against anyone, and is apparently designed to benefit him, the promise is often referred to as a 'gift promise.' The beneficiary of such a promise is often referred to as a 'donee beneficiary'; he is an intended beneficiary under Subsection (1)(b)." *Id.* § 302 cmt. c. As pointed out in Summers, Note, supra note 75, at 888 (citations omitted) (quoting *Restatement Second* §§ 302-15, Introductory Note, at 438-39 (1979)), "[t]he *Restatement Second* avoided the terms donee and creditor in its provisions because they 'carry overtones of obsolete doctrinal difficulties.' Nevertheless, in its method for determining when a beneficiary is intended, the *Restatement Second* tracks the language of the first *Restatement's* donee and creditor categories."

depends upon the intention of the parties; Subsection 1(b) turns on the intention of the promisee; and a third-party beneficiary who can enforce a contract is labeled an "intended beneficiary." *Restatement Second*, however, is even more restrictive than *Restatement First*, because under *Restatement Second* a third-party beneficiary cannot enforce a contract unless he satisfies not only one of the *Restatement First* tests but also the introductory clause of Section 302. In the end, therefore, the conjunctive test of Section 302(1) has most or all of the faults of both the intent-to-benefit and *Restatement First* tests.⁹⁵

In an apparent attempt to remedy the deficiencies of the black-letter text of Section 302, the Comment adds a new reasonability-of-reliance test:

d. Either a promise to pay the promisee's debt to a beneficiary or a gift promise involves a manifestation of intention by the promisee and promisor sufficient, in a contractual setting, to make reliance by the beneficiary both reasonable and probable. Other cases may be quite similar in this respect. Examples are a promise to perform a supposed or asserted duty of the promisee, a promise to discharge a lien on the promisee's property, or a promise to satisfy the duty of a third person. In such cases, if the beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him, he is an intended beneficiary.⁹⁶

Putting together Comment *d* and the black-letter rule yields a strangely disjointed result. If the critical test for determining whether a third-party beneficiary can enforce a contract is whether the beneficiary "would be reasonable in relying on the promise as manifesting an intention to confer a right upon him," that should be the black-letter test. In fact, however, the reasonability-of-reliance test of Comment *d* is not only absent from the black letter, but seems inconsistent with the black letter. While the black letter sets out complex conjunctive tests that center on the intention of the contracting parties, Comment *d* sets out a simple unified test that focuses on the perspective of the beneficiary.⁹⁷

Setting that tension aside, the reasonability-of-reliance test of Comment *d* is of little or no use in resolving critical questions. Presumably, Comment *d* does not require *actual* reliance. Such a requirement would overthrow much of third-party-beneficiary law: for example, neither Lawrence, the creditor beneficiary in *Lawrence v. Fox*, nor Marion, the donee beneficiary in *Seaver v. Ransome*, were required to establish reliance as a condition for bringing suit. Therefore, Comment *d* must propose an "as if" test—that is, under Comment *d*, in determining whether a third-party beneficiary can enforce a contract,

95. See *supra* text accompanying notes 68–91.

96. *Restatement Second*, *supra* note 4, § 302 cmt. d.

97. See Summers, *supra* note 94, at 894.

the courts should ask whether reliance would have been reasonable *if* it had occurred. But because Comment *d* provides no guidance for determining when reliance would be reasonable if it had occurred, all the Comment does is to shift from a largely empty intent test to a largely empty hypothetical-reliance test.

To put this differently, if we set aside the special issue of invited actual reliance, a hypothetical-reliance test makes no real contribution to determining which third-party beneficiaries should be allowed to enforce contracts, because whether a third party would be reasonable in relying on a contract depends on, rather than resolves, the ultimate question whether the third party should be allowed to enforce the contract.⁹⁸ A third party would be reasonable in relying on a contract if the contract is of a type that the third party should be allowed to enforce, and would not be reasonable in relying on a contract if the contract is not of a type that the third party should be allowed to enforce.⁹⁹

98. See Prince, *supra* note 76, at 987-88.

99. The issue of reliance by third parties is also addressed in the Restatement Second revision of § 90:

(1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee *or a third person* and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

Restatement Second, *supra* note 4, § 90 (emphasis added).

Unlike § 302, which concerns as-if reliance, § 90 concerns actual reliance. However, neither the black letter nor the Comments to Restatement Second §§ 90 and 302 articulate a relationship between the reliance tests of those two sections, and it is questionable whether the issue was thought through. In general, the same objections to using as-if reliance as a test under § 302 apply to allowing recovery on the basis of actual reliance under § 90; that is, whether actual reliance by a third party is reasonable generally should depend on the same elements that determine whether the contract was enforceable by the third party absent reliance. See *White v. Alaska Ins. Guar. Ass'n*, 592 P.2d 367, 369 (Alaska 1979) ("A third party cannot make himself a creditor beneficiary merely by acting in reliance upon a contract.").

The Comment to § 90 includes three Illustrations—5, 6, and 7—that concern third parties. In Illustration 6, a promisor conspires with a promisee to defraud a third party and the third party is effectively the legal successor of the promisee. The Illustration is unhelpful, because no special contract rules are required to deal with such a case. Illustration 7 concerns enforcement by the promisee rather than the third party, and is therefore also not helpful. In Illustration 5, the promisor makes a promise in writing that he knows will be shown to and relied upon by the third party, and makes the promise for the purpose of inducing that reliance. This may be a kind of case where reliance is an independent reason for enforceability by a third party, because the promise is effectively made to the third party as well as to the promisee. A comparable case is that in which the promisor has begun rendering performance to the beneficiary, particularly if the performance is of a kind that is likely to induce a reasonable expectation that it will be continued. See *C.R. Fedrick, Inc. v. Sterling-Salem Corp.*, 507 F.2d 319 (1974) (Merrill, J., concurring) (in California cases that have applied the principle of § 90 to third-party beneficiaries, the third party has been either an alter ego of the promisee or the recipient of substantially the same promise as was made by the promisor with knowledge that the promisee would pass the promise along to a third

D. *The Third-Party-Beneficiary Principle*

The *Restatement First* test, the intent-to-benefit test and its variations, and the *Restatement Second* tests are all inadequate and indeed largely meaningless. What principle, then, should determine whether a given third-party beneficiary should be permitted to enforce a contract?

To answer this question, recall the reason why not *every* third-party beneficiary should have power to enforce contracts: in some cases, such enforcement would conflict with the interests of the contracting parties.¹⁰⁰ The same reason points the way to the principle that should determine whether *any given* third-party beneficiary should have power to enforce a contract. This principle, which I will call *the third-party-beneficiary principle*, is as follows:

A third-party beneficiary should have power to enforce a contract if, but only if:

(I) allowing the beneficiary to enforce the contract is a necessary or important means of effectuating the contracting parties' performance objectives, as manifested in the contract read in the light of surrounding circumstances; or

(II) allowing the beneficiary to enforce the contract is supported by reasons of policy or morality independent of contract law and would not conflict with the contracting parties' performance objectives.

The term "the contracting parties' performance objectives" needs some exegesis. Normally, a third-party beneficiary will bring suit only if the promisor has breached. Obviously, it is not an objective of the promisor at that point to perform. Furthermore, in one sense it is never an objective of a promisor to perform, but only to obtain what is promised to her if she agrees to and does perform. Such a characterization of the promisor's objectives, however, would be too narrow, because the promisor can attain what she is promised only by joining in the enterprise that is embodied in the contract—an enterprise designed to fulfill various objectives, some shared, some dearer to the heart of the promisor, some dearer to the heart of the promisee. Accordingly, by the contracting parties' performance objectives I mean those objectives of the *enterprise* embodied in the contract, read in the light of surrounding circumstances, that the promisor either knew or should have known at the time the contract was made.

I will call the two elements of the third-party-beneficiary principle the first and second branches of that principle. The first branch of the principle reflects the concept that at its core contract law seeks to facili-

party); cf. *Beverly v. Macy*, 702 F.2d 931, 941-42 (11th Cir. 1983) (government agency's act of sending insurance-renewal notices to insured under agency's agreement with insurer gave rise to reasonable reliance by insured, which, taken with language of the contract, suggested that insured was a "direct" rather than an incidental beneficiary).

100. See *supra* text accompanying notes 66-67.

tate the power of self-governing parties to further their own interests by contracting. Under this branch, therefore, the purpose of allowing suit by a third party is not to ensure that the third party realizes a benefit, but to ensure that the contracting parties' performance objectives are effectuated. Unlike the intent-to-benefit test, which turns on whether the contracting parties had an *other-regarding* intent to benefit the third party, the first branch of the third-party-beneficiary principle turns on whether allowing the third party to enforce the contract will further the *self-regarding* interests of the contracting parties.¹⁰¹

To put this differently, under the first branch of the third-party-beneficiary principle, the law of third-party beneficiaries is largely conceived as *remedial*, rather than substantive. The question addressed by the first branch of the principle is not whether the contract creates a "right" in the third party, but whether empowering the third party to enforce the contract is a necessary or important means of effectuating the contracting parties' performance objectives.

Like other remedial problems, this question is seldom answered by the literal terms of the contract itself. In part, this is because it is costly to write contract terms, and it is likely to be more efficient to focus on terms that describe the performance the parties expect rather than on terms that describe the consequences that are to result if an expected performance is not rendered. Furthermore, although it is relatively easy for contracting parties to specify the performances they want, it is often extremely difficult to specify remedies in advance of knowing the nature of the breach and the circumstances of the world at the time of the breach.

Nevertheless, a court asked to determine a remedial problem would normally do well to ask what the parties would have provided if they had bargained under ideal conditions—that is, where foresight was perfect and negotiation and drafting were cost-free.¹⁰² The rules that the courts apply to fill in contracts should be both fair and efficient. Contracts negotiated under ideal conditions will be efficient, and enforcing the terms of such contracts will usually be regarded as fair. Thus, a remedial rule is fair and efficient if it corresponds to the terms that rational parties situated like the contracting parties would have reached when bargaining under ideal conditions. That determination, in turn, rests largely on whether the promisee will realize the objectives

101. See Robert P. Smith, Recent Case, 31 Tex. L. Rev. 210, 211 (1952).

102. See Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 97-100 (1989). Ayres and Gertner demonstrate that in some cases the choice of a default rule should be based on other grounds. In particular, the choice should sometimes be based on whether a given rule will induce one prospective contracting party to reveal certain kinds of information to another who is less informed. In general, however, the choice of basic remedial rules probably would not fall within such an exception, although some secondary remedial rules might be best selected in that way.

he bargained for if the suit is not allowed; whether the promisor's risk of liability will be extended if the suit is allowed; and, if that liability will be extended, whether the parties have implicitly bargained for that risk. To put the matter simply, the question is whether it is likely that the promisee would have made the contract on the price terms he accepted if the contract had explicitly stated that the third party would be allowed to bring suit, and whether the promisor would have made the contract on the price terms she accepted if the contract had explicitly stated that the third party would not be allowed to bring suit.

Unlike the first branch of the third-party-beneficiary principle, which focuses exclusively on effectuation of the contracting parties' performance objectives, the second branch of the principle reflects the concept that contract law properly may give effect to policy and moral concerns that are independent of the contracting parties' performance objectives. Policy and morality have traditionally entered into contract law in a variety of ways. For example, these elements help shape the rules of contract law on such issues as what kinds of promises the law should enforce, the extent to which the law should recognize limits (such as unconscionability) on the enforcement of bargain promises, and what remedies contract law should afford when enforceable promises are broken. Policy and morality also openly figure in the interpretation of contracts. *Restatement Second* Section 207 provides: "In choosing among the reasonable meanings of a promise or agreement or a term thereof, a meaning that serves the public interest is generally preferred."¹⁰³ Similarly, *Restatement Second* Section 204, Comment *d* states: "[W]here there is in fact no agreement [on a matter that falls within the ambit of a contract], the courts should supply a term that comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process."¹⁰⁴

If a given contract is enforceable as between the contracting parties, then by hypothesis neither the conduct of the contracting parties nor the contract they arrived at raises a problem of policy or morality. Given the primacy of the contracting parties' performance objectives, as manifested in their contract, enforcement by the third-party beneficiary should not be permitted if it would conflict with those objectives. If, however, there is no such conflict, and the interests of policy or morality would be served by allowing the third party to enforce the contract, the rules of contract law should be shaped to allow such enforcement, just as they are shaped by policy and morality in other cases. Indeed, the principle that enforcement by a third party should be allowed in such cases is even easier than the principle that policy and morality are relevant to determining such issues as the interpretation of a contract or the remedies to be afforded for breach. When policy and

103. *Restatement Second*, supra note 4, § 207.

104. *Id.* § 204 cmt. d.

morality figure in those areas, the results may conflict with the contracting parties' performance objectives. In contrast, under the second branch of the third-party-beneficiary principle enforcement is allowed only when there is no such conflict.

The third-party-beneficiary principle, while new in its articulation, has support in existing authority. To begin with, this principle explains the results of many or most of the modern cases better than its competitors.¹⁰⁵ Furthermore, the first branch of the principle can be thought of as a reconceptualization of the intent-to-benefit test, with the focus shifted from whether the promisor had a subjective intent to benefit the third party as an end, to whether allowing the third party to enforce the contract is necessary or important as a means to ensure effectuation of the contracting parties' performance objectives, as manifested in the contract read in the light of surrounding circumstances. The content of the term "intent" in such a reconceptualization would be heavily diluted, but the term is inherently ambiguous and can bear the meaning.

The first branch of the principle also draws support from the concept that apparently underlay the introductory clause of *Restatement Second* Section 302. This clause states that "a beneficiary of a promise is an intended beneficiary [and therefore can enforce the contract] if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties."¹⁰⁶ If Section 302 had stopped at that point, it could have been interpreted to have adopted a test comparable to the third-party-beneficiary principle. There is some evidence that the Reporter, Robert Braucher, thought Section 302 had done just that. On the floor, the Reporter stated that "[t]he basic spirit of the [Section] is that it is not the actual intent that counts. It is the manifested intent."¹⁰⁷ He added:

In these cases often the problem is one of whether the remedy is one which carries out the intention of the parties or whether the remedy sought is one which is likely to interrupt what the parties were trying to do. We all know that commonly the parties to a contract do not clearly foresee and provide for what happens in the event of a breakdown of the contractual relationship. Their natural focus is on performance, not upon breach.¹⁰⁸

Unfortunately, the drafters of Section 302 failed to see that if the introductory clause to that Section is satisfied—"if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties"¹⁰⁹—no additional test should be required. Instead, they added a conjunctive requirement under which the benefi-

105. See *infra* part III.

106. *Restatement Second*, *supra* note 4, § 302.

107. See 44 A.L.I. Proc. 307 (1967) (remarks of Reporter Braucher).

108. *Id.* at 308.

109. *Restatement Second*, *supra* note 4, § 302.

ary must also come within a counterpart of the *Restatement First* tests, and compounded matters by employing a rhetoric saturated with the terminology of intent. Nevertheless, Section 302 may be seen as at least a bridge between the traditional intent-to-benefit test and the third-party-beneficiary principle.

The second branch of the third-party-beneficiary principle finds even stronger support in *Restatement Second*—not, it is true, in the text of Section 302, but in Comment *d* to that Section:

[C]onsiderations of procedural convenience and other factors not strictly dependent on the manifested intention of the parties may affect the question whether . . . recognition of a right in the beneficiary is appropriate. In some cases an overriding policy, which may be embodied in a statute, requires recognition of such a right without regard to the intention of the parties.¹¹⁰

In short, the third-party-beneficiary principle, while new in its articulation, is not only justified by applicable social propositions, but is supported by existing doctrinal sources, including the results of the cases, the intent-to-benefit test read in an expansive manner, and the concepts underlying the formulations in *Restatement Second*.

III. SOME RECURRING THIRD-PARTY-BENEFICIARY CATEGORIES

Part III illustrates the third-party-beneficiary principle, develops its implications, and shows how it explains the results of many or most of the modern cases, by examining the application of the principle to some commonly recurring third-party-beneficiary problems. I begin with the two paradigmatic cases: donee beneficiaries (Section A) and creditor beneficiaries (Section B). I then consider cases in which the parties have explicitly provided that a third party should or should not be allowed to enforce the contract (Section C); suits by would-be legatees against attorneys who have failed properly to execute testamentary instructions (Section D); suits by subcontractors against sureties who have given bonds to owners (Section E); suits between prime contractors (Section F); suits by owners against subcontractors (Section G); and suits under government contracts (Section H).

A. Donee Beneficiaries

A third-party beneficiary is a *donee beneficiary* when a performance objective of the contracting parties, as manifested in the contract read in the light of surrounding circumstances, is to give effect to a donative intention of the promisee by obliging the promisor to render a performance that will benefit the third party. *Seaver v. Ransom*¹¹¹ is the

110. *Id.* § 302 cmt. d.

111. 120 N.E. 639 (N.Y. 1918). This case is discussed *supra* text accompanying notes 57–61.

paradigmatic case. An analysis of the facts of that case shows why a donee beneficiary should be permitted to enforce a contract under the first branch of the third-party-beneficiary principle.

Recall that a performance objective of the contracting parties in that case, Judge and Mrs. Beman, as manifested in the contract read in the light of surrounding circumstances, was that a gift be made to Mrs. Beman's niece Marion through the instrumentality of a contract that obliged Judge Beman to leave Marion a certain amount in his will. After Mrs. Beman's death, Judge Beman broke the contract.

On these facts, allowing Marion to enforce the contract was an important if not necessary means of effectuating that performance objective. If the contract could not be enforced by Marion, it could be enforced only by Mrs. Beman's estate. Mrs. Beman's estate, however, would have had no economic incentive to enforce the contract, because the estate would bear all the costs of enforcement while Marion would reap all the benefits. Furthermore, the estate's expectation damages would be zero, because performance of Judge Beman's promise would not have put Mrs. Beman's estate in a financially better position than would nonperformance.

Perhaps the estate could have sued Judge Beman's estate for unjust enrichment, but even if Mrs. Beman's estate prevailed on that theory, the suit would not effectuate the contracting parties' performance objectives because Mrs. Beman's estate, rather than Marion, would end up with the recovery, and in any event the amount by which Judge Beman was unjustly enriched (the value of a life estate in Mrs. Beman's house) might be less than the amount he had promised to confer on Marion (the value of the house itself). A suit by the estate for specific performance would solve these problems, but again the estate would have no economic incentive to bring such a suit, and in any event specific performance is always a problematic remedy because it rests so largely in the court's discretion, except in certain well-defined cases like contracts for the sale of land.

Finally, allowing Marion to enforce the contract would not enlarge the liability that Judge Beman must have expected to incur at the time the contract was made. Judge Beman's obligation under the contract was to confer upon Marion a certain amount of money. Allowing Marion to enforce the contract would not increase his liability beyond that amount.

This analysis of *Seaver* holds true for donee beneficiaries as a class. To begin with, many other donee-beneficiary cases involve promises that are likely to mature only after the promisee's death. The most common donee-beneficiary contract is the family life insurance policy, which is analytically identical to *Seaver v. Ransom* in that a performance objective of the contracting parties, as manifested in the contract, is to make a gift to the beneficiary through the instrumentality of the con-

tract, and the promisee will have died before the contract can be performed.

Of course, in some donee-beneficiary cases the promisee will not have died before the breach. The promisee herself may then have an altruistic interest in enforcing the contract. Even in such cases, however, at the time of breach the promisee will not have an economic incentive to enforce the contract. Furthermore, the problem of remedy remains. The promisee's expectation damages will often be zero; unjust enrichment might be less than the value of the promised performance; and specific performance is a problematic remedy. And, whether or not the promisee is still living, enforcement by the third-party beneficiary will not expand the promisor's obligation or liability beyond what he must have expected to incur at the time of contract formation.

Accordingly, donee-beneficiary cases as a class fall within the first branch of the third-party-beneficiary principle, because allowing donee beneficiaries to enforce contracts under which they will benefit is a necessary or important means of effectuating the performance objectives of the parties to such a contract.

B. *Creditor Beneficiaries*

A third-party beneficiary is a *creditor beneficiary* when the promisee owed the third party a legal obligation prior to the contract, and a performance objective of the contracting parties is to arrange for the discharge of that obligation by the promisor. *Lawrence v. Fox*¹¹² is the paradigmatic case. An analysis of the facts of that case shows why a creditor beneficiary should be permitted to enforce a contract under the first branch of the third-party-beneficiary principle.

Recall that Holly, the promisee in *Lawrence v. Fox*, owed a preexisting legal obligation to Lawrence, the third-party beneficiary. A performance objective of Holly and Fox, as manifested in the contract, was that Holly should be made economically (although not legally) free of his obligation to Lawrence through Fox's commitment to discharge the debt himself. Allowing Lawrence to enforce the contract against Fox was an important means of ensuring that this objective would be effectuated. Furthermore, allowing Lawrence to enforce the contract would not enlarge the liability that Fox must have expected to incur at the time the contract was made. Fox's obligation under the contract was to pay Lawrence \$300. If Lawrence is allowed to enforce the contract, Fox need only pay that amount. Indeed, Fox's liability would have been \$300 even if Lawrence could not enforce the contract, because if Fox breached the contract, Holly could sue Fox, and Holly's expectation damages would be \$300, the difference between his debts as they actually would have been on Fox's breach and his debts as they would have

112. 20 N.Y. 268 (1859). This case is discussed *supra* text accompanying notes 20-32.

been had Fox performed. This analysis holds true for creditor beneficiaries as a class.

Enforceability by creditor beneficiaries is also justified under the second branch of the third-party-beneficiary principle. Enforcement by creditor beneficiaries will not conflict with the contracting parties' performance objectives, for the reasons just examined. Enforcement is supported by an independent reason of policy, because it short-circuits multiple lawsuits. If the creditor beneficiary is not allowed to enforce the contract, two suits are required: one by the beneficiary against the promisee on the preexisting obligation, and one by the promisee against the promisor under the contract. If, however, the creditor beneficiary is allowed to enforce the contract, one suit will suffice.¹¹³

Permitting enforcement by creditor beneficiaries also helps prevent unjust enrichment. This characteristic is brought out by considering the question: Why doesn't the creditor beneficiary sue the promisee, who by hypothesis owes him a preexisting obligation, rather than taking the more problematic path of suing the promisor? Presumably, in most cases the reason is that the promisee is not easily subject to suit—because, for example, he is outside the jurisdiction or has become insolvent or incapacitated. If in such cases the creditor beneficiary cannot sue the promisor, the promisor would often be unjustly enriched by the amount of the consideration he has received from the promisee.

C. *Cases in Which the Parties Have Explicitly Provided that a Third-Party Beneficiary Should or Should Not Be Allowed to Enforce the Contract*

There is one class of cases that is even easier to resolve than the donee- and creditor-beneficiary cases—the class of cases in which the contracting parties explicitly provide that a third-party beneficiary should or should not be allowed to recover under or otherwise enforce the contract. Such cases are easy because they leave no doubt whether allowing the third party to enforce the contract is a necessary or important means of effectuating the contracting parties' performance objectives: the parties themselves have explicitly spoken to that issue. For example, an American Institute of Architects (AIA) form of a bond to be made between an owner on the one hand, and a principal contractor and a surety on the other, provides:

The . . . Principal and Surety hereby jointly and severally agree with the Owner that every [third-party] claimant as herein defined, who has not been paid in full before the expiration of a period of ninety (90) days after the date on which the last of such claimant's work or labor was done or performed, or materials were furnished by such claimant, may sue on this bond . . . , prosecute the suit to final judgment for such sum or

113. See *Matternes v. City of Winston-Salem*, 209 S.E.2d 481, 488 (N.C. 1974).

sums as may be justly due claimant, and have execution thereon.¹¹⁴

In contrast, an AIA form for contracts between owners and architects provides that “[n]othing contained in this Agreement shall create a contractual relationship with or a cause of action in favor of a third party against either the Owner or Architect.”¹¹⁵

Under the third-party-beneficiary principle, both types of provisions should be given effect—one type to allow enforcement by third parties and one type to deny such enforcement—because that result is required to effectuate the contracting parties’ explicit objectives.

D. *Would-Be Legatees*

Another relatively easy case involves a class of third parties that I will call would-be legatees. Assume that A wishes to confer a given benefit on T at the time of A’s death. B, an attorney, agrees with A to prepare a legal instrument—typically, a will—to accomplish A’s objective.¹¹⁶ Upon A’s death, it becomes clear for the first time that A’s will fails validly to confer the given benefit on T. T then sues B, the attorney, as a third-party beneficiary of the contract between B and A.

Under the first branch of the third-party-beneficiary principle, a

114. Am. Inst. Architects Doc. A311, Labor and Material Payment Bond art. 2 (1970).

The American Institute of Architects publishes two forms of payment bond: Am. Inst. Architects Doc. A311, quoted in the text, and Am. Inst. Architects Doc. A312, Payment Bond arts. 4, 11 (1984). The latter form is also fairly explicit, although not quite so much as the former.

See also *Frigidaire Sales Corp. v. Maguire Homes, Inc.*, 186 F. Supp. 767, 768–69 (D. Mass. 1959) (express provision in surety bond allows third party to overcome the then-Massachusetts rule that third parties cannot enforce contracts).

115. Am. Inst. Architects Doc. B141, Standard Form of Agreement Between Owner and Architect art. 9.7 (1987). See also Am. Inst. Architects Doc. A201, General Conditions of the Contract for Construction art. 1.1.2 (1987) (“The Contract Documents [between an owner and a contractor] shall not be construed to create a contractual relationship of any kind (1) between the Architect and Contractor, (2) between the Owner and a Subcontractor or Sub-subcontractor or (3) between any persons or entities other than the Owner and Contractor. The Architect shall, however, be entitled to performance and enforcement of obligations under the Contract intended to facilitate performance of the Architect’s duties”); *Honey v. George Hyman Constr. Co.*, 63 F.R.D. 443, 450 (D.D.C. 1974) (construction contract between contractor and subcontractor precludes third-party claim by owner against subcontractor); *Federal Mogul Corp. v. Universal Constr. Co.*, 376 So. 2d 716, 723–24 (Ala. Civ. App.) (same), cert. denied, 376 So. 2d 726 (Ala. 1979); *Lewis v. Globe Constr. Co.*, 630 P.2d 179, 185 (Kan. Ct. App. 1981) (road repair contract between city and contractor prohibits business owner on street from suing contractor as third-party beneficiary); *Hrushka v. Department of Pub. Works & Highways*, 381 A.2d 326, 327 (N.H. 1977) (contract between state and contractor excludes third-party claim brought by employee against state).

116. For ease of exposition, I will focus on would-be legatees, but the same analysis applies to other similarly situated persons, such as would-be beneficiaries under trusts that include benefits to take effect on the settlor’s death.

would-be legatee should be allowed to enforce the contract against the attorney. A performance objective of the contracting parties, testator and attorney, is to make whatever legal arrangements are required to ensure that on the testator's death a given benefit will be conferred on the would-be legatee. Allowing a would-be legatee to recover against the attorney is an important and indeed necessary means to effectuate that objective.¹¹⁷ The testator cannot sue the attorney, because the testator has died. The testator's estate cannot sue the attorney, because the estate has not been injured.¹¹⁸ Even if the estate could sue the attorney, its damages would be measured only by the testator's disappointed expectation, which would be almost impossible to measure, and in any event the recovery would end up in the hands of the estate rather than those of the would-be legatee.

Unlike the donee- and creditor-beneficiary cases, allowing a would-be legatee to enforce the contract between the testator and the attorney exposes the attorney to a liability that is different and inevitably much wider than the performance required under the contract, which is simply to draw up a will. However, this wider liability is generally comparable to the liability to which attorneys are routinely subject in nontestamentary cases, under the law of malpractice.¹¹⁹ Because an attorney's exposure to liability is greater if a would-be legatee can enforce the contract than if he cannot, the attorney's fee will presumably reflect a premium for that liability. However, testamentary clients are undoubtedly willing to pay that premium, just as non-testamentary clients are willing to pay a premium for attorney liability in all other cases.

The modern cases generally support the conclusion that a would-be legatee should be allowed to recover against an attorney who has failed properly to execute her client's testamentary objectives.¹²⁰

117. See *Guy v. Liederbach*, 459 A.2d 744, 751 (Pa. 1983); see also *Lucas v. Hamm*, 364 P.2d 685, 689 (Cal. 1961) (allowing legatee suit for damages when attorney was negligent in preparing will), cert. denied, 368 U.S. 987 (1962).

118. See *Heyer v. Flaig*, 449 P.2d 161, 165 (Cal. 1970); *Liederbach*, 459 A.2d at 749.

119. Cf. *Lucas*, 364 P.2d at 688 ("Although in some situations liability could be large and unpredictable in amount, this is also true of an attorney's liability to his client."). Indeed, in the absence of liability to a would-be legatee there would be a gap in the law governing the accountability of lawyers. "[U]nless the beneficiary could recover against the attorney in such a case, no one could do so and the social policy of preventing future harm would be frustrated." *Heyer*, 449 P.2d at 165; accord *Liederbach*, 459 A.2d at 753 (Nix, J., concurring) ("It would be unconscionable to permit admitted actionable conduct to be insulated by the fortuitous death of the person recognized in the law to have standing to prosecute such a claim, where the brunt of the injury from such conduct is born by a living party.").

120. See cases cited supra notes 117-119; see also *De Maris v. Asti*, 426 So. 2d 1153, 1154 (Fla. Dist. Ct. App. 1983) (an attorney is liable when, due to his negligence, a bequest to a legatee named in a will is diminished or lost; but because of concerns of evidentiary trustworthiness, an attorney is not liable to a would-be legatee who is not named in the will). But see *Maneri v. Amodeo*, 238 N.Y.S.2d 302, 304 (1963) (attorney not liable to third parties for simple negligence absent privity).

There is some conflict, however, concerning the proper theory on which the action should be based. Most of the modern cases allow a would-be legatee to rest on third-party-beneficiary theory,¹²¹ but many allow him to rest alternatively on negligence,¹²² some allow him to rest only on negligence,¹²³ and some allow him to rest only on contract.¹²⁴

This confusion is not surprising. Because the relationship between professionals and their clients is consensual, a suit against a negligent professional can often be conceptualized as sounding either in malpractice for nonperformance of an obligation to exercise care that is imposed by law, or in breach of contract for nonperformance of an obligation to exercise care to which the parties implicitly agreed.¹²⁵

Although the importance of allowing a would-be legatee to recover overshadows the theory of recovery, the contract theory is preferable to the tort theory, in part because it sharpens the nature of the attorney's obligation in the legatee case.¹²⁶ In contract cases, typically each contracting party obliges itself to achieve a given result. In contrast, in most malpractice cases the obligation of the professional is not to achieve a given result, but to employ an appropriate process. In the typical physician-patient case, for example, the physician's obligation is not to cure, but only to treat properly. Similarly, a litigator is typically not obliged to win her suit, or even to achieve a favorable settlement, but only to handle the suit properly. Because professionals normally do not explicitly or implicitly promise to do more than use an appropriate process, in most cases the professional's obligation could be treated under tort or contract law with essentially the same result.¹²⁷

Different considerations apply, however, when an attorney drafts a will. In such cases, a lay client is justified in forming the expectation that unless stated otherwise the attorney has committed herself to achieve a certain result—namely, that the client's stated objectives will be achieved. If there is doubt whether the client's stated objectives can be achieved—if, for example, the client's objectives are problematic under the Rule Against Perpetuities—the attorney is obliged to tell the

121. See, e.g., *Stowe v. Smith*, 441 A.2d 81, 83 (Conn. 1981); *Hale v. Groce*, 744 P.2d 1289, 1292 (Or. 1987); *Liederbach*, 459 A.2d at 753 (Nix, J., concurring).

122. See, e.g., *Lucas*, 364 P.2d at 688; *Garcia v. Borelli*, 180 Cal. Rptr. 768, 772 (Ct. App. 1982); *Bucquet v. Livingston*, 129 Cal. Rptr. 514, 518 (Ct. App. 1976); *Ogle v. Fuiten*, 445 N.E.2d 1344, 1348 (Ill. App. Ct. 1983).

123. See *Heyer*, 449 P.2d at 164.

124. See, e.g., *Liederbach*, 459 A.2d at 750 (lack of privity is a bar to a claim for negligence).

125. Cf. *id.* at 748 (client may sue attorney for malpractice under either trespass or assumpsit theory).

126. See also *infra* note 166 (suit by owner against subcontractor should be characterized as lying in contract rather than in negligence).

127. I put aside here peripheral rules, such as differences in the statutes of limitation for contract and tort or the availability of punitive damages, that are accidental in the sense that, as applied to the malpractice case, they turn on the form of the complaint rather than on the substance of the underlying transaction.

client of the doubt and lay out the risks and the options. If she fails to do so, and an unexplained risk matures, the attorney should be liable for breach of her implied promise to achieve the client's objectives. Courts that allow a would-be legatee to sue only in negligence may easily miss that point and focus instead on whether the attorney failed to use a required degree of skill.

E. Suits by Subcontractors Against the Sureties of Prime Contractors

This and the next two sections concern cases that arise in construction settings. The rich web of contracts that are often found in these settings gives rise to a variety of recurring third-party-beneficiary problems.

In the typical construction setting, a private or public entity—an owner—makes a contract with a prime contractor who agrees to perform specified construction. The prime contractor, in turn, contracts with various subcontractors, who agree to perform portions of the construction.¹²⁸ Because contractors are typically thinly capitalized, an owner often requires a prime to provide either a performance bond, under which a surety guarantees the owner that the prime contractor will perform its contract with the owner; a payment bond, under which a surety guarantees the owner that the claims of subcontractors will be paid; or both. In this Section, I consider the question whether an unpaid subcontractor can enforce a payment bond between a surety and an owner.

In the traditional analysis of this issue, the courts distinguished between surety bonds running to public owners and surety bonds running to private owners. Subcontractors were allowed to recover under payment bonds running to public owners, but not under payment bonds running to private owners.¹²⁹ The distinction rested on an application of the intent-to-benefit test to the assumed motivations of public and private owners in requiring the prime contractor's payment obligations to be bonded.¹³⁰

128. Persons who contract to supply materials used in construction—"materialmen"—normally have a legal status comparable to subcontractors (although this is not always so, see, e.g., *Florida ex rel. Westinghouse Elec. Supply Co. v. Wesley Constr. Co.*, 316 F. Supp. 490, 495 (S.D. Fla. 1970) (mem.), *aff'd mem.*, 453 F.2d 1366 (5th Cir. 1972); *James D. Shea Co. v. Perini Corp.*, 321 N.E.2d 831, 832 (Mass. App. Ct. 1975)). For ease of exposition, in this and the following sections I refer only to subcontractors.

129. See, e.g., *National Sur. Co. v. Brown-Graves Co.*, 7 F.2d 91, 92 (6th Cir. 1925); *Maryland Casualty Co. v. Johnson*, 15 F.2d 253, 254-55 (W.D. Mich. 1926); 1 *Williston on Contracts*, *supra* note 27, § 372, at 702-03. For a review of the older case law, see *Cretex Cos. v. Construction Leaders, Inc.*, 342 N.W.2d 135, 139-40 (Minn. 1984).

130. Professor Sweet has pointed out that the problem whether a subcontractor could sue on a bond in the owner's favor was also complicated by the use of a single bond called the Faithful Performance Bond. When a single bond covered both the

The analysis was as follows. A subcontractor usually has a right to file a lien on a private owner's property for the value of the work it has performed.¹³¹ As a result, if the prime contractor fails to pay a subcontractor, a private owner may be required either to pay the subcontractor itself or to bear the impact of a foreclosure under the lien. Accordingly, the courts reasoned, when a private owner requires a prime contractor to bond its payment obligation to subcontractors, the private owner's intent must be, not to benefit the subcontractors, but to benefit itself by ensuring that it will not suffer economic injury as a result of liens filed by unpaid subcontractors. Under the intent-to-benefit test, therefore, the subcontractors could not sue the surety in a private-construction case, because the owner did not intend to benefit them.¹³²

On the other hand, the lien laws typically do not extend to public construction. Therefore, a public owner will typically suffer no economic injury if subcontractors are not paid.¹³³ Accordingly, if a public owner requires a prime contractor to bond its payment obligation, the owner's intent must be to benefit not itself, but the subcontractors, and under the intent-to-benefit test the subcontractors could sue the surety in a public construction case.

In contrast to this traditional analysis, the modern tendency is to allow subcontractors to recover against the sureties of payment bonds in both private and public cases.¹³⁴ This approach is supported by the third-party-beneficiary principle. The traditional analysis of the

prime contractor's obligation to perform and his promise to pay subcontractors, "the interests of owner and unpaid subcontractors and suppliers could conflict if each had claims against the prime contractor and if the amount of the bond could not satisfy all claims." Justin Sweet, *Legal Aspects of Architecture, Engineering and the Construction Process* § 37.10, at 749 (4th ed. 1989).

131. See *id.* § 32.07(D), at 646-49; *id.* § 37.07, at 748.

132. See cases cited *supra* note 129.

133. See Sweet, *supra* note 130, § 37.07, at 748.

134. See, e.g., *Socony-Vacuum Oil Co. v. Continental Casualty Co.*, 219 F.2d 645, 649 (2d Cir. 1955); *Daniel-Morris Co. v. Glen Falls Indem. Co.*, 126 N.E.2d 750, 752-53 (N.Y. 1955) (materialman of subcontractor allowed to enforce subcontractor's payment bond to contractor); *Jacobs Assocs. v. Argonaut Ins. Co.*, 580 P.2d 529, 532 (Or. 1978) (subcontractor permitted to enforce performance-and-payment bond); Sweet, *supra* note 130, § 37.10(A), at 750. But see cases cited in Sweet, *supra* note 130, § 37.10(A), at 750 n.14 (citing cases in which a surety bond was written to exclude third-party claims of materialmen or in which courts required that bond expressly state that materialmen are obligees under bond).

A case that strikingly illustrates the transition between the older rule, prohibiting recovery under a payment bond in a private case, and the newer rule, permitting such recovery, is *Fidelity & Deposit Co. v. Rainer*, 125 So. 55 (Ala. 1929). There were two decisions in this case. The first decision, by a 4-3 vote, prohibited recovery by a subcontractor under a bond running to a private owner. See *id.* at 57. On rehearing, however, one of the judges who voted with the majority in the first decision switched sides, and the court held, again by a 4-3 vote, that the subcontractor could recover. See *id.* at 59.

owner's motivation was myopic, because under the intent-to-benefit test the courts looked for other-regarding rather than self-regarding objectives. Certainly, an owner securing a surety bond does so out of self-regarding reasons. However, it is easy to see why both public and private owners would have self-regarding objectives that would best be effectuated by allowing subcontractors to sue a surety on a payment bond.

Begin with public construction. A public owner may reasonably believe that the cost of construction will be lower if subcontractors are afforded assurance of payment. Subcontractors will make lower bids to prime contractors if they need not impound the risk of nonpayment into their costs, and if subcontractors' bids are lower, prime contractors' bids will also be lower.¹³⁵ It is true that the cost of a payment bond will be higher if subcontractors can enforce it,¹³⁶ and although the cost of the higher premium will be borne by the prime contractor in the first instance, that cost will be passed along to the owner when the prime contractor sets its total price. However, public owners may reasonably believe that the decrease in cost if subcontractors are assured of payment will exceed the increase in cost resulting from the surety's higher premium, because subcontractors would be likely to charge more than sureties for bearing the risk of a prime contractor's insolvency. Subcontractors are often both small and thinly capitalized, and therefore especially risk averse. Also, subcontractors are less able than sureties to determine the creditworthiness of prime contractors, and therefore are likely to include in their calculations an extra margin for ignorance.¹³⁷ Of course, public owners may reasonably believe the contrary; but the fact that a public owner has required a payment bond tells us that it has made a decision to adopt the performance objective of affording subcontractors assurance of payment. To effectuate this performance objective, subcontractors must be given a right to enforce the bond.

Essentially the same analysis applies to private construction. It is true that in the case of private construction, unpaid subcontractors often will not lose out completely, because they will be protected under the lien laws. Despite the lien laws, however, some risk will remain: the lien laws are not always easy to comply with; enforcing a lien can be complex and expensive; and the private owner's equity may be less than the total claims of lienholders. Even in the case of private construction,

135. See Sweet, *supra* note 130, § 37.07, at 748.

136. If subcontractors on a public bond remain unpaid, the public owner's loss, and therefore the surety's liability for the owner's damages, is likely to be zero. In contrast, the subcontractors' losses will be substantial. Therefore, if subcontractors can enforce the bond, the potential liability of the surety—and accordingly, its premium—will be higher than if the surety is liable only for the public owner's damages.

137. Alternatively, some subcontractors might simply refuse to contract if they were required to bear the risk of a contractor's nonpayment.

therefore, a subcontractor who is not afforded assurance of payment is likely to bid more than he otherwise would.

Professor Sweet has pointed out still another self-regarding motive that a private owner may have for affording subcontractors assurance of payment—an interest in the smooth administration of the construction process:

[Subcontractors] should be more willing to perform properly and deliver materials as quickly as possible when they have assurance they will be paid. Though they have a right to a mechanics' lien, the procedures for perfecting the lien and satisfying the unpaid obligation out of foreclosure proceeds are cumbersome and often ineffective. Payment bonds are preferable to mechanics' liens.¹³⁸

Finally, a private owner may also want to afford subcontractors assurance of payment to avoid the transaction costs involved when liens are filed.

In short, a private owner may reasonably believe that his costs will be lower if he affords assurance of payment to subcontractors. Allowing subcontractors to enforce a payment bond is a necessary means of effectuating that objective.

How do we know whether a given surety bond reflects that performance objective? Often, the bond tells us so. Recall that one form of the AIA Payment Bond explicitly states that subcontractors can sue the surety on the bond.¹³⁹ Even when a bond is not as explicit as the AIA Form, the very fact that a private owner has required a payment bond normally reveals that his objective is to afford subcontractors assurance of payment. If an owner only wants to protect himself against losses resulting from the nonpayment of subcontractors, he can do so by simply requiring the prime contractor to provide a performance bond. Performance bonds protect an owner against loss caused by the prime contractor's nonperformance, and therefore normally cover losses to the owner as a result of subcontractor liens.¹⁴⁰ Accordingly, if an owner requires a payment bond as well as a performance bond, the inference is compelling that the contracting parties' performance objectives include affording subcontractors assurance of payment.¹⁴¹

138. Sweet, *supra* note 130, § 37.07, at 748.

139. See *supra* text accompanying note 114.

140. See Am. Inst. Architects Doc. A101, Standard Form of Agreement Between Owner and Contractor art. 1 (1987) (contract documents include the General Conditions of the Contract); Am. Inst. Architects Doc. A201, General Conditions of the Contract for Construction art. 9.6.2 (1987) (contractor shall promptly pay each subcontractor upon receipt of payment by the owner).

141. See, e.g., *Socony-Vacuum Oil Co. v. Continental Casualty Co.*, 219 F.2d 645, 648 (2d Cir. 1955) (in suit by materialman of subcontractor under surety bond given by subcontractor to prime contractor, provision requiring reimbursement of loss that the prime contractor might sustain by reason of subcontractor's default was broad enough to protect prime contractor against claims of subcontractor's materialmen that were

Suppose an owner requires a performance bond, but not a payment bond, and an unpaid subcontractor sues the surety as a third-party beneficiary of the performance bond. A payment bond explicitly provides that subcontractors will be paid. A performance bond does not. Given the wide availability and frequent use of payment bonds, the decision of an owner to obtain only a performance bond reveals that the contracting parties' performance objectives do not include affording subcontractors assurance of payment, and subcontractors should not be allowed to enforce a performance bond.¹⁴²

F. *Multi-Prime Contracts*

Another, more difficult case that arises in the construction setting involves claims among prime contractors in a multi-prime contract. Most construction contracts involve a single general or prime contractor who contracts directly with the owner and is responsible for the coordination of all construction, and a number of specialized subcontractors who contract with the prime. In contrast, in multi-prime contracts an owner contracts directly with several general or prime contractors, or with specialized contractors who normally would contract only with a prime.

An owner may enter into a multi-prime contract for business reasons—for example, because the construction is divided into semi-independent segments, such as portions of a pipeline or highway, or because it is more efficient for the owner to take on the task of coordi-

timely prosecuted and actually caused loss to prime; provision calling for payment of material obligations therefore imported an intent to cover the payment of all claims by materialmen against subcontractor, whether or not timely prosecuted); *Fidelity & Deposit Co. v. Rainer*, 125 So. 55, 58 (Ala. 1929) (because claims for labor and material covered by the bond were not commensurate with indemnity to owner for cost and damage for contractor's failure to perform, payment provision of bond must have been intended for benefit of materialmen and laborers); *Jacobs Assocs. v. Argonaut Ins. Co.*, 580 P.2d 529, 531 (Or. 1978) (because contract provided a specific indemnity if work was not free of liens, and provided that owner would be indemnified against damage suffered as result of contractor's default, a provision promising to "[p]ay all persons . . . who perform labor or furnish equipment" created inference of a promise to pay laborers and materialmen).

142. See *Cretex Cos. v. Construction Leaders, Inc.*, 342 N.W.2d 135, 137-38 (Minn. 1984):

[The surety] points out that if the owner and general contractor had wished to protect third-party materialmen they could have purchased, for a separate premium, a "labor and material payment bond," a bond which [the surety] also sells and which is usually issued simultaneously with the performance bond. A "payment" bond expressly provides for the surety to pay the claims of third-party subcontractors and materialmen if the general contractor fails to do so. The distinction between performance bonds and payment bonds is well recognized in the construction industry; the two bonds cover different risks and premiums are set accordingly.

Accord Hewson Constr., Inc. v. Reintree Corp., 685 P.2d 1062, 1066 (Wash. 1984) (bond guaranteed only performance not payment).

nation than to pay a prime contractor for doing so. Often, however, multi-prime contracts are made because they are required by statute,¹⁴³ and indeed often one of the co-primes is made responsible for coordination.

Because the performances of prime contractors in a multi-prime contract tend to be closely interrelated, a delay or other breach by one prime will often lead to losses by others. Call a prime contractor who delays or otherwise breaches its contract with the owner Prime 1, and a prime contractor who is injured by the breach Prime 2. Can Prime 2 sue Prime 1 as a third-party beneficiary of the contract between Prime 1 and the owner? The general trend of the cases allows such suits,¹⁴⁴ and that result is supported by the third-party-beneficiary principle.

In some cases, Prime 1 explicitly promises the owner that it will pay the expenses of other primes resulting from its delays.¹⁴⁵ Breach of such a promise by Prime 1 is best remedied by allowing a suit by Prime 2. Often, the owner will suffer no damages from such a breach. For example, Prime 2 may manage to complete its performance on time, despite Prime 1's delay, by accelerating its efforts at an increased cost to compensate for the delay. The promise by Prime 1 would lose much of its effect if Prime 2 was not allowed to bring suit in such a case.

In other cases, each co-prime promises the owner that it will cooperate or coordinate with the other primes, but does not explicitly promise to pay the expenses that its co-primes incur as the result of its breach.¹⁴⁶ In such cases too, Prime 2 should be allowed to recover

143. See generally Sweet, *supra* note 130, § 21.04, at 379 (use of separate contracts was spurred, in part, by successful legislative efforts of trade associations). Such statutes are usually adopted at the instance of subcontractors, because subcontractors on public construction prefer to be in a direct contractual relation with the governmental entity, which typically presents little or no risk of insolvency, rather than with a prime contractor, which often presents a significant risk of insolvency.

144. In addition to the cases discussed and cited *infra* text accompanying notes 145-148, see *M.T. Reed Constr. Co. v. Virginia Metal Prods. Corp.*, 213 F.2d 337 (5th Cir. 1954); *Hanberry Corp. v. State Bldg. Comm'n*, 390 So. 2d 277, 278-81 (Miss. 1980); *J. Louis Crum Corp. v. Alfred Lindgren, Inc.*, 564 S.W.2d 544, 546-49 (Mo. Ct. App. 1978); *Moore Constr. Co. v. Clarksville Dep't of Elec.*, 707 S.W.2d 1, 10 (Tenn. Ct. App. 1985), *aff'd*, No. 85-29-I, 1986 WL 3631 (Tenn. Mar. 24, 1986). But see *J.F., Inc. v. S.M. Wilson & Co.*, 504 N.E.2d 1266, 1269-71 (Ill. App. Ct. 1987); *Buchman Plumbing Co. v. Regents of the Univ. of Minn.*, 215 N.W.2d 479, 483-85 (Minn. 1974).

145. For example, in *Broadway Maintenance Corp. v. Rutgers*, 447 A.2d 906 (N.J. 1982), each prime contractor had agreed that if it unnecessarily delayed the work of the other contractors, "the Contractor shall, in that case, pay all costs and expenses incurred by such parties due to any such delays." *Id.* at 910. (The contract went on to provide that the prime "hereby authorizes the Owner to deduct the amount of such costs and expenses from any monies due or to become due the Contractor under this Contract." *Id.* If that clause were read as the exclusive remedy, the co-primes could not recover against each other, but there was no reason to give the clause that reading.)

146. For example, in *Shea-S&M Ball v. Massman-Kiewit-Early*, 606 F.2d 1245 (D.C. Cir. 1979), a contract between the Washington Metropolitan Area Transit Authority and its primes stated:

against Prime 1. Because breach of a promise to cooperate or coordinate may also cause damage to the co-primes even though it does not cause damage to the owner, unless Prime 2 is allowed to sue Prime 1 the objective of the cooperate-and-coordinate provision may not be fully effectuated.

If Prime 1 will be liable to Prime 2 for breach of its contract with the owner, Prime 1 will presumably include in its price to the owner a premium that reflects this extra exposure to liability. Why would a self-regarding owner pay that premium, when liability by one co-prime to another seems to benefit the co-primes rather than the owner? The answer is comparable to that found in the analysis of surety bonds. Although a prime will include in its bid a premium for becoming exposed to liability to its co-primes, in the absence of such liability a prime will include in its bid a premium for bearing the risk of uncompensated breaches by its co-primes. An owner may reasonably believe that the premium that a prime will charge for bearing the risk of loss resulting from breach by its co-primes is likely to exceed the premium that a prime will charge for bearing the risk of liability to its co-primes, because a prime's own performance is largely within its control, while the performance of its co-primes is not. Furthermore, some breaches by a co-prime may subject the owner to liability for breach of an implied duty to coordinate and supervise the co-primes' activities.¹⁴⁷ An owner may therefore have the objective of making co-primes liable to each other for their breaches to afford an injured co-prime a more direct target than the owner himself. Indeed, if an owner owes its co-primes a duty to coordinate, and Prime 1 promises the owner that it will coordinate with its co-primes, Prime 2 could simply be treated as a creditor beneficiary of that promise.¹⁴⁸

G. Suits by Owners Against Subcontractors

Another recurring question in the construction setting is whether an owner can sue a subcontractor that has breached its contract with the prime. The results in these cases are mixed. Many cases have refused to permit an owner to bring suit against a subcontractor.¹⁴⁹

The Authority may undertake or award other contracts for additional work, and the Contractor shall fully cooperate with such other contractors and Authority employees and carefully fit his own work to such additional work as may be directed by the Contracting Officer. The Contractor shall not commit or permit any act which will interfere with the performance of work by any other contractor or by Authority employees.

Id. at 1250. The court allowed suit by one co-prime against another.

147. See *Shea-S&M Ball*, 606 F.2d at 1251; *Hoffman v. United States*, 340 F.2d 645, 650 (Cl. Ct. 1964); *Broadway*, 447 A.2d at 912.

148. See *COAC, Inc. v. Kennedy Eng'rs*, 136 Cal. Rptr. 890, 893 (Ct. App. 1977); *Visintine & Co. v. New York, Chi. & St. L. R.R.*, 160 N.E.2d 311, 313-14 (Ohio 1959).

149. See, e.g., *Pierce Assocs., Inc. v. Nemours Found.*, 865 F.2d 530, 535-39 (3d Cir.), cert. denied, 492 U.S. 907 (1989); *Vogel v. Reed Supply Co.*, 177 S.E.2d 273,

Other cases have permitted such a suit,¹⁵⁰ indicated that an owner's right to bring suit depended on the facts of the particular case,¹⁵¹ or held that the owner could recover on some theory other than third-party-beneficiary law, such as negligence¹⁵² or subrogation to the rights of the prime contractor.¹⁵³

These mixed results reflect the underlying difficulties presented by the issue. It might be argued that an owner is a creditor beneficiary of the contract between the prime contractor and the subcontractor, on the theory that the subcontractor has agreed to perform an obligation that the prime contractor owes to the owner.¹⁵⁴ Although the question is certainly not free from doubt, the better view seems to be that taken by Corbin:

[C]ontracts between a principal building contractor and subcontractors . . . are made to enable the principal contractor to perform; and their performance by the subcontractor does not in itself discharge the principal contractor's duty to the owner with whom he has contracted. The installation of plumbing fixtures or the construction of cement floors by a subcontractor is not a discharge of the principal contractor's

277-79 (N.C. 1970); *Manor Junior College v. Kaller's Inc.*, 507 A.2d 1245, 1246-48 (Pa. Super. Ct. 1986); 4 Corbin on Contracts, *supra* note 27, § 779D, at 43-50.

150. See *Syndoulos Lutheran Church v. A.R.C. Indus.*, 662 P.2d 109, 113-14 (Alaska 1983); *Oliver B. Cannon & Son, Inc. v. Dorr-Oliver, Inc.*, 336 A.2d 211, 215-16 (Del. 1975); *People ex rel. Resnik v. Curtis & Davis, Architects & Planners, Inc.*, 400 N.E.2d 918, 919-20 (Ill. 1980).

151. See *Chestnut Hill Dev. Corp. v. Otis Elevator Co.*, 653 F. Supp. 927, 930-31 (D. Mass. 1987).

152. See, e.g., *Federal Mogul Corp. v. Universal Constr. Co.*, 376 So. 2d 716, 724 (Ala. Civ. App. 1979); *Driscoll v. Columbia Realty-Woodland Park Co.*, 590 P.2d 73, 74 (Colo. Ct. App. 1978); *Juliano v. Gaston*, 455 A.2d 523, 525 (N.J. Super. Ct. App. Div. 1982), cert. denied, 460 A.2d 709 (N.J. 1983). But see *Pierce*, 865 F.2d at 539-41; *Crowell Corp. v. Topkis Constr. Co.*, 280 A.2d 730, 732 (Del. Super. Ct. 1971); *North Carolina State Ports Auth. v. Lloyd A. Fry Roofing Co.*, 240 S.E.2d 345, 353 (N.C. 1978); *B&C Constr. Co. v. Grain Handling Corp.*, 521 S.W.2d 98, 102 (Tex. Ct. App. 1975).

153. See *National Cash Register Co. v. Unarco Indus., Inc.*, 490 F.2d 285, 286-87 (7th Cir. 1974).

154. For example, in *Gilbert Fin. Corp. v. Steelform Contracting Co.*, 145 Cal. Rptr. 448 (Ct. App. 1971), the court said:

[T]he general contractor, Appel had the duty under its contract with Gilbert [the owner] to furnish all the material and labor necessary to construct the building in question. Steelform [the subcontractor] subcontracted with Appel [the general contractor] to furnish the materials and labor necessary for the construction of the roof. Clearly, Steelform (the promissor) realized it was assuming Appel's (the promisee) duties for this phase of the construction, and that Gilbert was the ultimate beneficiary of its performance as the owner of the building. . . . Gilbert would obviously be a creditor beneficiary.

Id. at 451; accord *Sears, Roebuck & Co. v. Jardel Co.*, 421 F.2d 1048, 1054 (3d Cir. 1970) (owner was a creditor beneficiary of subcontractor); *United States v. Ogden Technology Lab., Inc.*, 406 F. Supp. 1090, 1092-93 (E.D.N.Y. 1973) (subcontractor assumed duties of contractor).

duty to the owner to deliver a finished building containing those items The owner is . . . [therefore not] a creditor beneficiary¹⁵⁵

Other courts have tried to solve the owner-subcontractor problem by applying the intent-to-benefit test. Given the unsatisfactory nature of that test, this approach has led to inconsistent results. So, for example, in *Kaiser Aluminum & Chemical Corp. v. Ingersoll-Rand Co.*¹⁵⁶ and *Lake Placid Club Attached Lodges v. Elizabethtown Builders, Inc.*,¹⁵⁷ it was held that the owner was not an intended beneficiary of the contract between the prime contractor and the subcontractor, while in *Syndoulos Lutheran Church v. A.R.C. Industries, Inc.*,¹⁵⁸ it was held that the owner was "obviously" an intended beneficiary. Most of the cases do not go beyond a summary conclusion that the owner is or is not an intended beneficiary. Those that do go further purport to divine the requisite "intent" by sorting through such tea leaves as references to the owner in the contract between the prime contractor and the subcontractor or in other communications between them.¹⁵⁹ Since the object of the enterprise in all construction cases is to construct a project for the owner, references to the owner in contracts or other communications between the prime contractor and the subcontractor are not terribly illuminating. The bottom line is that the intent-to-benefit test has left the law in this area unsettled, and the analysis in the cases is most charitably described as picturesque.

What result is indicated under the third-party-beneficiary principle? Allowing the owner to sue a solvent subcontractor would ordinarily not be a necessary or important means of effectuating the performance objectives of the contracting parties (that is, the prime contractor and the subcontractor). A breach by a subcontractor will typically result in an injury to the prime contractor, because the prime contractor must either remedy the breach itself or pay damages to the owner. Accordingly, the prime contractor can normally sue the subcontractor for breach, and will have every incentive to do so. Indeed, in the normal case, allowing the owner to sue the subcontractor may tend to conflict with the prime contractor's administration of its contracts with subcontractors.

However, when the defect in the subcontractor's work is discovered only after the owner has paid the full contract price and the prime contractor has become insolvent, the second branch of the principle is

155. 4 Corbin on Contracts, *supra* note 27, § 779D, at 46-47; see also *North Carolina State Ports Auth.*, 240 S.E.2d at 354 (quoting Corbin, and concluding that owner was an incidental beneficiary).

156. 519 F. Supp. 60, 72-73 (S.D. Ga. 1981).

157. 521 N.Y.S.2d 165, 166 (App. Div. 1987).

158. 662 P.2d 109, 114 (Alaska 1983).

159. See, e.g., *Chestnut Hill Dev. Corp. v. Otis Elevator Co.*, 653 F. Supp. 927, 930 (D. Mass. 1987).

applicable. As a matter of corrective justice, as between the owner and the subcontractor, the cost of repairing the defective performance should be placed on the subcontractor.¹⁶⁰ Were it not for the adventitious insolvency of the prime contractor, that is exactly where the cost would have been placed, because the owner would have sued the prime contractor, the prime contractor would have sued the subcontractor, and the owner would have been made whole at the subcontractor's ultimate expense. In contrast, if the prime contractor has become insolvent, the owner's claim against the prime contractor can only be brought against the prime contractor's bankruptcy estate, and the prime contractor's claim against the subcontractor can only be brought by the bankruptcy trustee.¹⁶¹ However, the owner normally will have little or no incentive to sue the estate, because the return in a suit against a bankruptcy estate typically constitutes only a fraction of the debt. The owner also normally will have little or no incentive to persuade the bankruptcy trustee to bring suit, because the proceeds of the suit would benefit the general estate, not merely the owner. The trustee, in turn, need not pursue an action that is either "burdensome" or "inconsequential."¹⁶² Indeed, the trustee might have no damages as a basis for a suit against the subcontractor unless the owner sues the estate.

The net result is that by virtue of the adventitious insolvency of the prime contractor, the owner rather than the subcontractor is likely to end up shouldering the damages caused by the subcontractor, unless the owner is allowed to sue the subcontractor. The owner should therefore be allowed to sue the subcontractor in this kind of case under the second branch of the third-party-beneficiary principle, to work corrective justice. Allowing such a suit would not impair the performance objectives of the contracting parties. Because the construction process will have been completed, a suit by the owner against the subcontractor will not interfere with the normal administration of the construction process. If the subcontract contains special provisions limiting the subcontractor's damages, such as liquidated-damage clauses¹⁶³ or limitations on consequential damages,¹⁶⁴ those provisions should be taken into account in the owner's suit on the theory that if the owner wants to sue under the subcontract, he must accept its limitations.¹⁶⁵ If provisions in the contract between the owner and the prime contractor limit the owner's rights, they too can be taken into account. Corrective jus-

160. See William K. Jones, *Economic Losses Caused by Construction Deficiencies*, 59 U. Cin. L. Rev. 1051, 1085-86 (1991).

161. See 11 U.S.C. § 541(a)(1) (1988).

162. 11 U.S.C. § 554(a) (1988).

163. See, e.g., *Midwest Concrete Prods. Co. v. La Salle Nat'l Bank*, 418 N.E.2d 988, 990 (Ill. App. Ct. 1981).

164. See, e.g., *Chestnut Hill Dev. Corp. v. Otis Elevator Co.*, 653 F. Supp. 927, 931 (D. Mass. 1987).

165. See *id.*; *infra* part IV.A.

tice does not require that the owner be made better off than he would have been if the prime contractor had not become insolvent and the owner's only recourse had been a suit against the prime.¹⁶⁶

H. *Government Contracts*

Many third-party-beneficiary cases involve suits brought by members of the public to enforce government contracts.¹⁶⁷ Usually in these cases the third-party beneficiary seeks to enforce a promise made by a government entity to another person.¹⁶⁸ The courts have tended to give suits by third-party beneficiaries under government contracts special or "categorical" treatment.¹⁶⁹ This tendency is reflected in *Restatement Second* Section 313(2):

(2) . . . [A] promisor who contracts with a government or governmental agency to do an act for or render a service to the public is not subject to contractual liability to a member of the public for consequential damages resulting from performance or failure to perform unless

(a) the terms of the promise provide for such liability; or

(b) the promisee is subject to liability to the member of the public for the damages and a direct action against the promisor is consistent with the terms of the contract and with the policy of the law authorizing the contract and

166. Many of those cases that do permit an owner to sue a subcontractor are based not on third-party-beneficiary theory, but on the theory that the subcontractor is liable to the owner for negligence. See *supra* note 152 and accompanying text. However, if the only wrong that a subcontractor commits is a failure properly to perform its contract, and the only loss that an owner suffers as a result of that wrong is economic, the term "negligence" is typically no more than a characterization of a simple breach of contract. Suit against the subcontractor in such cases should be governed by contract law, not tort law, because allowing the owner to sue the subcontractor in negligence could permit frustration of the contracting parties' performance objectives. For example, allowing suit in negligence could easily lead to circumvention of contractual provisions that limit either the subcontractor's liability or the owner's recovery. Different principles may apply if the suit concerns injury to the person, or perhaps even physical injury to property, because the law may properly provide more extensive protection to those interests than to pure economic loss.

167. There are exceptions, some of which involve contracts in which both the promisor and the promisee are governmental entities. See, e.g., *Harrison v. Housing Auth.*, 445 F. Supp. 356, 358-59 (N.D. Ga. 1978), *aff'd*, 592 F.2d 281 (5th Cir. 1979); *Harris v. Board of Water & Sewer Comm'rs*, 320 So. 2d 624, 626-28 (Ala. 1975); *New Hampshire Ins. Co. v. City of Madera*, 192 Cal. Rptr. 548, 550, 555 (Ct. App. 1983); *Matternes v. City of Winston-Salem*, 209 S.E.2d 481, 482 (N.C. 1974); *Gonzalez v. City of Mission*, 620 S.W.2d 918, 919, 922 (Tex. Ct. App. 1981).

168. See *Prince*, *supra* note 76, at 950-51.

169. For present purposes, I use the term "government contracts" to mean contracts between a government entity and some other person in which part or all of the other person's performance will be rendered to members of the public. In practice, however, probably most contracts entered into by government entities are procurement contracts, which seldom if ever raise significant third-party-beneficiary problems.

prescribing remedies for its breach.¹⁷⁰

There is no more reason to apply a categorical rule to government contracts than to any other contracts. Government contracts can and should be analyzed under the general third-party-beneficiary principle. Government contracts, however, often present particularly difficult third-party-beneficiary problems, because two elements that are potentially present in any third-party-beneficiary case are often highly salient in the case of government contracts and often cut in opposite directions.

The first element concerns the extent of the private actor's liability. Because government contracts often benefit a large number of persons, if third-party beneficiaries can enforce such contracts against the private actor, the result may be the imposition of liability well out of proportion to the benefits the private actor stood to receive under the contract. The paradigm case is *H.R. Moch Co. v. Rensselaer Water Co.*¹⁷¹ A waterworks company had made a contract with the City of Rensselaer to supply water for public buildings, sewer flushing, street sprinkling, and fire hydrants. The hydrant service was to be furnished at the rate of \$42.50 a year for each hydrant. While this contract was in force, a fire broke out. The supply of water to fire hydrants did not comply with the contract, and as a result a warehouse owned by the plaintiff was destroyed. The New York court, in an opinion by Judge Cardozo, held

170. Restatement Second, *supra* note 4, § 313(2). Section 313 is not a model of clarity. Section 313(1) states: "The rules stated in this Chapter [on third-party beneficiaries] apply to contracts with a government or governmental agency . . ." *Id.* § 313(1). This section suggests that the general principles of third-party-beneficiary law—which would include the general tests of enforceability set out in § 302—should apply to government contracts. Section 313(2) then begins with the phrase "[i]n particular," (omitted from the quotation in the text) which suggests that § 313(2) is only an instantiation of § 313(1). *Id.* § 313(2). That suggestion is reinforced by the Comment:

Beneficiaries of government contracts have often been denied rights because of . . . doctrinal difficulties . . . Subsection (1) reflects the disappearance of those difficulties, but leaves room for the weighing of considerations peculiar to particular situations. Subsection (2) applies to a particular class of contracts the classification of beneficiaries in § 302.

Id. § 313 cmt. a.

In fact, however, § 313(2) departs radically from both § 313(1) and § 302. Rather than simply instantiate the general principle of those provisions, § 313(2) (like its predecessor Restatement First § 145) essentially creates a strong categorical presumption against enforcement of government contracts by third-party beneficiaries. This presumption is made clear by the text of § 313(2), which is couched in largely negative terms, see *id.* § 313(2); by the Reporter's Note to § 313, which states that § 313(2) is a counterpart of Restatement First § 145, see *id.* § 313 (Reporter's Note); and by another passage in the Comment: "Government contracts often benefit the public, but individual members of the public are treated as incidental beneficiaries unless a different intention is manifested." *Id.* § 313 cmt. a.

171. 159 N.E. 896 (N.Y. 1928).

that the plaintiff could not recover against the water company as a third-party beneficiary.

The result in *H.R. Moch* (and cases like it) might be rationalized on a policy, external to contract law, "to promote the performance of essential governmental functions by municipalities by insulating parties to municipal contracts from liability for potentially catastrophic losses."¹⁷² Alternatively, the result in *H.R. Moch* might be rationalized under the third-party-beneficiary principle, on the ground that if the contracting parties had addressed the issue of liability to the public, the water company might have refused to supply water for hydrants, limited its hydrant liability, or charged higher hydrant rates. Correspondingly, the hydrant price that the water company actually charged might have been based on the assumption of nonliability to the public.¹⁷³ Because most property owners are protected by insurance against losses caused by fire, the city, for its part, might have preferred lower hydrant rates, with no water-company liability, to higher rates, with liability. In short, it is at least arguable that the imposition of liability to members of the public in *H.R. Moch* would have conflicted with the contracting parties' performance objectives.¹⁷⁴

The second element that is especially salient in government con-

172. *Town of Ogden v. Earl R. Howarth & Sons, Inc.*, 294 N.Y.S.2d 430, 432 (Sup. Ct. 1968).

173. This was essentially the rationale adopted by Cardozo:

An intention to assume an obligation of indefinite extension to every member of the public is seen to be the more improbable when we recall the crushing burden that the obligation would impose. The consequences invited would bear no reasonable proportion to those attached by law to defaults not greatly different. . . . If the plaintiff is to prevail, one who negligently omits to supply sufficient pressure to extinguish a fire started by another assumes an obligation to pay the ensuing damage, though the whole city is laid low. A promisor will not be deemed to have had in mind the assumption of a risk so overwhelming for any trivial reward.

H.R. Moch, 159 N.E. at 897-98 (citations omitted).

174. The issue in the public-utility case is close, and the courts are divided, although *H.R. Moch* probably represents the general rule. Compare *Cole v. Arizona Edison Co.*, 86 P.2d 946 (Ariz. 1939) (no liability); *New Hampshire Ins. Co. v. Madera*, 192 Cal. Rptr. 548 (Ct. App. 1983) (same); *Earl E. Roher Transfer & Storage Co. v. Hutchinson Water Co.*, 322 P.2d 810 (Kan. 1958) (same) with *Harris v. Board of Water & Sewer Comm'rs*, 320 So. 2d 624 (Ala. 1975) (liability); *Koch v. Consolidated Edison Co.*, 468 N.E.2d 1 (N.Y. 1984) (same), cert. denied, 469 U.S. 1210 (1985); *Potter v. Carolina Water Co.*, 116 S.E.2d 374 (N.C. 1960) (same).

Restatement Second endorses the result in *H.R. Moch*. See Restatement Second, supra note 4, § 313 illus. 2. Some courts adopt the *H.R. Moch* rule in principle, but depart from it in practice by a readiness to distinguish the rule:

Even at a time contemporaneous with its decision . . . the rationale upon which the *Moch* opinion turned was subjected to severe criticism. . . . Although *Moch* continues to be recognized as the majority rule, it is only grudgingly followed. . . . In fact with regard to third party beneficiary contractual rights the *Moch* rule is increasingly being strictly limited to its facts and subjected to exceptions. Thus, if a plaintiff can show a *special* benefit to himself individually

tracts is that such contracts are often executed pursuant to statutes that embody a clear public policy in favor of a defined class of which the third parties are members.¹⁷⁵ This element tends to cut in favor of enforcement of government contracts by third-party beneficiaries under the second branch of the third-party-beneficiary principle—that a third party should be allowed to enforce a contract where enforcement is supported by an independent reason of policy or morality and would not conflict with the contracting parties' performance objectives.¹⁷⁶

Given the opposed elements of extended liability and public policy, the issue whether third-party beneficiaries should be allowed to enforce government contracts for the benefit of the public cannot be properly addressed by a special categorical rule. On the contrary, whether any given government contract should be enforceable by third-party beneficiaries depends on an individualized, highly fact-sensitive application of the third-party-beneficiary principle to the case at hand. This is illustrated by two California cases involving contracts between private actors and the federal government.

*Zigas v. Superior Court*¹⁷⁷ concerned a contract executed pursuant to the National Housing Act. That Act embodied a policy to "facilitate . . . the production of rental accommodations . . . at reasonable rents."'¹⁷⁸ In furtherance of this policy, the Act authorized HUD to take action that would direct the benefits of mortgage insurance under the Act primarily to those projects in which every effort had been made to achieve moderate rental charges.¹⁷⁹ Pursuant to the Act, HUD entered into a contract with Developer. Under the contract, HUD insured Developer's mortgage on an apartment building that Developer proposed to construct, and Developer agreed not to charge rents above an

in contrast to any benefit he enjoys as a member of the public generally, he may be able to bring an action as a third party beneficiary.

Town of Ogden, 294 N.Y.S.2d at 432-33 (citations omitted).

In *Doyle v. South Pittsburgh Water Co.*, 199 A.2d 875 (Pa. 1964), the court held on facts comparable to *H.R. Moch* that the plaintiffs had a valid complaint for negligence.

175. See, e.g., *Holbrook v. Pitt*, 643 F.2d 1261 (7th Cir. 1981) (contracts entered into by HUD to make rental payments on behalf of low-income tenants pursuant to Section 8 of the United States Housing Act); *Zigas v. Superior Court*, 174 Cal. Rptr. 806 (Ct. App. 1981) (contract between builders of apartment house and HUD requiring builders not to raise rents without HUD's permission, pursuant to the National Housing Act), cert. denied, 455 U.S. 943 (1982); *Shell v. Schmidt*, 272 P.2d 82 (Cal. Dist. Ct. App. 1954) (contracts between Federal Housing Authority and builder to provide housing for war veterans pursuant to Veterans' Emergency Housing Act), cert. denied, 348 U.S. 916 (1955).

176. Indeed, if not for the problem of extended liability, a third-party beneficiary under a government contract that benefits a well-defined and specifically favored class might be viewed as a true donee beneficiary.

177. 174 Cal. Rptr. 806 (Ct. App. 1981), cert. denied, 455 U.S. 943 (1982).

178. *Id.* at 810 (quoting 12 U.S.C. § 1713(b) (1988)).

179. See 12 U.S.C. § 1713(b) (1988).

approved rent schedule without HUD's prior approval. The contract authorized HUD to apply to any court for specific performance or for such other relief as may be appropriate. It also provided that the parties were personally liable for funds of the project coming into their hands which, by the provisions of the contract, they were not entitled to retain. Developer increased its rents without HUD approval, and the tenants brought suit. The court held that the tenants could recover damages from Developer as third-party beneficiaries of the contract between Developer and HUD.¹⁸⁰

*Martinez v. Socoma Companies*¹⁸¹ concerned contracts executed under programs instituted pursuant to the federal Economic Opportunity Act to benefit the residents of Special Impact Areas "having especially large concentrations of low income persons and suffering from dependency, chronic unemployment and rising tensions."¹⁸² Pursuant to the statute, the federal government entered into contracts with three manufacturing corporations. Under those contracts, the government agreed to pay each manufacturer a stated amount. In exchange, each manufacturer agreed, among other things, to acquire and equip designated manufacturing facilities, and to train and employ for at least one year at minimum-wage rates a specified number of East Los Angeles

180. See *Zigas*, 174 Cal. Rptr. at 809, 812-13. The cases discussed in the text are not the only significant government-contract cases decided in California during this period. In particular, see *City & County of S.F. v. Western Air Lines, Inc.*, 22 Cal. Rptr. 216 (Ct. App. 1962), cert. denied, 371 U.S. 953 (1963). This case concerned a contract executed between the City and the federal government pursuant to the Federal Airport Act. Under the contract, the City obtained federal funds for an airport. In return, the City promised the government, among other things, that the airport would be operated "for the use and benefit of the public, on fair and reasonable terms and without unjust discrimination." *Id.* at 223. *Western Air Lines* defended against a suit on the ground that the City had violated the contract by charging rates that discriminated against *Western*. The court held that "[a]n examination of the act as a whole discloses that its purpose is to promote a nationwide system of public airports and not to regulate airport operations," and that the contract made pursuant to the Act had the same objective. *Id.* at 224 (citations omitted); accord *Shell v. Schmidt*, 272 P.2d 82, (Cal. Dist. Ct. App. 1954).

For other government-contract cases in which the third-party beneficiary was allowed to enforce the contract, see, e.g., *Holbrook v. Pitt*, 643 F.2d 1261 (7th Cir. 1981) (tenants have enforceable rights under contracts between HUD and project owners); *H.B. Deal & Co. v. Head*, 251 S.W.2d 1017 (Ark. 1952) (employees entitled to overtime compensation that employer, in contract with United States government, promised to pay). For other government-contract cases in which the third-party beneficiary was not allowed to enforce the contract, see, e.g., *Perry v. Housing Auth.*, 664 F.2d 1210 (4th Cir. 1981) (tenants have no enforceable rights under Annual Contributions contract between local housing authority and HUD); *Falzarano v. United States*, 607 F.2d 506 (1st Cir. 1979) (tenants in subsidized housing project are not third-party beneficiaries of contract between landlords and HUD). See generally *Waters*, supra note 25, at 1176-92, 1200-08 (discussing a number of government-contract cases).

181. 521 P.2d 841 (Cal. 1974).

182. *Id.* at 843.

residents certified by the government as disadvantaged.¹⁸³

Each contract provided that any dispute of fact was to be determined by the government's contracting officer, subject to an appeal to the Secretary of Labor. The Secretary's decision would be final unless determined by a competent court to have been fraudulent, capricious, arbitrary, in bad faith, or not supported by substantial evidence. Each contract also contained a liquidated-damages provision. This provision obliged the manufacturer to refund all amounts received from the government in the event of the manufacturer's failure to acquire and equip the specified manufacturing facility, and to refund a stated amount, equivalent to the total contract compensation divided by the number of jobs the manufacturer agreed to provide, for each employment opportunity it failed to provide.¹⁸⁴

Some 2,017 East Los Angeles residents were certified as disadvantaged and qualified for employment under the contracts. Plaintiffs, as members of the class of certified persons, claimed damages for lost wages and other elements on the ground that the manufacturers failed to perform.¹⁸⁵ The court held that the plaintiffs could not recover damages against the manufacturers as third-party beneficiaries of the manufacturers' contracts with the government.

The results in these cases, although apparently conflicting, are supported by the third-party-beneficiary principle.

The result in *Zigas* is supported by the first branch of the third-party-beneficiary principle. It is true that the contracting parties' performance objectives could be effectuated even without allowing the tenants to sue, because the Act empowered the government to obtain damages on the tenants' behalf. However, because the government's litigation resources are very limited, unless the tenants were allowed to bring suit the performance objectives might not have been effectuated, despite the provision allowing the government to bring suit for the tenants' damages, for the adventitious reason that the government was forced to allocate its litigation resources to matters with higher priority. Allowing the tenants to bring suit was therefore an important means of effectuating the contracting parties' performance objectives. The result is also supported by the second branch of the third-party-beneficiary principle. Allowing the low-income tenants to bring suit furthered the policy of the Act to favor such tenants and did not conflict with the contracting parties' performance objectives, because the contract itself made Developer liable for funds it was not entitled to retain, and Developer's liability to the tenants was the same as its liability to the government.

In contrast, the first branch of the third-party-beneficiary principle

183. See *id.*

184. See *id.* at 846.

185. See *id.* at 843-44.

did not support enforcement in *Martinez*. Under the liquidated-damages provisions of the contracts in that case, the manufacturers were obliged to refund to the government a stated amount for every employment opportunity they failed to provide. This provision served as a limitation of the manufacturers' damages. Allowing the plaintiffs to recover the damages they sought would have conflicted with this provision of the contract by creating the possibility of liability in excess of the contractual limitation. Furthermore, the contracts also provided that disputes of fact were to be determined by the government's contracting officer, subject only to appeal to the Secretary of Labor, whose decision was to be final. Allowing the plaintiffs to bring suit under the contract would have conflicted with this term as well.

Enforcement was also not supported by the second branch of the third-party-beneficiary principle. It is true that enforcement would have furthered the policy of the Act to benefit residents of Special Impact Areas. Moreover, the group of potential beneficiaries, although large, was bounded, so that the manufacturers' liability to those residents would also have been bounded. Nevertheless, the second branch of the third-party-beneficiary principle is applicable only if allowing the third party to enforce the contract would not conflict with the contracting parties' performance objectives, as manifested in their contract read in the light of surrounding circumstances. Enforcement in *Martinez* would have conflicted with the contracts' liquidated-damages and dispute-resolution provisions.

As the government-contracts cases illustrate, the third-party-beneficiary principle will not clearly and easily resolve all issues concerning which third-party beneficiaries should be allowed to bring suit. However, no principle does or could accomplish that objective. Even when the application of the third-party principle to a given class of cases presents significant difficulties, as it does in the area of government contracts, the principle provides a standard for judgment and forces to the surface the considerations, admittedly sometimes conflicting, on which the issue should be determined.

IV. DEFENSES

In Part IV, I consider the problem of what defenses a promisor should be entitled to raise against a beneficiary who would otherwise have power to enforce a contract. For convenience, I will call such a third party a *recognized beneficiary*.¹⁸⁶ I begin with the question, what general principle should govern the issue whether a promisor may

186. I use the term "recognized beneficiary" to capture the concept that the beneficiary is one whose power to bring suit should be recognized by the court. The term is comparable in its function to the term "intended beneficiary" used in Restatement Second, but avoids the latter term's connotation that a third-party beneficiary can bring suit only if the contracting parties had an intent to benefit him.

raise, against a recognized beneficiary, a defense the promisor would have had against the promisee under the contract (Section A). I then examine a special instance of this question: whether the promisor may raise the defense that the contracting parties have modified or rescinded the contract in a way that varies or eliminates the power of a recognized beneficiary to enforce the contract (Section B). Next, I consider whether the promisor should be allowed to raise, against a recognized beneficiary, a defense the promisee would have had against the beneficiary (Section C). Finally, I briefly compare the effects of current doctrine and the third-party-beneficiary principle on the power of third parties to enforce contracts and the defenses that the promisor can raise (Section D).

A. Defenses the Promisor Would Have Had Against the Promisee Under the Contract

The general rule, supported by the cases and adopted by *Restatement Second*, is that the promisor can raise against a recognized beneficiary any defense the promisor would have had against the promisee under the contract.¹⁸⁷ This rule is consistent with the third-party-beneficiary principle, because under that principle the third party should have no greater rights under the contract than the parties themselves. So, for example, if the promisee has defrauded the promisor, or if the contract lacked consideration, or if the promisee failed to perform its part of the bargain, that should be a defense against the third party as well as against the promisee.¹⁸⁸

187. See *Rouse v. United States*, 215 F.2d 872, 873 (D.C. Cir. 1954); *Chiriboga v. International Bank for Reconstr.*, 616 F. Supp. 963, 967 (D.D.C. 1985); *Alexander H. Revell & Co. v. C.H. Morgan Grocery Co.*, 214 Ill. App. 526 (App. Ct. 1919); *Restatement Second*, supra note 4, § 309(1)-(2).

188. The result may be different if the promisor is estopped from asserting a defense against the third party because of representations that the promisor has made, or authorized or permitted the promisee to make, to the third party. See, e.g., *Aetna Ins. Co. v. Eisenberg*, 294 F.2d 301, 307 (8th Cir. 1961) (insurer estopped from using defense of misrepresentation to claims of insured's customers whose stored furs were destroyed, because insurer should have been aware of misrepresentations of values of furs made by insured).

In addition, a special rule has been applied in cases where the promisor is an employer; the promisee is a labor union; the third-party beneficiary is an employee pension fund to which the employer has promised to make benefit contributions; the fund claims that the employer-promisor owes benefit contributions; and the employer attempts to raise, as a defense against the fund, a claim that the employer has against the union. See *Lewis v. Benedict*, 361 U.S. 459, 466-71 (1960); *Huge v. Long's Hauling Co.*, 590 F.2d 457, 459 (3d Cir. 1978), cert. denied, 442 U.S. 918 (1979); *Goldies v. Alaska Hotel & Restaurant Employers*, 622 P.2d 979, 980 (Alaska 1981); *Restatement Second*, supra note 4, § 309 cmt. c, illus. 10. This result is sometimes defended on the ground that the employment and pension contracts are separate, but might be better defended on the ground of a policy of special solicitude for pension rights.

B. *Modification and Rescission*

Suppose the promisor and promisee have modified or rescinded the contract in a way that varies or eliminates the power of a recognized beneficiary to enforce it. Under the general rule that the promisor can raise against the third party any defense the promisor would have had against the promisee under the contract, the promisor should be allowed to raise a defense of modification or rescission, because modification and rescission are defenses against the promisee under the contract. The third-party-beneficiary principle leads to the same result. Under that principle, whether a third party should have the power to enforce a contract depends primarily on whether such enforcement is a necessary or important means of effectuating the contracting parties' performance objectives. If the contract is modified or rescinded, then the contracting parties' performance objectives are defined by the modification or rescission, and allowing the third party to enforce the original contract would defeat the contracting parties' performance objectives. Accordingly, a modification or rescission should be effective against a third-party beneficiary, except to the extent that the beneficiary justifiably relied on the contract before the modification or rescission. As I will show, the law has been steadily moving to just this position. Although *Restatement First* largely rejected this position, apparently for doctrinal reasons, the position has been largely accepted by *Restatement Second*. Even *Restatement Second*, however, is still burdened with some doctrinal baggage in this area, as are some courts.

At the time of the adoption of *Restatement First*, the law in this area was unclear. Some cases adopted a general rule that allowed the promisor to raise a defense of modification or rescission.¹⁸⁹ The third parties in these cases tended to be creditor beneficiaries,¹⁹⁰ but the cases typically did not rest their holdings on that ground. Other cases held that a recognized third-party beneficiary had a "vested right" under the contract, and the contracting parties therefore could not effectively vary or eliminate the power of such a beneficiary to enforce the contract.¹⁹¹

189. See, e.g., *Biddel v. Brizzolara*, 30 P. 609, 612 (Cal. 1883) ("The general rule of chancery is that, as to strangers to the contract, the parties may at their pleasure abandon it, and mutually release each other from its performance."); *Gilbert v. Sanderson*, 9 N.W. 293, 295 (Iowa 1881) ("[W]hen one person makes a promise to another for the benefit of a third person, the person to whom the promise is made may execute a valid release of such promise before it has been accepted by the latter. . . ."); *People's Bank & Trust Co. v. Weidinger*, 64 A. 179, 181 (N.J. 1906) (same).

190. See, e.g., cases cited *supra* note 189.

191. See, e.g., *Filley v. Illinois Life Ins. Co.*, 137 P. 793, 794 (Kan. 1914); *Preston v. Connecticut Mut. Life Ins. Co.*, 51 A. 838, 838 (Md. 1902); *Walsh v. Mutual Life Ins. Co.*, 31 N.E. 228, 230 (N.Y. 1892); *Marquet v. Aetna Life Ins. Co.*, 159 S.W. 733, 735 (Tenn. 1913). In *Central Bank v. Hume*, 128 U.S. 195, 206 (1888), the Supreme Court stated, "[i]t is indeed the general rule that a policy, and the money to become due under it, belong, the moment it is issued, to the person or persons named in it as the beneficiary or beneficiaries, and that there is no power in the person procuring the

Most of these cases concerned life-insurance policies,¹⁹² although a few concerned intra-familial settlements in which one family member made a gift of land to another in exchange for a promise to make payments to a third.¹⁹³

Given this state of the law, the drafters of *Restatement First* had a relatively free hand on the issue. For example, the drafters could have adopted a general rule, supported by some of the cases, that a promisor could raise the defense of modification or rescission against a recognized beneficiary. The life-insurance cases could have been distinguished, because in these cases the third party was typically a spouse and the premiums were in effect paid out of family funds that the spouse had helped to produce.¹⁹⁴ The family-settlement cases could have been distinguished on the ground that the beneficiary in those cases was typically a minor, and the courts have tended to give special solicitude to minors in this area.¹⁹⁵

Alternatively, the drafters could have adopted a rule that the promisor was allowed to raise the defense of modification or rescission unless the third party was a true donee beneficiary. This rule would have given some effect to the life-insurance and the family-settlement cases, but distinguished those cases on the ground that they concerned only true donee beneficiaries.

A third alternative was chosen. First, the drafters cabined off the cases that adopted a rule that a promisor could raise the defense of modification or rescission against a recognized beneficiary, on the ground that those cases involved only creditor beneficiaries. Next, the drafters adopted a very restrictive rule explicitly based on the life-insurance cases.¹⁹⁶ The rule adopted in *Restatement First* was essentially that the contracting parties could vary or eliminate the power of a creditor beneficiary to enforce a contract (Section 143), but could not vary or

insurance by any act of his, by deed or by will, to transfer to any other person the interest of the person named."

192. See, e.g., cases cited supra note 191.

193. See, e.g., *Waterman v. Morgan*, 16 N.E. 590 (Ind. 1888); *Thompson v. Gordon*, 34 S.C.L. (3 Strob.) 196 (1848); *Wetutzke v. Wetutzke*, 148 N.W. 1088 (Wis. 1914); *Tweeddale v. Tweeddale*, 93 N.W. 440 (Wis. 1903); 4 *Corbin on Contracts*, supra note 27, § 814, at 253-54.

194. In any event, those cases had been made virtually moot by the practice of including provisions in life-insurance policies under which the policyholder reserved the right to change the beneficiary. See Note, *The Interest of the Beneficiary of a Life Insurance Policy*, 12 *Colum. L. Rev.* 551, 552 (1912).

195. See, e.g., *James v. Pawsey*, 328 P.2d 1023 (Cal. Ct. App. 1958) (parties not allowed to rescind agreement to make mutual wills benefiting an infant third party); *Rhodes v. Rhodes*, 266 S.W.2d 790 (Ky. 1953) (renegotiation of contract ineffective without consent of infant beneficiary); *Quinn v. Thigpen*, 147 S.E.2d 191 (N.C. 1966) (separation agreement between parents confers vested rights on infant beneficiaries). But see *Restatement Second*, supra note 4, § 311 cmt. d (the inference that a contract that benefits a minor third-party beneficiary is irrevocable is rebuttable).

196. See *Restatement First*, supra note 4, § 142, app. at 261 (Official Draft 1928).

eliminate the power of a *donee* beneficiary to enforce a contract (Section 142).¹⁹⁷

The scope of the rule adopted in Section 142 was extremely wide. Under *Restatement First*, the term "donee beneficiary" covered all beneficiaries who were allowed to bring suit, other than creditor beneficiaries. As a result, under *Restatement First* the contracting parties could never eliminate or vary the power of a recognized beneficiary to enforce the contract, except in the limited case of a creditor beneficiary. A rule that had arisen in a very restricted class of cases had been expanded to cover all but a very restricted class of cases.¹⁹⁸

The special rule of *Restatement First* governing the defense of modification or rescission overrode the contracting parties' performance objectives for no good social reason. Indeed, the rule was hard to justify even on doctrinal grounds, because it was inconsistent with the general rule that the promisor can raise, against a recognized beneficiary, a defense the promisor had against the promisee under the contract. The difficulty of drawing a distinction between (i) a defense based on modification or rescission and (ii) other defenses under the contract can be exemplified by the following hypothetical: A and B make a contract under which A promises to pay \$10,000 a year for five years to his son, and B promises to pay the same amount to her daughter, who is married to A's son. Before the son or daughter learns of the contract, A breaches the contract by failing to pay his son. Under the general rule, if B's daughter brought suit against B, B could raise A's breach as a defense. Under the rule of Section 142, however, if instead of breaching the contract A *agreed* with B not to make payments, that agreement would not be a defense to B in a suit against B by her daughter. The paradoxical result is that B is worse off if A agrees not to perform than if A refuses to perform.¹⁹⁹

In his 1920 treatise, Williston defended the rule that was later to be embodied in *Restatement First* by a doctrinal analogy to completed gifts:

In the case of a sole [or donee] beneficiary [a rescission or re-

197. See *id.* §§ 142, 143. This rule was dramatically exemplified by Illustration 2 to Section 142:

A promises B to pay A's son, C, \$1,000 a year for five years, in consideration of which B promises A to pay B's daughter D, who is C's wife, the same amount. Before C or D learn of this contract A and B mutually agree to rescind it. C and D can treat the agreement of rescission as inoperative to destroy their respective rights to enforce the original contract.

Id. § 142 illus. 2.

198. An irony of § 142 was that it placed a donee beneficiary, who did not have an original claim against the promisee, in a better position than a creditor beneficiary, who was entitled to performance from the promisee before the third-party-beneficiary contract ever existed. See Summers, *supra* note 75, at 886.

199. This hypothetical is a variation of *Restatement First*, *supra* note 4, § 142 illus. 2.

lease between the contracting parties] is like the attempted revocation of a gift. The promisor for good consideration has given the beneficiary a right. Later he seeks to take it away by procuring the extinction of the promise. If it be admitted that the beneficiary has a direct right of his own, it ought not to be extinguished without his consent. The only question can be, when does the beneficiary's right arise—when the promise for his benefit was made or when he was notified of it or assented to it? For unless a right has vested in the beneficiary before the rescission or release he cannot object. The question is analogous to that arising upon a gift of property or the creation of a trust for the benefit of another. As a gift is a pure benefit to the donee there seems no reason why his assent should not be presumed, unless and until he expresses dissent.²⁰⁰

The reasoning is relentlessly scholastic in its steadfast avoidance of social propositions, and exceptionally brittle in its dependence on “presumed assent” as the keystone of the argument. Furthermore, the analogy to gifts is both misleading and wrong. It is misleading, because only a limited number of third-party-beneficiary contracts involves a true donative intent. It is wrong, because if a gift analogy were relevant, the best analogy, in contract cases, would not be to completed gifts, which are indeed irrevocable once made, but to promises to make a gift, which are revocable unless relied upon.

Apart from the argument based on the analogy to gifts, the concept that a recognized third-party beneficiary obtains a vested right the moment the contract is made has an obvious doctrinal connection to the intent-to-benefit test. Assume, as this test does, that it is a predicate to enforcement of a contract by a third-party beneficiary that the intent of the promisee (or of the contracting parties) is to confer a benefit on the third party. Given that assumption, when a court concludes that the test is satisfied, it is easy to conclude simultaneously that the contract must “give” something to the beneficiary. The balance of the doctrinal reasoning follows. Because the contract gives something to the third party, then axiomatically the third party must hold not merely a power, but a “right.” Since a right must belong to the right-holder, then axiomatically the right of the third party must be “vested” the moment the contract is made. And because the right is vested, then axiomatically it cannot be divested.

The unfortunate result was that just as classical contract law undervalued the position of third-party beneficiaries on the basis of axioms about privity and consideration, *Restatement First*, having swept aside those axioms, adopted a new axiomatic apparatus that led to an overvaluation of the position of third-party beneficiaries. Under *Restatement First*, that position moved from a super-low level, at which hardly any

200. 1 Williston on Contracts, *supra* note 27, § 396, at 739–40.

third parties could enforce a contract, to a super-high level, at which most beneficiaries who could enforce a contract had a vested right the moment the contract was made.

Although some jurisdictions followed the rule of Section 142,²⁰¹ the rule was not supported by the weight of authority.²⁰² Furthermore, *Restatement Second* reversed *Restatement First* on this issue and adopted a rule very close to that suggested by the third-party-beneficiary principle. Under *Restatement Second* Section 311, the contracting parties can modify or rescind the contract in a manner that varies or eliminates the power of an intended beneficiary to bring suit, unless the beneficiary, before receiving notice of the modification or rescission, materially changes his position in justifiable reliance on the original contract, brings suit on the original contract, or manifests assent to the original contract at the request of the promisor or promisee.²⁰³ A majority of the cases decided since the adoption of *Restatement Second* have apparently adopted the principle embodied in Section 311.²⁰⁴

Restatement Second Section 311 marks a considerable step forward from *Restatement First* Section 142. However, *Restatement Second* and some of the cases continue to provide the beneficiary with somewhat greater remedial protection than is justified. To begin with, Section 311 appears to provide undesirably broad remedial protection to a recognized third-party beneficiary who has relied on the contract. Certainly, the law should protect the reliance interest of a recognized beneficiary. However, that interest will normally be sufficiently protected by reliance damages. In contrast, Section 311 provides that the power of the contracting parties to vary or eliminate an intended bene-

201. See, e.g., *Logan v. Glass*, 7 A.2d 116, 118-19 (Pa. Super. Ct. 1939), aff'd, 14 A.2d 306 (1940) (donee beneficiary has right of action to enforce duty of promisor despite rescission of contract).

202. See *McCulloch v. Canadian Pac. Ry.*, 53 F. Supp. 534 (D. Minn. 1943); *Wolosoff v. Gadsden Land & Bldg. Corp.*, 18 So. 2d 568 (Ala. 1944); *Mitchell v. Markland*, 47 Cal. Rptr. 756 (Dist. Ct. App. 1965); *Spates v. Spates*, 296 A.2d 581 (Md. 1972); *Camden Trust Co. v. Haldeman*, 33 A.2d 611 (N.J. Ch. 1943), aff'd, 40 A.2d 601 (1945); *Restatement Second*, supra note 4, § 311 (Reporter's Note); *William H. Page, The Power of the Contracting Parties to Alter a Contract for Rendering a Performance to a Third Person*, 12 Wis. L. Rev. 141 (1937); Note, supra note 76, at 418-20. Indeed, rescission was allowed even in some true donee-beneficiary cases. See *In re Estate of Gross*, 317 N.Y.S.2d 45 (App. Div. 1970), aff'd, 276 N.E.2d 230 (1971); *Salesky v. Hat Corp. of Am.*, 244 N.Y.S.2d 965 (App. Div. 1963). But cf. *Forman v. Forman*, 270 N.Y.S.2d 586 (App. Div. 1966) (children, as beneficiaries of separation agreement, could hold father to that agreement even though mother could not because of her own actions).

203. See *Restatement Second*, supra note 4, § 311.

204. See, e.g., *Karo v. San Diego Symphony Orchestra Ass'n*, 762 F.2d 819 (9th Cir. 1985); *Jardell Enters. v. Triconsultants, Inc.*, 770 P.2d 1301 (Colo. Ct. App. 1988); *Board of Educ. v. Village of Hoffman Estates*, 467 N.E.2d 1064, 1066 (Ill. App. Ct. 1984); *Bridgman v. Curry*, 398 N.W.2d 167, 172 (Iowa 1986). But see *Hickox v. Bell*, 552 N.E.2d 1133 (Ill. App. Ct.), appeal denied, 555 N.E.2d 376 (1990); *Biggins v. Shore*, 565 A.2d 737 (Pa. 1989).

fiary's power to enforce the contract "terminates" when the beneficiary changes his position in justifiable reliance.²⁰⁵ This language suggests—perhaps inadvertently—that once an intended beneficiary justifiably relies on the contract, the contracting parties cannot vary or eliminate the beneficiary's right to enforce the contract, and the third party can therefore recover expectation damages.

Such a rule would be mistaken. Expectation damages are an unusual remedy, because, unlike most legal remedies, they do more than restore a party to his pre-injury position. Contract law nevertheless allows parties to a bargain contract to recover expectation damages, largely because it is socially desirable to require each party to a bargain to internalize the other's potential gains.²⁰⁶ This reasoning does not apply to a third-party beneficiary, who has not entered into any bargain. On the contrary, allowing a beneficiary to enforce a contract against the wishes of the contracting parties conflicts with the interests of the only persons who have made a bargain. If a recognized beneficiary has justifiably relied on a contract, the importance of protecting that reliance outweighs the interests of the contracting parties, but only to the extent of the reliance.

Indeed, a rule that requires the award of expectation damages to a relying beneficiary, even when the contract has been modified or rescinded, would treat a true donee beneficiary, to whom a promise is not directly made, better than the law treats a donative promisee, to whom a promise *is* directly made. Under *Restatement Second* Section 90, if a donative promise is directly made to a promisee who then relies upon the promise, the promisee's damages may be limited to reliance.²⁰⁷ Section 311 should parallel Section 90 in this regard, both in the case of the true donee and in other cases in which the third party has an interest only because of his reliance.

Restatement Second Section 311 also appears to adopt the position that the contracting parties cannot vary or eliminate the power of a recognized beneficiary to enforce the contract once the beneficiary has brought suit. That position would be similarly mistaken. The act of bringing suit is simply a special kind of reliance, in which the expenditure consists of the cost of suit. The contracting parties should be able to vary or eliminate the power of a recognized beneficiary to enforce the contract even after the beneficiary has brought suit, subject to the promisor's obligation to reimburse the beneficiary for her litigation expenses.²⁰⁸

A final question is whether the right of the contracting parties to

205. *Restatement Second*, supra note 4, § 311.

206. See Cooter & Eisenberg, supra note 66, at 1462-64.

207. See *Restatement Second*, supra note 4, § 90 cmt. d.

208. Cf. *Puro v. Puro*, 393 N.Y.S.2d 633, 635-36 (Sup. Ct. 1976) (individual cannot, by act of filing suit, transform contract into an unconditional agreement to benefit him).

vary or eliminate the power of a recognized beneficiary to enforce the contract should be subject to an exception where the beneficiary has assented to the contract. It is often said that a variation or modification cannot be made after the beneficiary's assent.²⁰⁹ Such an exception is uncontroversial when the contracting parties have essentially made an offer to the beneficiary, so that the beneficiary's assent concludes an independent contract under the rules of offer and acceptance. Unless such an offer has been made, however, an assent by the beneficiary is a virtually meaningless act. Recall that Williston, in proposing a broad vesting rule, argued that "[a]s a gift is a pure benefit to the donee [beneficiary] there seems no reason why his assent should not be presumed."²¹⁰ What Williston meant is that any beneficiary who knew he was a beneficiary would assent to being a beneficiary, because the status of beneficiary is all up and no down. The corollary is that a beneficiary's assent is normally of no real significance. A beneficiary who actually assents should not be treated better than one who surely would have assented once he knew that his assent would improve his legal position at no cost to himself.

The support for an assent exception to the right of the contracting parties to modify or rescind the contract is unclear. In some of the cases that have stated the exception, the statement had no significance in the actual decision, because the beneficiary had not assented.²¹¹ In other cases, the beneficiary had not only assented but relied,²¹² and these cases are better explained by the reliance than by the assent.²¹³ In still other cases, the beneficiary's assent was essentially an acceptance of an offer, which concluded an independent contract.²¹⁴ The black letter text of *Restatement Second* Section 311 seems to limit the effectiveness of a beneficiary's assent to this context. Under Section 311(3), the assent of a beneficiary precludes the contracting parties from varying or eliminating the beneficiary's power to enforce the contract if the third party "manifests assent . . . at the request of the promisor or the promisee."²¹⁵ In a contractual setting, an assent manifested in response to a request for assent would normally constitute an accept-

209. See, e.g., *Copeland v. Beard*, 115 So. 389 (Ala. 1928).

210. 1 Williston on Contracts, supra note 27, § 396, at 740; accord supra text accompanying note 200.

211. See, e.g., *Copeland*, 115 So. at 390-91.

212. See, e.g., *Bridgman v. Curry*, 398 N.W.2d 167, 173 (Iowa 1986).

213. A number of cases concern infant donee beneficiaries. See, e.g., *James v. Pawsey*, 328 P.2d 1023 (Cal. App. 1958); *Rhodes v. Rhodes*, 266 S.W.2d 790 (Ky. 1953). These cases adopt a syllogism that (i) a beneficiary's rights vest upon his assent; (ii) in the case of an infant, assent is presumed; and, therefore, (iii) an infant beneficiary's rights vest when the contract is made even if the infant does not assent. The brittle nature of the syllogism, and the lack of assent, show that these cases are explained not by assent, but by a policy of solicitude for infant donees.

214. See, e.g., *Wolosoff v. Gadsden Land & Bldg. Corp.*, 18 So. 2d 568, 571-72 (Ala. 1944).

215. *Restatement Second*, supra note 4, § 311(3).

ance that concluded an independent contract.²¹⁶ The test of Section 311, so construed, states the preferable rule. Reliance by a recognized beneficiary should change the beneficiary's legal position, to the extent of the reliance. Assent by a recognized beneficiary, unaccompanied by reliance, should not change the beneficiary's legal position unless the assent amounts to an acceptance of a true offer.

C. Defenses of the Promisee Against the Third Party

The issue in the last two Sections of this Article was whether a promisor can raise, against a recognized beneficiary, a defense the promisor would have against the promisee under the contract. This Section considers the more difficult question of whether the promisor should be allowed to raise, against a recognized beneficiary, a defense the *promisee* would have had against the beneficiary in a suit by the beneficiary against the promisee.

In some respects, this question is very narrow, because it seldom arises outside the creditor-beneficiary context. For example, we could not talk sensibly about whether Mrs. Beman, the promisee in *Seaver v. Ransom*,²¹⁷ had a "defense" against her niece, Marion; or about whether a testator had a "defense" against a would-be legatee. Cases like these do not rest on a preexisting claim the beneficiary had against the promisee, and in the absence of such a claim the concept of a defense that the promisee would have had against the beneficiary is usually not meaningful. In contrast, a third-party beneficiary qualifies as a creditor beneficiary only if he had a preexisting claim against the promisee, and in that context the promisee might well have had a defense against the beneficiary. When the beneficiary sues the promisor instead of the promisee, the promisor will want to assert the promisee's defense.

Many of the cases on this issue involve a special fact pattern arising out of successive sales of mortgaged property. I will call this fact pat-

216. Illustration 11 to Section 311 exemplifies such a case:

A and B, two affiliated corporations, contract that upon surrender of outstanding bonds issued by A new bonds will be issued, bond for bond, paying less interest but guaranteed by B. Forty years later, shortly before the old bonds mature, only a small number of the old bonds have been surrendered, and A and B release each other from the contract with respect to any new bonds not yet issued. The releases are effective against any holder of old bonds who receives notification of the releases before he surrenders his bonds.

Id. § 311 cmt. h, illus. 11. In contrast, Illustration 10 seems to conflict with the black-letter test, because the beneficiary's assent is given effect although the assent is not requested: "B contracts with A to pay C \$200 which A owes C, and A notifies C of the contract by mail. C mails a letter to A assenting to the contract before receiving notification of a rescission by A and B. The rescission is ineffective against C." Id. § 311 cmt. h, illus. 10.

217. 120 N.E. 639 (N.Y. 1918), discussed *supra* text accompanying notes 57-61, 111.

tern the *broken-chain case*. Here is a stylized version. Mortgagor, who owns a parcel of real property, has mortgaged the property to T and promised to pay T the mortgage debt. Later, Mortgagor sells the property to Purchaser 1. At the time of this sale, Purchaser 1 may either pay the mortgage debt, assume (promise to pay) the mortgage, or take the property subject to the mortgage but without assuming it. If Purchaser 1 promises to pay the mortgage, T is a creditor beneficiary of Purchaser 1's promise. If Purchaser 1 takes the property subject to the mortgage but does not assume it, T continues to hold a security interest in the property and has a personal right against Mortgagor, but T is not a creditor beneficiary of Purchaser 1, because Purchaser 1 has made no promise.

Now suppose that Purchaser 1 has not assumed the mortgage. Purchaser 1 then sells the property to Purchaser 2, who *does* assume the mortgage. Neither Mortgagor, Purchaser 1, nor Purchaser 2 pays the mortgage, and T sues Purchaser 2, claiming that T is a creditor beneficiary of Purchaser 2's promise to pay the mortgage. Should Purchaser 2 be allowed to raise, against T, the defense that Purchaser 1 owed no obligation to Mortgagor, and that T is therefore not a creditor beneficiary because Purchaser 2 was not promising to pay a preexisting debt of the promisee?

To answer that question, recall the reasons why creditor beneficiaries are allowed to bring suit. First, allowing a creditor beneficiary to enforce a contract is an important means of effectuating the contracting parties' performance objective of economically shifting to the promisor the debt owed by the promisee. This reason is inapplicable to the broken-chain case, because the promisee, Purchaser 1, does not owe a debt to the beneficiary, T. Second, allowing a creditor beneficiary to enforce the contract short-circuits litigation, because if the beneficiary were not allowed to sue the promisor he would sue the promisee, and the promisee would then sue the promisor. This reason is also inapplicable, because T could not sue Purchaser 1. Finally, allowing a creditor beneficiary to bring suit prevents unjust enrichment of the promisor. This reason is also unlikely to be applicable. It is true that the price Purchaser 2 paid for the land probably will have been reduced by the amount of the mortgage. However, the price probably would have been reduced by the amount of the mortgage even if Purchaser 2 had not assumed the mortgage, but had purchased the property subject to the mortgage.

Of course, it is possible in such cases that Purchaser 1 bargained for Purchaser 2's unconditional liability to T. For example, Purchaser 1 may have had a familial or economic relationship with Mortgagor, and for that reason may have wanted to shift financial responsibility for the mortgage from Mortgagor to Purchaser 2. Or, Purchaser 1 may have had a familial or economic relationship with T, and for that reason may have wanted to give T an extra string to his bow. In such cases, Pur-

chaser 2 should not be able to defend against a suit by T on the ground that Purchaser 1 was not liable to T, because Purchaser 2's payment of the mortgage was a performance objective of the contracting parties, as manifested in the contract read in the light of surrounding circumstances.

Suppose, however, that Purchaser 1 had no relationship with either Mortgagor or T that would have given Purchaser 1 a reason for wanting to make Purchaser 2 unconditionally liable to T for the mortgage debt. Why then does Purchaser 1 have Purchaser 2 assume the mortgage? One possible reason is that Purchaser 1 erroneously believes that he is liable on the mortgage. In that case, no reason is apparent why Purchaser 2 should be liable when it turns out that Purchaser 1's belief is mistaken. An alternative, related reason is that Purchaser 1 is not sure whether he is liable on the mortgage and wants to be protected if he is liable. In that case, Purchaser 2's promise to Purchaser 1 can best be interpreted as a promise to be responsible for and defend against T's possible claim against Purchaser 1. Allowing Purchaser 2 to raise Purchaser 1's defense, in a suit by T, is then perfectly consistent with the contracting parties' performance objectives.

The cases are divided, but the majority rule is that in a suit by T against Purchaser 2, Purchaser 2 can raise as a defense that Purchaser 1 was not indebted to T.²¹⁸ Furthermore, at least some of the cases that have refused to allow Purchaser 2 to raise this defense are distinguishable because Purchaser 1 had a familial or economic relationship with either Mortgagor or T, so that the performance objectives manifested in the contract probably included the imposition on Purchaser 2 of an unconditional liability to T.²¹⁹

In one section of his treatise, Williston approved the majority rule that in a broken-chain case Purchaser 2 could raise against T the defense that Purchaser 1 was not liable to T:

A curious situation arises when a mortgagor transfers the premises to one who, though taking them subject to the mortgage, does not agree to pay it, and this grantee thereafter transfers the premises to another who by the deed assumes and agrees to pay the mortgage. The promisee has no interest in the performance of this promise, since he is not personally liable for the debt, and he is no longer the owner of the premises. It may be thought that the only intelligent object for requiring the promise from the grantee is a wish to benefit the mortgagee. . . . But it is hard to suppose that the promisee

218. Compare *Ward v. De Oca*, 52 P. 130, 131 (Cal. 1898) (no liability); *Colorado Sav. Bank v. Bales*, 165 P. 843, 843-44 (Kan. 1917) (no liability); *Garfinkel v. Vinik*, 169 A. 527, 528 (N.J. Ch. 1933) (no liability); and *Fry v. Ausman*, 135 N.W. 708 (S.D. 1912) (no liability) with *Scott v. Wharton*, 148 So. 308, 309 (Ala. 1933) (liability); *Schneider v. Ferrigno*, 147 A. 303, 304 (Conn. 1929) (liability); and *Prudential Ins. Co. v. Clybourn Realty Co.*, 253 N.W. 397, 398 (Wis. 1934) (liability).

219. See, e.g., *Schneider*, 147 A. at 304.

had any such intention. The object in fact of such a stipulation, if its insertion is not altogether a mistake, in which case the grantee would be entitled to reformation of the deed, is doubtless to guard against a supposed or possible liability on the part of the promisee which in fact does not exist. The decisions which generally deny the mortgagee a right to recover in such a case, therefore, seem sound.²²⁰

For reasons that are not clear, however, Williston dealt with the *general* defense "that the debtor [promisee] did not owe the debt" in a different section of his treatise,²²¹ and argued in that section that the promisor normally should *not* be allowed to raise a defense that the promisee did not owe the debt:

Another kind of defence to a promise to pay a debt has given rise to considerable litigation. May the promisor set up that the debtor did not owe the debt or that it was an illegal debt? The answer to this question depends upon the true meaning in fact of the promise rather than upon any rule of law. If the promisor's agreement is to be construed as a promise to discharge whatever liability the promisee is under, the promisor must certainly be allowed to show that the promisee was under no liability. . . . On the other hand, if the promise means that the promisor agrees to pay a sum of money to A, to whom the promisee says he is indebted, it is immaterial whether the promisee is actually indebted to that amount or at all. The promisee has decided that question himself. Where the promise is to pay a specific debt, for example to assume a specific mortgage, especially if the amount of it is deducted from the consideration paid by the promisor for the mortgaged property, this construction will generally be the true one.²²²

Writing in 1920, Williston cited a number of earlier cases in support of his text.²²³ Most of these cases concerned technical defenses that are often disfavored in any event, such as usury, coverture, and the Statute of Limitations.²²⁴ Furthermore, the majority of broken-chain cases, which seem to be difficult or impossible to distinguish, go the other way.²²⁵ However, some modern cases have followed Williston in situations in which the defense was not merely technical. For example,

220. 1 Williston on Contracts, *supra* note 27, § 386, at 728.

221. The broken-chain case was treated under the title "Successive purchases of mortgaged property." See *id.* § 386, at 725-28. Other cases involving a defense that the promisee did not owe the debt were treated under the title "Invalidity of debt assumed." See *id.* § 399, at 745-46.

222. *Id.* § 399, at 745.

223. See cases cited *id.* § 399, at 745-46 nn.20-21.

224. The major illustration on this issue in Restatement Second involves the Statute of Frauds. See Restatement Second, *supra* note 4, § 309 *illus.* 2.

225. See cases cited *supra* note 218.

in *Rouse v. United States*,²²⁶ T had installed a heating plant in Winston's house in exchange for a \$1,008 promissory note, payable in installments. Rouse later purchased the house and agreed to assume Winston's remaining \$850 obligation to T. T's assignee sued Rouse as a creditor beneficiary of Rouse's promise to Winston. Rouse defended in part on the ground that the heating plant was defective when sold by T to Winston. The court, quoting Williston, held that Rouse could not raise Winston's defense against T or its assignee.²²⁷

Restatement First also followed Williston's line on this issue. Section 133(1)(b) defined a third-party beneficiary as a creditor beneficiary if "performance of the promise [made in the contract] will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary."²²⁸ Because *Restatement First* provided that creditor beneficiaries, as defined, were allowed to enforce contracts, the effect of this definition was to render irrelevant any defense the promisee would have had against a creditor beneficiary.²²⁹ This aspect of the definition of a creditor beneficiary in *Restatement First*, however, was inconsistent with the basic creditor-beneficiary concept—that is, the concept of a beneficiary to whom the promisee owed a preexisting obligation. As the Reporter for *Restatement Second* later pointed out, "where the promise is to pay [only] a supposed or doubtful debt . . . [i]t's a non-creditor beneficiary."²³⁰

Accordingly, *Restatement Second* Section 302(1)(a), the counterpart of *Restatement First* Section 133(1)(b), is limited to cases in which "the performance of the promise will satisfy an [actual] obligation of the promisee to pay money to the beneficiary."²³¹ However, the Comment to Section 302 makes clear that the beneficiary of a supposed but non-existent debt may be an intended beneficiary under Section 302(1)(b),²³² and Section 309(3) adopts the rule that a promisor cannot raise, against a beneficiary, a defense the promisee could have raised against the beneficiary.²³³

226. 215 F.2d 872, 874 (D.C. Cir. 1954); accord *Peters Grazing Assoc. v. Legerski*, 544 P.2d 449, 457 (Wy. 1976) (citing *Rouse*).

227. *Rouse*, 215 F.2d at 874.

228. *Restatement First*, supra note 4, § 133(1)(b) (emphasis added).

229. In addition, *Restatement First* § 144 provided:

Unless the case is within the rules making contracts voidable for mutual mistake, where performance of a promise in a contract will benefit a person other than the promisee, the promisor's duty is not avoided or limited by an erroneous belief of the promisor or of the promisee as to the existence or extent of a duty of the promisee to the beneficiary.

Id. § 144.

230. 44 A.L.I. Proc. 306 (1967) (remarks of Reporter Braucher) (emphasis added).

231. *Restatement Second*, supra note 4, § 302(1)(a).

232. See *id.* § 302 cmt. b.

233. Section 309(3) is supplemented by § 312: "The effect of an erroneous belief of the promisor or promisee as to the existence or extent of a duty owed to an intended beneficiary is determined by the rules making contracts voidable for mistake." *Id.* § 312. It is very hard to discern the intent underlying § 312. The black-letter text refers

The Comment to Section 309(3) provides little if any justification for the flat position it adopts:

[T]he beneficiary's right is direct, not merely derivative, and claims and defenses of the promisor against the promisee arising out of separate transactions do not affect the right of the beneficiary except in accordance with the terms of the contract. Similarly, the beneficiary's right against the promisor is not subject to claims and defenses of the promisee against the beneficiary unless the contract so provides.²³⁴

This kind of legalistic and conclusory reasoning is yet another example of how the modern law of third-party beneficiaries has tended to overvalue the third party's position on doctrinal grounds, just as classical contract law undervalued that position on doctrinal grounds. The position taken in Section 309(3) is mistaken in at least one important kind of problem, the broken-chain case. The analysis of that case applies as well to any other case in which the promisee has no reason to impose upon the promisor an unconditional liability to the beneficiary, and is fully protected if the promisor's obligation is to be responsible for and defend against the beneficiary's claim. The Comment to Section 309(3) fails to confront the basic issue: If a promisee has no demonstrable interest in the beneficiary's welfare, why should it be presumed that the promisee bargained for the promisor to have an unconditional obligation to the beneficiary, rather than an obligation to be responsible for and defend against the beneficiary's claim?

Moreover, insofar as the Comment is based on the theory that "[t]he beneficiary's right is direct, not merely derivative," it is wrong even on doctrinal grounds. A recognized third-party beneficiary has a power, not a right, and the power is derivative, not direct; that is, the power of the beneficiary to bring suit derives from the desirability of allowing the beneficiary to enforce the contract so as to effectuate the performance objectives of the contracting parties. If an intended beneficiary did indeed have a "right [that] is direct," it would be impermissible to allow the contracting parties to vary or eliminate that right without the beneficiary's consent, as *Restatement Second* itself permits.²³⁵

Furthermore, *Restatement Second* Section 309(3) and cases like *Rouse* are inconsistent with a large body of law involving suits *against* a contractor by a person who, like *Rouse*, had purchased a defective home from a seller for whom the contractor had built or improved the home. Although these cases are divided, the better rule, supported by abun-

to an erroneous belief or mistake by either the promisor or the promisee. However, erroneous beliefs are usually a defense only insofar as permitted by the doctrine of mutual mistake, and that kind of mistake normally requires an erroneous belief by *both* contracting parties. The only significant mistake case among the Illustrations to § 312 is Illustration 4, which concerns the relatively trivial case of a mistake by a scrivener. See *id.* § 312 illus. 4.

234. *Id.* § 309 cmt. c.

235. See *supra* text accompanying note 203.

dant authority, upholds the right of the subsequent owners to bring suit against the contractor if the defect was not apparent at the time of the sale to the subsequent owner.²³⁶ Some of these cases impose liability in tort for negligence, but the better theory—reflected, for example, in *Aronsohn v. Mandara*²³⁷ and *Meadowbrook Condominium Association v. South Burlington Realty Corp.*²³⁸—is that when the defect was not apparent, the subsequent purchaser, S, can sue on the contractor's implied warranty of good workmanship or habitability, on the ground that when the seller transferred the home to S he assigned his claim against the contractor as well.²³⁹

When the defect is not apparent, the argument for allowing S to sue the contractor is compelling. If S cannot sue the contractor, S will suffer an undeserved loss. Correspondingly, the contractor will obtain a windfall, because the contractor's liability will be cut off by the adventitious occurrence of the sale to S. If, on the other hand, S is allowed to make a claim against the contractor, then S is made whole and the amount of liability of the contractor is not extended beyond that implicitly bargained for in the original contract.²⁴⁰

Cases in which a subsequent owner brings suit against the contractor on the basis of defective construction cannot be distinguished from cases in which the contractor, as a third-party beneficiary, brings suit against the subsequent owner. If the subsequent owner is allowed to bring suit against the contractor on the basis of defects in the construction that was performed for the original owner, he must also be allowed

236. See Jones, *supra* note 160, at 1077–83.

237. 484 A.2d 675, 678–79 (N.J. 1984).

238. 565 A.2d 238, 241–43 & n.1 (Vt. 1989).

239. See generally Jones, *supra* note 160, at 1077–83 (arguing that subsequent purchasers should be allowed to recover on implied warranty of habitability or good workmanship for all defects).

240. See *id.* at 1081.

Aronsohn limited its ruling to cases involving defects that were apparent or discoverable on reasonable inspection, on the theory that defects that were apparent or discoverable would or should be reflected in the price paid by S. See 484 A.2d at 680–81. *Meadowbrook* came to the same conclusion. See 565 A.2d at 241. It is at least arguable, however, that a subsequent owner should be allowed to assert the defense of defective construction even if the defect was obvious. As William Jones has pointed out:

The subsequent purchaser should be permitted to pursue the builder for all defects for which the initial purchaser could have brought suit. In this way, builders are held fully accountable for construction deficiencies and, if a subsequent purchaser receives a windfall, the windfall is a product of the transaction between the initial purchaser and the subsequent purchaser and does not concern the builder.

Jones, *supra* note 160, at 1083. In *Meadowbrook*, the court sought to hold the contractor accountable for all the damage it caused by ruling that “owners who sold their units after the defects in the roads and carparks had become obvious—and who, presumably, were forced to accept a lower price as a consequence—did not thereby waive their individual causes of action.” 565 A.2d at 243 n.1.

to raise these defects as defenses when he is the defendant rather than the plaintiff.

These cases and the broken-chain cases illustrate that the flat rule set forth in *Restatement Second* Section 309(3) is incorrect. In at least some cases, the promisor should be allowed to raise a defense that the promisee would have had. Whether a promisor should be able to raise a defense of the promisee in any given case should turn on the functional question, what values would be served or disserved by refusing to allow the promisor to raise the defense. In particular, the issue should turn on whether the promisee would have had a reason for extracting from the promisor an unconditional promise to pay the promisee's debt rather than a promise to be responsible for and defend against it, and whether the promisor on the one hand, or the third party on the other, would be unjustly enriched if the defense was disallowed.

D. *A Look Back*

In regard to the power of a third party to enforce a contract, the third-party-beneficiary principle is likely to be modestly expansive as compared to current doctrine. The intent-to-benefit test, as traditionally formulated and applied, is difficult to satisfy because except in some true donee cases contracting parties rarely have as their end the conferring of a benefit on a third party. Accordingly, those cases that allow a third-party beneficiary to enforce a contract are reasoned poorly, if at all, and the case law concerning any given type of third-party beneficiary is often in disarray. In contrast, the third-party-beneficiary principle probably leads more often to the conclusion that a third party should be allowed to enforce a contract and certainly better explains when that result should or should not be reached.

In regard to defenses, however, the third-party-beneficiary principle favors the promisor as compared to current doctrine. *Restatement First* was relatively restrictive concerning the defenses that a promisor could raise, largely on conceptualistic grounds. *Restatement Second* and current case law are less restrictive, but remnants of the older conceptualism remain. Under the third-party-beneficiary principle, however, the promisor's defenses depend not on such concepts as "vesting," but on the legitimate functional interests of the promisor, the promisee, and the third party, and on those relevant considerations of justice and social policy that do not impinge on those interests. The major relevant interests are the performance objectives of the contracting parties and the third party's reliance. Under the third-party-beneficiary principle, therefore, the promisor can raise against the beneficiary any defense that could have been raised against the promisee under the contract, including modification and rescission, subject to the third party's reliance. The promisor can also raise a defense the promisee would have had against the third party, when allowing such a defense

will further the contracting parties' performance objectives or not conflict with those objectives and do justice under the circumstances.

CONCLUSION

One ideal for the common law is the standard of social congruence, that the body of the law should correspond to the body of legal rules that one would arrive at by giving appropriate weight to all applicable social propositions and making the best choices when such propositions collide. A second ideal is the standard of doctrinal stability. Often these two standards conflict. In different eras and in different bodies of law, different weights may be placed on each standard. Under classical contract law, relatively more weight was put on stability of doctrine than is the case under modern contract law. At the extreme, the courts and commentators in the classical era sometimes stated or implied that only doctrine mattered.

One aspect of classical doctrine was a rejection of the power of third-party beneficiaries to enforce contracts. This result, although justified in purely doctrinal terms, can be understood in terms of social propositions, because allowing a third party to enforce a contract may unduly enlarge a promisor's liability. Nevertheless, on balance it is clear that there are a number of cases in which third-party beneficiaries should be allowed to enforce contracts. In some cases, such enforcement furthers the performance objectives of the contracting parties themselves, and in other cases such enforcement is supported by reasons of morality or policy and does not conflict with the contracting parties' performance objectives. As a result, the classical school's rejection of the power of a third-party beneficiary to enforce a contract lacked substantial social congruence. Common-law rules that lack such congruence seldom survive. Courts will find a way to get around such rules, and as they do the certainty sought to be achieved by doctrinal stability will crumble. Eventually, a new rule will be formulated.

When this step occurred in the third-party-beneficiary area, contract law was still in the grip of the apparatus of classical doctrine. Although courts and scholars recognized that a new approach was required, they had difficulty formulating a principle that squared with that apparatus. Accordingly, the courts and the *Restatements* tended to address the problem by adopting either an approach that was basically impoverished, a series of categorical rules that hopefully would do ad hoc justice, or both. As a consequence, the cases in this area have typically been conclusory rather than reasoned, and the conclusions have been insecurely rooted and often wrong. In contrast, the third-party-beneficiary principle provides a general and principled standard, anchored in the basic aims of contract law, for determining when a third-party beneficiary should be allowed to bring suit. For some classes of cases the principle can be elaborated into a rule, subject to contractual provisions or circumstances that indicate a different result.

In other cases, the principle provides a standard for judgment and forces the relevant considerations to the surface.

Finally, modern contract law tended to repeat the mistake of classical contract law by focusing on whether the third party acquires a "right" under the contract. This perspective leads to the natural conclusion that if a third party has standing to sue, the right may "vest" and will be subject to only limited defenses. In contrast, the third-party-beneficiary principle focuses in large part on whether allowing a third party to enforce a contract is an apt remedial device to further the contracting parties' performance objectives. Under that principle, therefore, a recognized beneficiary is conceived to hold a power rather than to be vested with a right. Subject to the protection of justifiable reliance, that power may be eliminated, limited, or made subject to defenses when doing so either furthers the contracting parties' performance interests or does not conflict with those interests and furthers an independent interest of morality or policy.