

Third-Party Beneficiaries

Alice, a painter, owes Tom \$400, which she does not currently have. Bob, however, needs to have his house painted and is willing to pay Alice \$400 to do it. Alice plans to use that money to pay Tom. What if, in the contract between Alice and Bob, in consideration for Alice's promise to paint the house, Bob promises to pay Alice's debt directly to Tom?

There can be many reasons why Alice and Bob would prefer that Bob directly pays Tom instead of Alice. For example, Bob and Tom might be neighbors, which would make the transfer of funds easy. Or maybe Tom is afraid that Alice will fail to perform, and her contract with Bob can reassure Tom that he will soon be paid. It might even convince Tom to provide Alice with an additional line of credit. Regardless of the reason, in many situations, it makes sense that as part of a transaction, one party (here, Bob) will make a promise to the other party (here, Alice) for the benefit of a third party (here, Tom).

The core question we explore in this section is what legal rights a third party has with respect to a contract that benefits it. For example, if Bob breaches the contract, say by not paying, can Tom sue him, or is Alice the only party who can sue? What defenses can Bob assert against such a claim? And can Tom otherwise intervene in the relationship between Alice and Bob to guarantee his payment?

Note: The Short (but still relevant) History of Third-Party Beneficiaries

Historically, the common law did not allow non-parties to enforce a contract. That approach changed over time. Two famous decisions of the Court of Appeals of New York—*Lawrence v. Fox* and *Seaver v. Ransom*—mark that change in the United States.

In the first of these cases, Holly loaned \$300 to Fox, and Fox promised to pay that amount to Lawrence the next day. Holly notified Fox that this payment would satisfy his (Holly's) debt to Lawrence. When Fox failed to pay, Lawrence sued him. In his defense, Fox argued, among other things, that there was no privity between him and Lawrence. In other words, Fox argued that because Lawrence was not a party to the contract between Fox and Holly, Lawrence could not sue him for a breach of the contract. The court rejected that claim, holding that "a promise made to one for the benefit of another, he for whose benefit it is made may bring an action for its breach." *Lawrence v. Fox*, 20 N.Y. 268, 274 (1859).

Following *Lawrence*, most courts recognized the third party's right to sue in comparable situations. Specifically, the third party was able to sue when the promisee was in debt to the third party that the promise was satisfying.

Seaver v. Ransom, 224 N.Y. 233 (1918), deals with a different set of facts. Judge Beman prepared his wife's will, but when she read the draft document, she stated she wanted to leave her house to Seaver. The judge offered to write another will, but Mrs. Beman was afraid she would not hold out long enough to sign it. The judge then promised that if she signed the current will, he would leave Seaver enough in his will to make her whole. When the judge died without doing it, Seaver sued his estate (managed by Ransom) for breach of his promise to his wife.

The court stated that historically "the general rule, both in law and equity, was that privity between a plaintiff and a defendant is necessary to the maintenance of an action on the contract." *Id.* at 237. However, the court continues, over time, several categories of third parties were recognized as having a right to sue. The first category includes cases, like *Lawrence v. Fox*, "where there is a pecuniary obligation running from the promisee to the beneficiary." *Id.* The second category is when the beneficiary is the spouse or the child of a party to the contract. An example is a contract in which the promisor promises to take care of the promisee's child after the promisee passes. The third category includes cases when "the public contract case when the municipality seeks to protect its inhabitants." *Id.* at 238.

The *Seaver* court, however, identified another category, and an especially important one: "where, at the request of a party to the contract, the promise runs directly to the beneficiary although he does not furnish the consideration." *Id.* Recognizing this fourth category allowed Seaver's claim to proceed because "[t]he contract [between Judge Beman and his wife] was made for the plaintiff's benefit. She alone is substantially damaged by its breach. The representatives of the wife's estate have no interest in enforcing it specifically." *Id.* at 239.

The first Restatement of Contracts, published in 1932, noted that in the years following *Seaver*, courts recognized two main categories of third-party beneficiaries who have the right to enforce the contract. The first of those categories was based on *Seaver v. Ransom* and the second on *Lawrence v. Fox*. The Restatement explains that third parties who can enforce the contract may be:

- 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 to make a gift to the beneficiary or 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...

Restatement (First) of Contracts § 133(1). Any other third party was defined as an “incidental beneficiary.” *Id.* Incidental beneficiaries do not have a right to enforce the contract. Both the First Restatement and the caselaw at the time recognized certain differences between the rights of donee beneficiaries and creditor beneficiaries. However, over time, those relatively minor differences mostly disappear.

For the most part, the Second Restatement sought to abandon the distinction between donee beneficiaries and creditor beneficiaries, explaining that “[s]ince the terms ‘donee’ beneficiary and ‘creditor’ beneficiary carry overtones of obsolete doctrinal difficulties, they are avoided in the statement of rules [in the Restatement]. Instead, the terms ‘intended’ beneficiary and ‘incidental’ beneficiary are used to distinguish beneficiaries who have rights from those who do not.” Restatement (Second) of Contracts ch. 14, Introductory Note. However, while the Second Restatement eliminated the (relatively minor) distinctions between the rights of donee and creditor beneficiaries, obvious remanences of those categories still appeared in the definition of “intended beneficiary”:

(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.

(2) An incidental beneficiary is a beneficiary who is not an intended beneficiary.

Restatement (Second) of Contracts § 302. Most courts nowadays, although not all, no longer use the terms “donee” and “creditor” beneficiary.

A. Identifying Intended Beneficiary

While it makes sense that some third- party beneficiaries should be able to enforce the contract, it is similarly obvious that not all third parties who are about to benefit from a contract should be allowed to do so. On the one extreme, consider a life insurance policy. If Alice entered an agreement with Ian which states that, in return for paying a premium during her lifetime, Ian will pay a considerable sum to Alice’s daughter, Diana, upon Alice’s death, then it makes sense that Diana will be allowed to enforce this promise. Alice and Ian clearly intended to benefit Diana and give her an effective and enforceable legal right.

On the other extreme, remember that most contracts create some benefit for third parties. When Bob hires Graham to develop and maintain a butterfly garden in his front yard, all of Bob’s neighbors are expected to benefit from the performance of the contract. However, neither Bob nor Graham would want any of those neighbors to sue Graham if he does not perform to their satisfaction (do you see why even Bob would not want that?).

In other words, while most courts have abandoned the distinction between “donee” and “creditor” beneficiaries, they still need to distinguish between intended and incidental beneficiaries. As the name (and the caselaw and the Restatement) suggests, the heart of this inquiry has to do with the parties’ intent. In most cases, the parties can state whether or not they would like to allow a third party to enforce the contract or any part thereof. However, when they fail to do so explicitly, the court’s task in distinguishing between an intended and incidental beneficiary becomes more challenging.

As you read the following cases, see how courts do just that. What factors do they use to identify intended beneficiaries and distinguish between them and incidental beneficiaries?

Vogan v. Hayes Appraisal Associates, Inc.

588 N.W.2d 420 (Iowa Supreme Court 1999)

CARTER, Justice.

Hayes Appraisal Associates, Inc. (Hayes Appraisal), the defendant in the district court, had been hired by MidAmerica Savings Bank (MidAmerica) to monitor the progress of new home

construction for plaintiffs, Susan J. Vogan and Rollin G. Vogan. The Vogans had obtained a construction loan from MidAmerica. The contractor defaulted after all of the original construction loan proceeds and a subsequent portion of a second mortgage loan had been paid out by the bank.

The Vogans recovered judgment against Hayes Appraisal on a third-party beneficiary theory based on its alleged failure to properly monitor the progress of construction, thus allowing funds to be improperly released by the lender to the defaulting contractor. The court of appeals reversed the judgment on the basis that erroneous progress reports by Hayes Appraisal were not the cause of any loss to the Vogans. After reviewing the record and considering the arguments of the parties, we vacate the decision of the court of appeals and affirm the judgment of the district court.

In June 1989 the Vogans moved to Des Moines. They wanted to build a home in West Des Moines. They met with builder Gary Markley of Char Enterprises, Inc. Markley agreed to build the home for \$169,633.59. The Vogans contacted MidAmerica for a mortgage. MidAmerica orally contracted with Hayes Appraisal to do the initial appraisal and make periodic appraisals of the progress of the construction...Thereafter, the Vogans obtained a \$170,000 mortgage from MidAmerica. MidAmerica was to disburse progress payments to Markley based on progress reports received from Hayes Appraisal.

[The earlier stages of the project were built and financed without difficulties.] On March 20, 1990, Hayes Appraisal certified that the home was sixty percent complete. Only eight days later, Hayes Appraisal issued another progress report indicating that ninety percent of the work had been completed on the home. During the trial, witnesses testified for the Vogans that this was an inaccurate report overstating the extent of the contractor's progress on the job. As late as October 1990, substantial additional work was required on the house. At this point, Markley defaulted on the job after having been paid all of the initial \$170,000 and much of the additional monies raised by the Vogans. Another contractor estimated the completion of the home would cost an additional \$60,000.

The Vogans stopped making mortgage payments, and MidAmerica brought an action to foreclose the mortgage. The Vogans counterclaimed, alleging that the bank had improperly

authorized payment of funds to Markley... An undisclosed settlement was reached in the litigation between Vogans and MidAmerica.

The Vogans then filed a petition against Hayes Appraisal, contending it negligently certified the extent of the construction that had been completed... The case proceeded to jury trial on a contract theory. The court denied Hayes Appraisal's motions for directed verdict in which it argued the Vogans were not third-party beneficiaries of its contract with MidAmerica and the March 1990 progress reports did not proximately cause the damages alleged. The jury returned a verdict for the Vogans. Hayes Appraisal's motion for judgment notwithstanding the verdict was denied.

Hayes Appraisal appealed. It contended the evidence was insufficient to prove the Vogans were third-party beneficiaries or that its conduct proximately caused any damage to the Vogans ... The court of appeals reversed. It concluded the March 1990 progress reports did not result in any damage to the Vogans because the bank had already released more funds than recommended in those reports.

I. Whether the Vogans Were Third-Party Beneficiaries of the Contract Between MidAmerica and Hayes Appraisal.

A. Standard of review. In assessing a motion for judgment notwithstanding the verdict, this court's only inquiry is whether there is sufficient evidence to justify submitting the case to the jury. If there is substantial evidence to support a plaintiff's claims, a motion for judgment notwithstanding the verdict should be denied...

B. Arguments. The Vogans argue that they presented ample evidence to generate a jury question concerning whether they were third-party beneficiaries of the contract between MidAmerica and Hayes Appraisal. The Vogans assert that the court should look to the intent of the parties and the surrounding circumstances and argue that the bank's intent was to protect the Vogans' money as construction progressed. The Vogans claim that Hayes Appraisal knew they were owners of the property and that they would benefit from the progress reports.

Hayes Appraisal, however, claims that the verbal contract between MidAmerica and Hayes had no provision or intent to make the Vogans third-party beneficiaries. Hayes Appraisal claims that the Vogans presented no evidence of intent on behalf of the bank to benefit the Vogans and so failed to meet their burden of proof. Hayes Appraisal argues that this failure

of proof entitles them to a directed verdict or judgment notwithstanding the verdict on this issue.

C. Analysis. This court has adopted the following principles from [Section 302 of] the Restatement (Second) of Contracts that are applicable to third-party beneficiary cases. [the court cites Section 302]

This court has determined that the primary question in a third-party beneficiary case is whether the contract manifests an intent to benefit a third party. However, this intent need not be to benefit a third party directly.

In *Tredrea v. Anesthesia & Analgesia*, 584 N.W.2d 276 (Iowa 1998) we explained:

“[w]hen a contract is made, the two or more contracting parties have separate purposes; each is stimulated by various motives, some of which he may not be acutely conscious.... A third party who is not a promisee and who gave no consideration has an enforceable right by reason of a contract made by two others ... if the promised performance will be of pecuniary benefit to [the third party] and the contract is so expressed as to give the promisor reason to know that such benefit is contemplated by the promisee as one of the motivating causes of his making the contract.”

Id. at 281–82 (quoting 4 Arthur Linton Corbin, A Comprehensive Treatise on the Working Rules of Contract Law § 776, at 15–16, 18 (1951)). In the present case, MidAmerica is the promisee, who stands to benefit from Hayes Appraisal’s performance, and Hayes Appraisal is the promisor, who agreed to provide periodic inspections to the bank.

The promised performance of Hayes Appraisal to MidAmerica will be of pecuniary benefit to the Vogans, and the contract is so expressed as to give Hayes reason to know that such benefit is contemplated by MidAmerica as one of the motivating causes of making the contract. The inspection reports and invoices that Hayes Appraisal provided MidAmerica contained not only the location of the project, but also the Vogans’ name as the home purchasers. This information gave Hayes Appraisal reason to know that the purpose of MidAmerica obtaining the periodic progress reports from Hayes was to provide the Vogans with some protection for the money they had invested in the project. If we apply the *Tredrea* standard to these circumstances, the Vogans qualify as third-party beneficiaries of the agreement between MidAmerica and Hayes Appraisal.

[In an omitted part of the opinion, the court held that “the erroneous reporting of the project’s completion caused the bank to disburse other funds of the Vogans that would have been retained had the report been accurate” and therefore it was the proximate cause for some of the harm that the plaintiffs suffered. In addition, the court held that that damage was predictable in accordance with the rule of *Hadley v. Baxendale*.]

Decision of court of appeals VACATED; district court judgment AFFIRMED.

Anderson v. Fox Hill Village Homeowners Corp.

676 N.E.2d 821 (Massachusetts Supreme Judicial Court 1997)

LYNCH, Justice.

The plaintiff appeals from summary judgment for the defendant entered in her claim for damages arising from a slip and fall caused by an icy condition on property under the control of the defendant. We transferred the case here on our own motion and now affirm the judgment.

The following facts are not in dispute for the purposes of summary judgment. The defendant is a tenant of property used as a retirement community in Westwood. Its lease states in part:

“Tenant agrees to be solely responsible for maintaining the Premises and the Improvements and each and every part thereof in good condition throughout the term of this Lease, reasonable wear and use only excepted and agrees without limitation to: ... (iv) *promptly remove snow and ice from all driveways and walkways*” (emphasis added).

The plaintiff worked at Clark House, a skilled nursing facility, located on the premises. On December 9, 1990, while getting out of her automobile, she slipped and fell on a patch of ice in the Clark House parking lot. The defendant did nothing to remove the ice prior to that morning.

On appeal the plaintiff claims that she was entitled to recover on two theories. First, the plaintiff argues that she was an intended third-party beneficiary of the lease. Alternatively, the plaintiff argues that the defendant assumed a duty greater than that imposed under tort principles to remove the snow and ice promptly, and negligently failed to do so.

The judge correctly ruled that the plaintiff was not an intended third-party beneficiary under the lease.

In order to prevail under this theory the plaintiff must show that the defendant and the lessor intended to give her the benefit of the promised performance. ... See also Restatement (Second) of Contracts § 302 (1981). We look at the language and circumstances of the contract for indicia of intention. The intent must be clear and definite . . .

Under the lease the defendant assumed sole responsibility for operation and maintenance of a retirement complex.³ There is no indication, express or implied, that any obligations were imposed for the benefit of employees of the nursing facility... In these circumstances the plaintiff is no more than an incidental beneficiary and cannot recover under the lease.

Neither can the plaintiff recover in tort. As a general rule, there is no duty by a landowner to remove a natural accumulation of snow or ice. [The court proceeds to reject the plaintiff's claim that the defendant assumed a greater duty of care under tort law than that imposed under the common law because of the contract, holding that "failure to perform a contractual obligation is not a tort in the absence of a duty to act apart from the promise made ... To conclude that tort liability exists solely because the defendant did not perform a contractual duty to remove snow and ice would give rise to a common law duty which we repeatedly have declined to impose on landowners."]

Judgment AFFIRMED.

³ The "Background and Purpose" section of the lease reads, in pertinent part, as follows:

"Whereas, concurrently herewith, Landlord has conveyed to Tenant all of Landlord's right, title and interest in and to the improvements on said parcel, except for the building containing a 70-bed skilled nursing facility and the land under said improvements and building...."

Hale v. Groce

744 P.2d 1289 (Oregon Supreme Court 1987)

LINDE, Justice.

Defendant, who is an attorney, was directed by a client to prepare testamentary instruments and to include a bequest of a specified sum to plaintiff. After the client's death, it was discovered that the gift was not included either in the will or in a related trust instrument. After an unsuccessful attempt to obtain judicial reformation of the will and trust, plaintiff brought the present action for damages against the attorney.

The complaint alleged as two separate claims, first, that defendant was negligent in a number of particulars and, second, that he failed to carry out a contractual promise to his client, the decedent, which the decedent had intended specifically for the benefit of plaintiff. In other states plaintiffs in such cases have sometimes been allowed to recover on one or both of these theories, as negligently injured parties or as third-party beneficiaries under a contract. It is a new question in this court.

Defendant moved to dismiss the complaint on grounds that the stated facts did not constitute a claim under either theory and that, at least as to the tort theory, the action was not commenced within the time limited by the applicable statute. The circuit court held that the action was not time-barred but allowed defendant's motion to dismiss both claims. On plaintiff's appeal, the Court of Appeals reinstated plaintiff's negligence claim. . . .

Both parties petitioned this court for review. Defendant asserts that a lawyer owes a professional duty of care only to his client and cannot be sued for malpractice by others who are injured by the way he performs that duty. Plaintiff asks us to reinstate her contract claim as a third-party beneficiary. We hold that the complaint states claims for damages under both theories, a claim as the intended beneficiary of defendant's professional contract with the decedent and a derivative tort claim based on breach of the duty created by that contract to the plaintiff as its intended beneficiary.

The two claims are related, but they differ in important respects ... [for example] A contract claim ... does not necessarily depend on showing negligence.

Similar claims [against attorneys] were made in *Currey v. Butcher*, 37 Or. 380 (1900), in which attorneys were charged with a faulty search of a title. This court held that they ... would not be liable to a person for whom their client may have acted unbeknownst to them. A chief

precedent for Currey was *Buckley v. Gray*, 110 Cal. 339 (1895), which the court cited for the proposition that “an attorney employed to draw a will is not liable to a person who, through the attorney’s ignorance or negligence in the discharge of his professional duties, was deprived of the portion of the estate which the testator instructed the attorney should be given such person by the will.”

Since 1900, many courts have reconsidered that proposition, some preferring a contract analysis, some negligence, and at least one “a definite maybe.” *Buckley v. Gray* itself was overruled in *Lucas v. Hamm*, 56 Cal.2d 583, 588 (1961). The California Supreme Court stated that a lawyer might be liable to an intended testamentary beneficiary either for negligence or for breach of the lawyer’s contract with the testator, though the court balked at recognizing professional negligence in a lawyer’s failure to meet the state’s rule against perpetuities and restraints on alienation. After *Lucas*, the California court treated contract liability as superfluous and settled on negligence theory, which in California calls for applying “public policy” by “balancing” half a dozen “factors” in each case.

The Pennsylvania Supreme Court chose the contrary course in *Guy v. Liederbach*, 501 Pa. 47 (1983), a claim by a beneficiary who lost a legacy because the testator’s lawyer let her subscribe as a witness to the will. The court rejected both open-ended tort liability to foreseeably injured third parties and what it considered the “unworkable” California standard, *id.* at 57 . . .

The Connecticut Supreme Court . . . allowed a disappointed beneficiary of a testamentary trust to proceed against the testatrix’s lawyer on a contract theory over an objection that the lawyer’s promise obligated him only to the client and not to the intended beneficiary, because the benefit to the plaintiff also was the essence of the benefit promised to the testatrix.

We agree that the beneficiary in these cases is not only a plausible but a classic “intended” third-party beneficiary of the lawyer’s promise to his client within the rule of Restatement section 302(1)(b) and may enforce the duty so created, as stated *id.* section 304. The promise, of course, was not that the lawyer would pay plaintiff the stipulated sum, and it is too late for the lawyer to perform the promise that he did make, but this does not preclude an action for damages for the nonperformance. In principle, such an action is available to one in plaintiff’s position.

Because under third-party analysis the contract creates a “duty” not only to the promisee, the client, but also to the intended beneficiary, negligent nonperformance may give rise to a negligence action as well...

For this reason, we REVERSE so much of the decision of the Court of Appeals as affirmed the dismissal of the contract claim.

Zigas v. Superior Court

174 Cal. Rptr. 806 (California Court of Appeal, First District 1981)

FEINBERG, Justice.

Petitioners are tenants of an apartment building at 2000 Broadway in San Francisco, which was financed with a federally insured mortgage in excess of \$5 million, pursuant to the National Housing Act (12 U.S.C. § 1701 et seq.) (the Act) and the regulations promulgated thereunder (24 C.F.R. § 207 et seq.). They seek in a class action, inter alia, damages for the landlords’ (real parties in interest) violation of a provision of the financing agreement which requires that the landlords charge no more than the Department of Housing and Urban Development (HUD) approved schedule of rents. The trial court has sustained demurrers without leave to amend to 5 causes of action of 15 alleged, apparently on the ground that there is no right in the tenants to enforce the provisions of an agreement between their landlords and the federal government.

Petitioners allege that their landlords were required under their contract with HUD to file a maximum rental schedule with HUD and to refrain from charging more than those rents without the prior approval of the Secretary of HUD. Petitioners further allege that real parties are, and have been, charging rent in excess of the maximums set out in the rental schedule; the complaint avers that real parties have collected excessive rents and fees in an amount exceeding \$2 million.

The issues presented include: (1) whether federal or state law applies; (2) whether petitioners have standing to sue; and (3) whether the action has become moot as a result of real parties’ repayment of the HUD insured loan.

Federal or State Law

Real parties appear to argue at one point that whether petitioners have standing to sue is to be determined by federal law because a federal contract arising under a federal statute is involved. In so arguing, real parties misconceive the nature of the complaint in the case at bar. The complaint does not allege a federal cause of action, i.e., arising out of the National Housing Act. What it alleges, in substance, is that pursuant to the Act, an agreement was entered into between HUD and real parties whereby real parties promised not to charge as rent more than that approved by HUD. Real parties did so charge and petitioners, under California law, seek redress as the parties aggrieved...

We turn now to the question of whether petitioners have a cause of action under California law.

Standing to Sue-Third Party Beneficiary

California law clearly allows third-party suits for breaches of contract where no government agency is a party to the contract. (Civ. Code, § 1559.) Whether such suits are allowed when the government contracts with a private party depends upon analysis of the decisions in *Shell v. Schmidt* (1954) 126 Cal.App.2d 279 and *Martinez v. Socoma Companies, Inc.*, 11 Cal.3d 394 [(1974)].

In *Shell*, plaintiffs sued as third-party beneficiaries to defendant's contract with the Federal Housing Authority (FHA). The contract entailed an agreement by the defendant to build homes for sale to veterans according to plans and specifications submitted by the defendant to FHA in return for which FHA gave priorities to the defendant to secure the materials necessary for the building.

In deciding that plaintiffs had standing to enforce the terms of the contract between the defendant and the FHA, the *Shell* court relied on common law principles as embodied in Civil Code section 1559, which states: "A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it." Applying this provision to the facts before it, the *Shell* court observed: "Once it is established that the relationship between the contractor and the government is contractual, it follows that veterans purchasing homes, that is, the class intended to be protected by that contract, are third party beneficiaries of that contract. As already pointed out, the statute and the regulations passed thereunder resulting in the contract were passed to aid and assist veterans and for their benefit. Purchasing veterans constitute the class intended to be benefitted, and the contract must therefore be for their benefit." *Id.* at p. 290.

It is evident that petitioners are entitled to maintain a third-party cause of action under the *Shell* rationale. Real parties do not dispute the contractual nature of their relationship with HUD. And it is clear that a requirement of HUD approval of rent increases could only benefit the tenants.

Furthermore, even the most cursory review of the statutes and regulations which resulted in the contract in the present case leads to the conclusion that the tenants constitute the class which Congress intended to benefit. As stated in 12 United States Code section 1701t: “The Congress affirms the national goal, as set forth in section 1441 of Title 42, of ‘a decent home under a suitable living environment for every American family.’” (Section 1713(b) of title 12, United States Code, also provides, in part: “The insurance of mortgages under this section is intended to facilitate particularly the production of rental accommodations, at reasonable rents, ... The Secretary is, therefore, authorized ... to take action, by regulation or otherwise, which will direct the benefits of mortgage insurance hereunder primarily to those projects which make adequate provision for families with children, and *in which every effort has been made to achieve moderate rental charges.*” (Italics added, see also 24 C.F.R. § 207.19(e).)

This national goal, along with the purposes enunciated throughout the Act and the regulations promulgated thereunder, can leave no doubt that petitioners are members of the class which this legislation was intended to benefit. Under *Shell*, this conclusion, coupled with the uncontested contractual relationship between real parties and HUD, is sufficient to support the tenants’ standing to sue as third-party beneficiaries to a government contract.

In the subsequent case of *Martinez v. Socoma Companies, Inc.*, 11 Cal.3d 394 [(1974)], the court approved of the result in *Shell* but, at the same time, applied a different standard. Plaintiffs in *Martinez* sought to enforce the terms of a contract between Socoma Companies, Inc. and the Secretary of Labor. Under this agreement, defendants received government funds in exchange for a promise to hire and train “hard core unemployed” residents of a “Special Impact Area” in East Los Angeles. Defendants failed to perform, and plaintiffs, who were residents of East Los Angeles and members of the class which the government intended to benefit, sought to recover under the contract.

In holding that the plaintiffs had no standing to sue as third-party beneficiaries, the *Martinez* court adopted a more restrictive standard than that embodied in Civil Code section 1559, choosing instead to be guided by the principles set forth in section 145 of the [first] Restatement of Contracts: “A promisor bound to the United States or to a State or

municipality by contract to do an act or render a service to some or all of the members of the public, is subject to no duty under the contract to such members to give compensation for the injurious consequences of performing or attempting to perform it, or of failing to do so, unless, ... *an intention is manifested in the contract*, as interpreted in the light of the circumstances surrounding its formation, *that the promisor shall compensate members of the public for such injurious consequences...*”

Thus, under *Martinez*, standing to sue as a third-party beneficiary to a government contract depends on the intent of the parties as manifested by the contract and the circumstances surrounding its formation. “Insofar as intent to benefit a third person is important in determining his right to bring an action under a contract, it is sufficient that the promisor must have understood that the promisee had such intent. No specific manifestation by the promisor of an intent to benefit the third person is required.” *Lucas v. Hamm* 56 Cal.2d 583, 591 (1961).

We therefore must determine, from the terms of the contract between HUD and real parties and the attendant circumstances, whether there was manifested an intention that petitioners be compensated in the event of real parties’ nonperformance.

Mindful of the rule that “[w]hen a complaint is based on a written contract which it sets out in full, a general demurrer to the complaint admits not only the contents of the instrument but also any pleaded meaning to which the instrument is reasonably susceptible. [Citation.]” *Martinez v. Socoma Companies, Inc.*, 11 Cal. 3d at 400 and focusing upon the precepts of *Martinez* as to standing, we are of the view that the case falls within *Shell*; that is to say, appellants were direct beneficiaries of the contract and have standing, and not, as in *Martinez*, incidental beneficiaries without standing.

We explicate:

1. In *Martinez*, the contract between the government and Socoma provided that if Socoma breached the agreement, Socoma would refund to the government that which the government had paid Socoma pursuant to the contract between them. Thus, it is clear in *Martinez* that it was the government that was out of pocket as a consequence of the breach and should be reimbursed therefor, not the people to be trained and given jobs. In the case at bench, as in *Shell*, the government suffered no loss as a consequence of the breach, it was the renter here and the veteran purchaser in *Shell* that suffered the direct pecuniary loss.

2. Unlike *Martinez*, too, in the case at bench, no governmental administrative procedure was provided for the resolution of disputes arising under the agreement. Thus, to permit this litigation would in no way affect the “efficiency and uniformity of interpretation fostered by these administrative procedures.” *Martinez v. Socoma Companies, Inc.*, 11 Cal. 3d at 402. On the contrary, as we earlier noted, lawsuits such as this promote the federal interest by inducing compliance with HUD agreements.

3. In *Martinez*, the court held that “To allow plaintiffs’ claim would nullify the limited liability for which defendants bargained and which the Government may well have held out as an inducement in negotiating the contracts.” Here, there is no “limited liability.” As we shall point out, real parties are liable under the agreement, without limitation, for breach of the agreement.

4. Further, in *Martinez*, the contracts “were designed not to benefit individuals as such but to utilize the training and employment of disadvantaged persons as a means of improving the East Los Angeles neighborhood.” Moreover, the training and employment programs were but one aspect of a “broad, long-range objective” contemplated by the agreement and designed to benefit not only those to be trained and employed but also “other local enterprises and the government itself through reduction of law enforcement and welfare costs.”

Here, on the other hand, as in *Shell*, the purpose of the Legislature and of the contract between real parties and HUD is narrow and specific: to provide moderate rental housing for families with children; in *Shell*, to provide moderate priced homes for veterans.

5. Finally, we believe the agreement itself manifests an intent to make tenants direct beneficiaries, not incidental beneficiaries, of real parties’ promise to charge no more than the HUD approved rent schedule.

Section 4(a) and 4(c) of the agreement, providing that there can be no increase in rental fees, over the approved rent schedule, without the prior approval in writing of HUD, were obviously designed to protect the tenant against arbitrary increases in rents, precisely that which is alleged to have occurred here. Certainly, it was not intended to benefit the government as a guarantor of the mortgage.

Furthermore, the provision in section 11(d) of the agreement, authorizing the Secretary of HUD to “[a]pply to any court ... for specific performance ..., for an injunction against any violation ... or *for such other relief as may be appropriate*” (italics added) would entitle the secretary to seek restitution on behalf of the tenants overcharged, for such relief would surely be

“appropriate.” Thus, there was an intent upon the part of the government in executing the agreement with real parties, to secure the return of any rents exacted in excess of the rent schedule.

We are supported in our view by section 17 of the Agreement which specifically provides that real parties are personally liable, “(a) for funds ... of the project coming into their hands which, by the provisions [of the Agreement] *they are not entitled to retain*; and (b) for their own acts and deeds or acts and deeds of other [*sic*] which they have authorized in violation of the provisions [of the Agreement].” (Italics added.)

By the allegations of the complaint, real parties have “retained” in excess of \$2 million in violation of the Agreement. Therefore, they are liable for that sum. To whom should they be liable? To ask the question is to answer it. It is not the government from whom the money was exacted; it was taken from the tenants. Therefore, it should be returned to the tenants.

In the face of this evidence of intent to direct the benefits of mortgage insurance to the tenants of the facilities involved, real parties argue that petitioners have no standing to sue because enforcement of the agreement is vested solely in the Secretary. They point to 12 United States Code section 1731a, which empowers the Secretary to refuse the benefits of participation to any mortgagor who violates the terms of the agreement. However, section 1731a’s authorization does not constitute the exclusive remedy for enforcement of the agreement by the Secretary or by third parties. As stated by the court in *Shell v. Schmidt, supra.*, 126 Cal. App. 2d at p. 287: “This fundamental purpose would, in many cases, be defeated if the statute were interpreted so as to deprive the veterans of their normal remedies to the benefit of defaulting contractors-the very class it was the purpose of the statute to protect the veterans against. It must be held, therefore, that the enumeration of remedies in the statute merely created new enumerated remedies and was not intended to and did not deprive the veterans of any action for fraud or breach of contract that they might have under general common law principles.”

Similarly, it would be anomalous if a congressional program, and the regulatory agreement formed thereunder, all of which was designed to assist in providing housing for low and moderate income families, were construed so as to provide cheap financing for the housing industry while at the same time denying tenants any means of protecting the benefits which they were intended to receive.

Thus, for reasons we have set forth, appellants are entitled to maintain a third-party beneficiary action against real parties.

Conclusion

Surely it would be unconscionable if a builder could secure the benefits of a government guaranteed loan upon his promise to charge no more than a schedule of rents he had agreed to and then find there is no remedy by which the builder can be forced to disgorge rents he had collected in excess of his agreement simply because the government had failed to act.

Notes and Questions

1. The Second Restatement focuses on intent to distinguish between intended and incidental beneficiaries. That, however, leaves open a host of questions, including whose intent to focus on, intent for what exactly, and how intent should be proven.

Section 302 of the Restatement (Second) is somewhat unclear as to whose intent matters, mentioning in one place “the intention of the parties” and in another that “the promise intends to give the beneficiary the benefit.” Courts, similarly, at times, focus on both parties' intent and at other times on the promisee's intent. Compare, for example, *Grigerik v. Sharpe*, 721 A.2d 526, 529 (Conn. 1998) (“it is the intent of both parties to a contract that determines whether a third party is [an intended] beneficiary of a contract”) with *KMART Corp. v. Balfour Beatty, Inc.*, 994 F. Supp. 634, 637 (D.V.I. 1998) (“it is enough that the promisor ... understood that the promisee had an intent to benefit the third party.”). Which of those approaches make more sense? Is there any reason to give greater weight to the promisee's intent? Should any weight be given to the promisor's intent or knowledge?

One may also wonder if an intent to benefit the beneficiary suffices or does the beneficiary need to show intent to give it standing to enforce the contract. If, for example, the defendant's lease with the city stated that it must administer the leased property “for the benefit of the public at large,” does this mean that any member of the public is an intended third-party beneficiary? In *Libraries v. Marx*, No. 652427/13, 2014 WL 2472103 (N.Y. Sup. Ct. May 30, 2014), a case dealing with the New York Public Library, the court held it does not.

2. The centrality of intent means that, for the most part, parties are free to explicitly state that an individual is an intended third-party beneficiary of the contract (life insurance policies often include such a clause), that a specific third party is not an intended third-party beneficiary, or that the contract does not create *any* intended third-party-beneficiaries. The latter option, called “a no third-party beneficiary clause,” is often included in the boilerplate of commercial contracts.
3. If the contract is silent on the status of a third-party, courts can use any factor both within and outside of the contract to determine this question. Important factors include the naming of the beneficiary in the contract, the existence of specific arrangements in the contract regarding enforceability, the size of the beneficiary class, how central was the benefit to the contract, and the likelihood that the promisee will effectively enforce the promise on its own. What is the significance of those factors? Can you identify those and other factors that the cases above use in determining this question?
4. Any contract may create intended third- party beneficiaries. However, some common and often litigated categories can also be identified. Those include a promise to pay the promisee’s debt to a third party (as in *Lawrence v. Fox*), a clear promise to give the promisee’s gift to a third party, especially when the third party is a relative of the promisee (as in *Seaver v. Ransom*), a promise by a lawyer to draft a will or estate documents (as in *Hale v. Groce*), a promise to an employer to benefit its employees (for example, to provide health insurance to the employees), and governmental contracts (as in *Zigas v Superior Court*). See 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, 942-60 (1984).
5. Real estate development projects also often create intended third-party beneficiaries (*Vogan v. Haynes* is an example). Courts, for example, are often deciding whether an agreement between the owner and a general contractor makes the subcontractors intended third-party beneficiaries, and similarly, whether the contracts between the general contractor and its subcontractors make the owner an intended third-party beneficiary. *Prince*, at 60–73.
6. The government routinely enters contracts that benefit large segments of the population. Recognizing those beneficiaries as intended third-party beneficiaries might create a host of difficulties, including exposing the contractors to claims from a large

number of beneficiaries and the interventions of those beneficiaries in the government relationships and operations, including its ability to control the litigation and settlements of its contractual rights.

The Restatement demonstrates the careful approach needed in handling governmental contracts. It clarifies that while the general rules concerning third-party beneficiaries apply to such contracts, the contractor “is not subject to contractual liability to a member of the public for consequential damages ... 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 prescribing remedies for its breach.” Restatement (Second) of Contracts § 313.

With this in mind, do you agree with the decision in *Zigas* and especially with the ways in which the court distinguishes *Martinez*? For example, the court mentions that in *Martinez*, the contract includes a specific arrangement concerning enforcement. Why does it matter? Didn’t the parties in *Zigas* similarly have such arrangements in place?

7. Should the court recognize an intended third-party beneficiary status in those cases?
 - a. A buyer promised to purchase land, conditional upon the buyer securing a loan. A bank promised the buyer to finance the transaction but then reneged. Can the seller sue the bank?
 - b. A company promised to provide water at a certain pressure to a city. Should a resident be allowed to sue the company after a low water pressure prevented the fire department from extinguishing the fire on his property?
 - c. A county promised the Federal Aviation Administration to guarantee the safe operation of an airport and surrounding properties controlled by the county. The county, however, operated a large garbage dump near the airport, and a jet crashed after ingesting a large number of birds swarming over the airport and that dump. Can the estate of passengers that died in the crash sue the county under its contract with the FAA?

- d. A lease agreement between the city and a non-profit corporation that operated a large museum provided that the museum will not charge any admission fees. The museum charged admission fees on certain days. Can those who paid sue?
- e. In an agreement to provide for the maintenance of parking meters, a company promised the city to pay its employees according to a certain schedule and to provide them with certain benefits. Can the employees sue as beneficiaries of the company's agreement with the city?
- f. A buyer of real estate promised to pay the seller's final property tax bill in return for a discount in the purchase price. Can the government sue the buyer for breach of contract if it fails to pay the property tax?
- g. In order to participate in a complex federal program that provides funds for the purchase of medicines (which is part of Medicaid), pharmaceutical companies must sign an agreement with the Department of Health and Human Services (HHS), promising to charge hospitals not more than a predetermined cap. Can hospitals sue a pharmaceutical company that charged them more than it promised in its agreement with HHS?

B. The Power of Intended Third-Party Beneficiaries

We saw that an intended third-party beneficiary can sue a promisor for a breach of contract. That is, however, not the only way in which it is entitled to intervene in the contractual relationship once its rights vest. The following case considers the timing and significance of vesting.

Olson v. Etheridge

686 N.E.2d 563 (Illinois Supreme Court 1997)

BILANDIC, Justice.

Bay v. Williams, 112 Ill. 91 (1884), established the rule in Illinois that the rights of a third-party beneficiary in a contract are subject to immediate vesting and, once vested, cannot be altered or extinguished through a later agreement of the contracting parties without the assent of the beneficiary. We are here called upon to determine the continued validity of the Bay rule.

FACTS

The facts are not in dispute. The four plaintiffs were the owners of Heitzler, Inc., a John Deere dealership in Walnut, Illinois. In 1979 they sold all the stock in Heitzler, Inc., to a group of three buyers, including Dean Etheridge, for \$350,000 pursuant to the terms of a stock purchase agreement and a corresponding promissory note, hereinafter referred to as Agreement I and Note I. Agreement I and Note I obligated the buyers to make annual payments to the plaintiffs on December 1 of each year...

Nearly four years later, in August of 1983, Dean Etheridge and the appellant, August Engelhaupt, executed a written agreement wherein Etheridge sold one-half of his stock in the corporation to Engelhaupt, hereinafter referred to as Agreement II. In Agreement II, Engelhaupt agreed “to assume” one-half of Etheridge’s liability and obligation under Agreement I, which included the obligation to satisfy Note I. In exchange, Etheridge assigned one-half of his rights in Agreement I over to Engelhaupt. This assignment of rights was made subject to the terms of Agreement I. The entirety of Agreement I was incorporated by reference into Agreement II.

Agreement II obligated Engelhaupt to make annual payments [to the plaintiffs] on December 1 of each year. These payments were to be credited toward Etheridge’s balance due to the plaintiffs under Agreement I and Note I...

From 1983 through 1985, Engelhaupt apparently made the payments due under Agreement II and Note II ...

[On February 10, 1986 Etheridge, Engelhaupt, and one of Etheridge’s creditors, Citizens First National Bank of Princeton (Princeton Bank), entered a set of contracts. As part of those contracts, Engelhaupt completed the purchase of the stocks by paying the remaining of his debt to Princeton Bank (and not to the plaintiff, as provided in Agreement II).]

In March of 1986 the plaintiffs filed a complaint against the original purchasers of the corporation, including Etheridge, and against Engelhaupt. The counts against the original purchasers charged that they had defaulted on Agreement I and Note I. Count V was directed against Engelhaupt. In count V, the plaintiffs asserted that they were intended third-party beneficiaries of Agreement II, the contract entered into between Etheridge and Engelhaupt. The plaintiffs claimed that, as third-party beneficiaries of Agreement II, they were entitled to enforce it. They requested the circuit court to enter a judgment against Engelhaupt for the

sum of \$76,500 plus interest and attorney fees. The plaintiffs asserted that \$76,500 was the principal sum which remained owing under Agreement II.

Engelhaupt filed an answer to the plaintiffs' complaint and raised an affirmative defense. Engelhaupt first argued that the plaintiffs were not intended third-party beneficiaries of Agreement II. Alternatively, Engelhaupt argued that, even if the plaintiffs were intended third-party beneficiaries, any rights that they had under Agreement II were terminated before they brought suit. Specifically, Engelhaupt claimed that all his obligations under Agreement II and Note II were discharged by the actions taken between him, Etheridge, and Princeton Bank on February 10, 1986.

Ultimately, the circuit court granted the plaintiffs' motion for summary judgment against Engelhaupt on count V in the amount of \$159,375.08 (representing principal and accrued interest) plus \$22,000 in attorney fees.

Engelhaupt appealed, and the appellate court affirmed. The appellate court held that, as a matter of law, Agreement II conferred intended third-party beneficiary status on the plaintiffs. The appellate court reached this conclusion because Agreement II (1) incorporates by reference Agreement I; (2) states that Engelhaupt assumed one-half of Etheridge's liability and obligation under Agreement I; (3) contains a payment schedule identical to that in Agreement I; and (4) required Engelhaupt to make his payments directly to the plaintiffs' account.

The appellate court next rejected Engelhaupt's claim that his obligations to the plaintiffs as third-party beneficiaries under Agreement II and Note II were discharged by the actions taken between him, Etheridge, and Princeton Bank on February 10, 1986. The appellate court determined that *Bay v. Williams*, 112 Ill. 91 (1884), was dispositive of this issue. *Bay* established the rule in Illinois that third-party beneficiary rights are subject to immediate vesting and, once vested, cannot subsequently be altered or extinguished through a later agreement of the original parties to the contract. Applying the Bay rule, the appellate court concluded that the plaintiffs' third-party beneficiary rights in Agreement II vested immediately upon Etheridge's and Engelhaupt's execution of that agreement. Once this vesting occurred, Etheridge and Engelhaupt were powerless to modify the terms of Agreement II in a manner detrimental to the plaintiffs without their consent. The appellate court therefore affirmed the circuit court's grant of summary judgment in favor of the plaintiffs and against Engelhaupt.

We allowed Engelhaupt's petition for leave to appeal to determine whether *Bay* remains good law.

ANALYSIS

As a preliminary matter, we note that Engelhaupt does not challenge the appellate court's initial holding that the plaintiffs are intended third-party beneficiaries of Agreement II. We therefore accept that holding as correct for purposes of this appeal ...

Engelhaupt ... argues that the *Bay* rule should be replaced with the vesting rule set forth in section 311 of the Restatement (Second) of Contracts (1981). According to Engelhaupt, if section 311 is applied, the summary judgment entered in favor of the plaintiffs was improper because questions of material fact remain to be determined...

Before addressing the parties' arguments, we briefly summarize third-party beneficiary law. The well-established rule in Illinois is that if a contract is entered into for the direct benefit of a third person, the third person may sue for a breach of the contract in his or her own name, even though the third person is a stranger to the contract and the consideration. This principle of law is widely accepted throughout the United States, because allowing a third-party beneficiary to sue the promisor directly is said to be manifestly just and practical. In cases such as this one, it increases judicial efficiency by removing the privity requirement, under which the beneficiary must sue the promisee, who then in turn must sue the promisor.

An important corollary to this principle is that the promisor may assert against the beneficiary any defense that the promisor could assert against the promisee if the promisee were suing on the contract. This is because the third-party beneficiary's rights stem from a contract to which the beneficiary is not a party. Accordingly, the promisor in this case, Engelhaupt, may assert against the plaintiffs-beneficiaries any defense that he could assert against the promisee, Etheridge, if Etheridge were suing him on Agreement II. Engelhaupt here asserts the defense that all his obligations under Agreement II and Note II were discharged when he made full payment to Princeton Bank [on February 10, 1986].

The plaintiffs maintain, however, that Engelhaupt is not entitled to assert this defense against them because their rights as third-party beneficiaries had "vested." The vesting doctrine is an exception to the above rule that the promisor may assert against the beneficiary any defense that the promisor could assert against the promisee. Under this doctrine, once a third-party beneficiary's rights vest, the original contracting parties cannot modify or discharge those

rights without the beneficiary's assent. The question of vesting arises only where the promisor and the promisee purport to vary or discharge the rights of the beneficiary; otherwise, the topic of vesting is irrelevant...

[The court explains that the plaintiffs are the beneficiaries of Engelhaupt's promise in Agreement II "to assume" one-half of Etheridge's obligation to pay the plaintiffs under Agreement I, and that on February 10, 1986 Engelhaupt, Etheridge, and Princeton Bank purported to modify and discard that promise.]

We now turn to the primary issue in this case: how vesting should be defined in this context. The plaintiffs urge application of the vesting rule declared in *Bay*. Engelhaupt, on the other hand, asks us to apply the vesting rule set forth in section 311 of the Second Restatement of Contracts.

In *Bay*, Williams sold land to Newman and Sissons in exchange for a down payment and promissory notes payable in installments. Newman and Sissons then sold the land to Bay. The deed tendered to Bay contained an express promise by Bay to pay the balance due on the promissory notes executed by Williams and Newman and Sissons. Bay later obtained a release of his obligation to pay Williams from Sissons. Newman went bankrupt without giving Bay a release. Williams exercised her power of foreclosure and sold the land, but was left being owed \$3,559 on the notes. She sued Bay for that amount as third-party beneficiary of the deed between Newman and Sissons and Bay.

Bay argued that he was absolved from his promise to pay the promissory notes by Sissons' release. He proposed ... different theories: (1) that third-party beneficiary rights do not vest until suit is brought; [and] (2) that third-party beneficiary rights do not vest until the beneficiary relies upon or accepts the promisor's promise.... This court in *Bay* rejected these views, holding:

"[The promisor's] promise invests the person for whose use it is made with an immediate interest and right, as though the promise had been made to him. This being true, the person who procures the promise has no legal right to release or discharge the person who made the promise, from his liability to the beneficiary. Having the right, it is under the sole control of the person for whose benefit it is made,—as much so as if made directly to him."

Consequently, *Bay* established the rule in Illinois that third-party beneficiary rights vest immediately and cannot be altered or extinguished through a later agreement of the original parties to the contract, unless the beneficiary assents.

Engelhaupt urges us to replace the *Bay* rule with the “modern view” as set forth in section 311 of the Second Restatement. Section 311, entitled “Variation of a Duty to a Beneficiary,” stands in direct contrast to *Bay*. It provides that, in the absence of language in a contract making the rights of a third-party beneficiary irrevocable, the parties to the contract “retain power to discharge or modify the duty by subsequent agreement,” without the third-party beneficiary’s assent, at any time until the third-party beneficiary, without notice of the discharge or modification, materially changes position in justifiable reliance on the promise, brings suit on the promise or manifests assent to the promise at the request of the promisor or promisee. Restatement (Second) of Contracts § 311 (1981).

Section 311 now represents the majority view on the subject of vesting. *Karo v. San Diego Symphony Orchestra Ass’n*, 762 F.2d 819 (9th Cir.1985) (applying California law); see, e.g., *Bridgman v. Curry*, 398 N.W.2d 167 (Iowa 1986); *Detroit Bank & Trust Co. v. Chicago Flame Hardening Co.*, 541 F.Supp. 1278 (N.D.Ind.1982) (applying Indiana law). In contrast, the immediate vesting rule as set forth in *Bay* represents the minority view, followed by only a handful of states.

Engelhaupt maintains that we should adopt section 311. He asserts that section 311 represents the majority rule on vesting because it better conforms to modern commercial practices and general principles of contract law. According to Engelhaupt, parties should remain free to modify or discharge their contracts as they see fit, without the assent of a third-party beneficiary, subject only to the three exceptions provided for in section 311. Section 311 makes sense, Engelhaupt contends, because third-party beneficiaries should not be able to enforce contracts for which they do not give any consideration, unless they demonstrate some detriment or act of faith in reliance on the contract.

Engelhaupt asserts that the superiority of the Restatement approach over the *Bay* rule is demonstrated by the facts present in this case. As he explains, the plaintiffs here freely chose to extend credit to Etheridge, who was then bound to pay them under Agreement I and Note I. Etheridge and Engelhaupt then freely contracted with each other that Engelhaupt would make one-half of Etheridge’s payments to the plaintiffs, in Agreement II and Note II. The plaintiffs, however, were not bound to accept Engelhaupt’s promise to pay in Agreement II

and Note II in replacement of Etheridge's promise to pay in Agreement I and Note I, and did not do so. Consequently, the plaintiffs' contractual remedies against Etheridge in the event of Etheridge's nonpayment under Agreement I remained intact. Engelhaupt asserts that, in this situation, he and Etheridge should not be forever barred from modifying or discharging their agreement without the plaintiffs' assent, which is precisely what *Bay* mandates. Rather, Engelhaupt asserts, the third-party beneficiary plaintiffs should be found to have obtained vested rights in his and Etheridge's contract only if they meet one of the circumstances set forth in section 311.

Finding Engelhaupt's arguments persuasive, we hereby adopt the vesting rule set forth in section 311 of the Second Restatement. The rationale underlying section 311's vesting rule is that parties to a contract should remain free to amend or rescind their agreement so long as there is no detriment to a third party who has provided no consideration for the benefit received. This rationale is compelling. Moreover, we find this rationale to be consistent with the general principles running throughout contract law. Contract law generally favors the freedom to contract. Contract law also allows for equitable remedies where the facts compel such a result.

In contrast, the immediate vesting rule of *Bay* curtails the freedom to contract. It provides, in essence, that every promise which benefits a third-party beneficiary carries with it another term, implied at law, that the parties to the contract are prohibited from modifying or discharging the promise that benefits the beneficiary, without the beneficiary's assent. We do not believe that the modern law of contracts should always imply such a term. To do so can work a great injustice upon the parties involved in a particular case. Although, as the plaintiffs contend, the *Bay* rule is clear and easy to apply, this does not persuade us to retain it. Our concern is that the rule of law we expound best serves the pursuit of justice, not that it is the easiest rule of law for courts to apply.

In conclusion, we adopt the vesting rule set forth in section 311 of the Second Restatement. *Bay* is hereby overruled. The circuit court awarded summary judgment to the plaintiffs based on the *Bay* rule. The circuit court did not consider the plaintiffs' motion for summary judgment in the context of the vesting rule of section 311. We therefore REVERSE this award of summary judgment for the plaintiffs and REMAND to the circuit court for further proceedings, consistent with section 311's vesting rule. [The case is remanded so that the plaintiff's reliance can be considered in light of section 311].

Notes and Questions

1. The case deals with the moment of vesting. As the court explains, once the right of the intended third-party beneficiary vests, it gets additional legal protection by limiting one of the core rights of contracting parties—the right to modify or cancel their agreement. This powerful right might provide another reason for being careful in recognizing third parties as intended beneficiaries, especially when it comes to governmental contracts.
2. Under the First Restatement, the rights of donee beneficiaries vested immediately, but the rights on creditor beneficiaries vested later. The Second Restatement eliminated this distinction, and most courts agree. Under Section 311 of the Second Restatement, the rights of intended third-party beneficiaries vest when they either rely on the promise, sue to enforce the promise, or accept it.
3. There are multiple cases and contexts within contract law in which justified reliance can, at times, limit the freedom that a party (or in this case, both parties) otherwise have. The most important example is promissory estoppel, where reliance causes a promise that is not supported by consideration to be binding. Interestingly, while in many other contexts, including promissory estoppel, the promise is enforced “as justice required,” here, no similar limitation exists. Does that result make sense? Assume, for example, that a mother enters a contract with a university to pay her son’s \$20,000 tuition, and the son, after learning about that contract, purchases a \$100 book. If the mother and the university mutually decide to cancel their agreement, what is the son’s remedy?
4. Even if the intended beneficiary neither relied on the promise nor sued to enforce it, its rights might vest “when the beneficiary manifests assent to the promise in a manner invited by the promisor or promisee.” Restatement (Second) of Contracts § 311, cmt. h. The Restatement explains that “[t]his rule rests in part on an analogy to the law of offer and acceptance and in part on the probability that the beneficiary will rely in ways difficult or impossible to prove.” *Id.*
5. The vesting rule is a default rule, and parties can explicitly set their own rule concerning vesting, including by adopting the older rule that vests the rights of the third party immediately. The Restatement notes that those arrangements “are unusual and would often be unwise.” Restatement (Second) of Contracts § 311, cmt b. Do you agree?

Would most parties perceive the default rule, set forth by the Second Restatement, as wiser?

6. In *Olson*, the court states that “the promisor may assert against the beneficiary any defense that the promisor could assert against the promisee if the promisee were suing on the contract. This is because the third-party beneficiary’s rights stem from a contract to which the beneficiary is not a party.” Restatement (Second) of Contracts § 209 similarly recognizes that promisors can assert almost all defenses against intended third-party beneficiaries.

As the source of the promisor’s obligations to the beneficiary is the contract between the promisor and the promisee, any formation defense that would make the contract or those promises voidable or unenforceable can be asserted against the beneficiary. For example, if the promisor was a minor when the contract was made or if it was an oral contract within the statute of frauds, the promisor can avoid the contract, which would release its obligations to both the promisee and the beneficiary.

In addition, the promisor can assert performance excuses, such as impracticability. Importantly a failure of a condition affects the beneficiary’s right as much as the promisee’s rights. If, for example, Alice promises to pay Charlie \$100 in consideration for Bob cleaning her house, then the failure of Bob to clean, assuming it is a material breach, will allow Alice to suspend her duty to pay Charlie.

Defenses that are outside the scope of the contract are not available against the beneficiary. For example, if Alice promises to pay Bob \$100 as soon as he cleans her house, but Bob owes her \$40 in relations to a separate contract, Alice is typically allowed to setoff one debt for the other and pay Bob only \$60. However, if the agreement between Alice and Bob requires her to pay the \$100 to Charlie as an intended third-party beneficiary, Alice cannot use setoff against Bob’s other debt and must pay Charlie the full \$100.