Formation of Contracts - Part 2

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This second article in the series considers three further factors relating to the formation of contracts.

Privity of contract As contract law, a least in theory, is based upon negotiation, and market transactions freely entered into, it follows that as a general rule contractual agreements can only affect those persons who have entered into the agreement expressed in the terms of the contract.

The corollary of this, however, is that a contract can only impose rights on those persons who are parties to it. In other words, it is normally the case that no third party can rely on, or enforce any terms in a contractual agreement to which they are not themselves a party. Thus stated, this is the meaning and effect of the doctrine of privity.

- The classic case in this point is *Dunlop v. Selfridge* (1915) in which a tyre manufacture sought to enforce resale price maintenance through a series of linked contractual agreements. The manufacturer, Dunlop, sold tyres to a distributor, Dew & Co., on terms that the distributor would not sell them at less than the manufacturer's list price, and that they would extract a similar undertaking from any retailer they supplied with tyres. Dew & Co. resold the tyres to Selfridge who agreed to abide by the restrictions and to pay Dunlop £5 for each tyre they sold in breach of them. When Selfridge sold tyres at below Dunlop's list price, Dunlop sought to recover the promised £5 per tyre sold. It was held that Dunlop could not recover damages on the basis of the contract between Dew and Selfridge for the simple reason that they, Dunlop, were not a party to the agreement and consequently had no rights under, or in relation to, it.

Exceptions to the privity rule

It is possible to formally transfer the benefit of a contract to a third party. This process, known as assignment, must be in writing. It should be noted that the burden of a contract cannot be assigned without the consent of the other party to the contract.

It is also possible for a person to create a contract specifically for the benefit of a third party. In such limited circumstances the promisee is considered as a trustee of the contractual promise for the benefit of the third party. In order to enforce the contract the third party must act through the promisee by making them a party to any action *(Les Affreteurs Reunis SA v. Leopold Walford (London) Ltd* (1919)).

Dunlop v. Selfridge was a restraint of trade case and so was unlikely to find favour with the judiciary, but in other cases, of a more sympathetic nature, the courts have been more willing to find ways in which the consequences of the strict operation of the doctrine of privity can be avoided in order to allow a third party to enforce a contract. Such instances tend to occur as follows:

- **the beneficiary sues in some other capacity**. Although not a party to the original agreement, individuals may, nonetheless, acquire the power to enforce the contract where they are legally appointed to administer the affairs of one of the original parties. An example of this can be seen in *Beswick v. Beswick* (1967) in which a coal merchant sold his business to his nephew in return for a weekly consultancy fee during his lifetime, and thereafter an annuity of £5 per week payable to his widow. On the death of the uncle, the

- nephew stopped paying the widow. However, once the widow was appointed administratrix of her late husband's estate she successfully sued the nephew for specific performance of the agreement in that capacity. Thus she was able to enforce an agreement in her favour that she could not have enforced in her personal capacity as she was not a party to it.

- **the situation involves a collateral contract**. This situation arises where one party promises something to another party if that other party enters into a contract with a third party: e.g., A promises to give B something if B enters into a contract with C. In such a situation B can insist on A complying with the original promise. An example of the operation of collateral contracts can be seen in *Shanklin Pier v. Detel Products Ltd* (1951) which concerned the painting of a seaside pier. On the basis of promises as to its quality, the defendants persuaded the pier company to insist that a particular paint produced by Detel be used when their pier was repainted. The painters used the paint but it proved unsatisfactory. When the plaintiffs sued for breach of the original promise as to the paint's suitability, the defendants countered that the only contract they had entered into was between them and the painters to whom they had sold the paint. They maintained that as the pier company was not a party to that contract it had no right of action against Detel. It was held that in addition to the contract for the sale of paint, there was a second collateral contract between the plaintiffs and the defendants by which the latter guaranteed the suitability of the paint in return for the pier company specifying that the painters used it. The pier company, therefore, successfully sued the paint manufacturers.

- **it is foreseeable that damage caused by any breach of contract will cause a loss to a third party**. In *Linden Gardens Trust Ltd v. Lenesta Sludge Disposals Ltd* (1994) the original parties had entered into a contract for work to be carried out on property with the likelihood that it would subsequently be transferred to a third party. The defendant's poor work, amounting to a breach of contract, only became apparent after the property had been transferred. There had been no assignment of the original contract and normally under the doctrine of privity the new owners would have no contractual rights against the defendants and the original owners of the property would have suffered only a nominal breach as they had sold it at no loss to themselves. Nonetheless the House of Lords held that under such circumstances and within a commercial context, the original promisee should be able to claim full damages on behalf of the third party for the breach of contract.

The other main exception to the privity rule is agency, where the whole point is for the agent to bring about contractual relations between their principal and a third party.

In the area of motoring insurance statute law has intervened to permit third parties to claim directly against insurers, but much wider statutory intervention has been proposed by a recent Law Commission Report (1996) which recommended that third parties should be entitled to enforce contracts entered into for their benefit. At present if someone buys a present for someone else and it turns out to be faulty then, due to the operation of the privity rule, the recipient of the present has no contractual rights against the supplier. The Law Commission's proposal would remove this legal technicality by permitting the third party to take action against the supplier. It should be noted that the proposal does not give rights to all third parties. It is essential, for example, that the contract actually seeks to benefit the third party so it will not affect the situation where someone buys something and makes a present of it to a third party. In such a situation the contract whereby the article was originally bought did not purport to give any rights to the third party and therefore it would still not be covered by the proposed legislation.

Capacity Capacity refers to the fact that the law does not recognise the ability of some people to enter into binding contractual arrangements, or at least limits their capacity to enter into such arrangements. The reason for this is the paternalistic one that such individuals might not be in a position to fully appreciate the terms of any agreement they might enter into and consequently there is the possibility that they will be taken advantage of without their even realising it.

Minors

In general terms, adults of sound mind have full contractual capacity and are free to enter into such agreements as they wish and will be required to comply with any such. Minors, however, those under the age of 18, do not have full capacity. The rules which apply to minors are a mixture of common law and statute, and depend on when the contract was made. Contracts entered into after 9th June 1987 are subject to the Minors' Contracts Act (1987). In considering the cases cited in relation to capacity of minors it should be remembered that the age of majority was only lowered to 18 from 21 in 1969, so in the early cases minors were significantly older than they are now.

Agreements entered into by minors may be classified within three possible categories:

Valid contracts.

Voidable contracts.

Unenforceable contracts.

***(i)* Valid contracts**

These are agreements that can be enforced against minors and involve one of the following:

- **contracts for necessaries**. Minors are under a legal obligation to pay for things necessary for their maintenance although even then they will only be required to pay a reasonable price for any necessaries purchased. Necessaries are defined in the Sale of Goods Act, Section 3, as goods suitable to the condition in life of the minor and their actual requirements at the time of sale. The classic case on this point is the wonderfully anachronistic *Nash v. Inman* (1908) in which a tailor sued a minor to whom he had supplied clothes, including 11 fancy waistcoats. It was decided that, as the minor was an undergraduate at Cambridge University at the time, the clothes were suitable according to the minor's station in life. Unfortunately for the tailor, however, it was further decided that they were not necessary, as he already had sufficient clothing.

- **beneficial contracts of service**. A minor is bound by a contract of apprenticeship or employment, as long as it contains an element of education or training and is, on the whole, for their benefit. In *Doyle v. White City Stadium* (1935), a minor who had obtained a professional boxer's licence, attempted to avoid some of the rules contained in the agreement by having it declared unenforceable due to his lack of capacity. In deciding the case, not only was the licence treated as a contract of apprenticeship, but it was also held that, taken as whole, it was beneficial to him.

***(ii)* Voidable contracts**

These may be avoided by the minor, but if no steps are taken to repudiate the contract during the time of their minority, or within a reasonable time after reaching the age of majority, then they are binding and cannot be avoided subsequently.

Voidable agreements relate to transactions in which the minor acquires an interest of a permanent nature with obligations continuing into the time of their majority: examples are contracts for shares, or leases of property, or partnership agreements.

The minor will only be able to recover money paid out under the terms of the agreement before repudiation of the contract, where there is a total failure of consideration. In other words they will not be able to recover the money unless they received no benefit whatsoever from the agreement. As an example see Steinberg v. Scala (Leeds) (1923) in which a minor, applied for and was allotted shares in the defendant company. After paying some money on the shares she repudiated the contract. Although the company agreed to remove her name from its register of members, it refused to return any of her money. It was held that the plaintiff had benefited from membership rights and thus, as there had not been a complete failure of consideration, she was not entitled to the return of the money paid.

***(iii)* Unenforceable contracts**

Under the Infants Relief Act (1874) the following contracts were stated to be absolutely void:

- contracts for the repayment of loans;
- contracts for goods other than necessaries;
- accounts stated: i.e., admissions of money owed.

In addition, no action could be brought on the basis of the ratification, made after the attainment of full age, of an otherwise void contract.

Although the Infants Relief Act stated that such contracts were absolutely void; in effect this simply meant that they could not be enforced against the minor. The Minors' Contracts Act 1987 now declares that the contracts set out in the Infants Relief Act are no longer to be considered as absolutely void. As a consequence, unenforceable contracts may be ratified on the minor attaining the age of majority.

The Minors' Contracts Act has also given the courts wider powers to order the restoration of property acquired by a minor. They are no longer restricted to cases where the minor has acquired the property through fraud but can order restitution where they think it "just and equitable" to do so.

Minors liability in tort

As there is no minimum age limit in relation to actions in tort, minors may be liable under a tortious action. The courts, however, will not permit a party to enforce a contract indirectly by substituting an action in tort, or quasi-contract, for an action in contract. Thus in *Leslie v. Shiell* (1914), the defendant, whilst a minor, had obtained a loan from Leslie by lying about his age. When Leslie sued to recover the money as damages in an action for the tort of deceit, it was held that he could not succeed as he was merely using an indirect way of enforcing the otherwise void contract.

Mental incapacity and intoxication

Age is not the only ground for denying capacity to someone in order to protect them from entering into adverse contractual agreements. The law, however, is less accommodating towards these other forms of incapacity. Thus any contract entered into by a person who is of unsound mind or under the influence of drink or drugs is prima facie valid. The onus is placed on the party claiming such incapacity in order to avoid a contract to show:

- that their mind was so affected at the time that they were incapable of understanding the nature of their actions; and
- that the other party either knew or ought to have known of their disability;
- even then, if the contract relates to necessities, they will still be bound by the contract but will only be required to pay a reasonable price for them.

Intention to create legal relations In order to limit the number of cases that might otherwise be brought, the courts will only enforce those agreements which the parties themselves intended to have legal effect. Although expressed in terms of the parties' intentions, the test for the presence of such intention is an objective, rather than a subjective, one. In deciding cases the courts will apply different presumptions depending on the context of the agreement.

- **Domestic and social agreements**
  In this type of situation the presumption is that the parties do not intend to create legal relations when they exchange promises. Thus in *Balfour v. Balfour* (1919) when a husband returned to Ceylon to take up his employment he promised his wife, who could not return with him due to ill health, that he would pay her £30 per month as maintenance. When the marriage later ended in divorce the wife sued for the promised maintenance. It was held that the parties had not intended the original promise to be binding and therefore it was not legally enforceable. A similar presumption was applied to decide the case of *Jones v. Pandavatton* (1969) in which a daughter failed in an action for breach of contract against her mother. The mother had promised to provide for the daughter whilst she completed her legal study, but had later refused to keep the promise.

  It is essential to realise that the intention not to create legal relations in such relationships is only a presumption and that, as with all presumptions, it may be rebutted by the actual facts and circumstances of a particular case. Thus the presumption applied in *Balfour v. Balfour* was successfully rebutted in *Merritt v. Merritt* (1970) where it was held that the agreement between a married, although separated, couple was enforceable, as in the circumstances the parties had clearly intended to enter into a legally enforceable agreement.

  Similarly, in *Simpkins v. Pays* (1955) what appeared to be a social agreement between members of a household in relation to entering a competition, was held to be a binding agreement.

- **Commercial agreements**
  In commercial situations there is a strong presumption that the parties intend to enter into a legally binding relationship in consequence of their dealings. An example of the operation of the presumption is *Edwards v. Skyways* (1964). In this case the plaintiff's employers had promised to make him what they referred to as an ex gratia payment as a result of his redundancy. It was held that in such a situation the use of the term *ex gratia* was not sufficient to rebut the presumption that the establishment of legal relations had been

intended. Edwards was, therefore, entitled to the payment promised.

As with the presumption relating to domestic and social agreements, this one is also open to rebuttal. In commercial situations, however, the presumption is so strong that it will usually take express words to the contrary to avoid its operation. An example of just such wording can be found in *Rose & Frank Co v. Crompton Bros* (1925) in which it was held that an express clause stating that no legal relations were to be created by a business transaction was effective. Another example involves agreements, such as football pools coupons, which are stated to be "binding in honour" only *(Jones v. Vernon's Pools Ltd* (1938)).

Collective agreements between employers and trade unions make up a distinct category of agreement, for although they are commercial agreements, they are presumed not to give rise to legal relations, and, therefore, are not normally enforceable in the courts *(Ford Motor Co v. AUEFW* (1969)).

Letters of comfort are documents used by parent companies to encourage potential lenders to extend credit to their subsidiaries by stating their intention to provide financial backing for those subsidiaries. It is generally the case that such documents merely amount to statements of present intention on the part of the parent company. They do not amount to offers that can be accepted by the creditors of any subsidiary companies and therefore are, by and large, not worth the paper they are written on(*Kleimwort Benson v. Malaysian Mining Corp* (1989)).