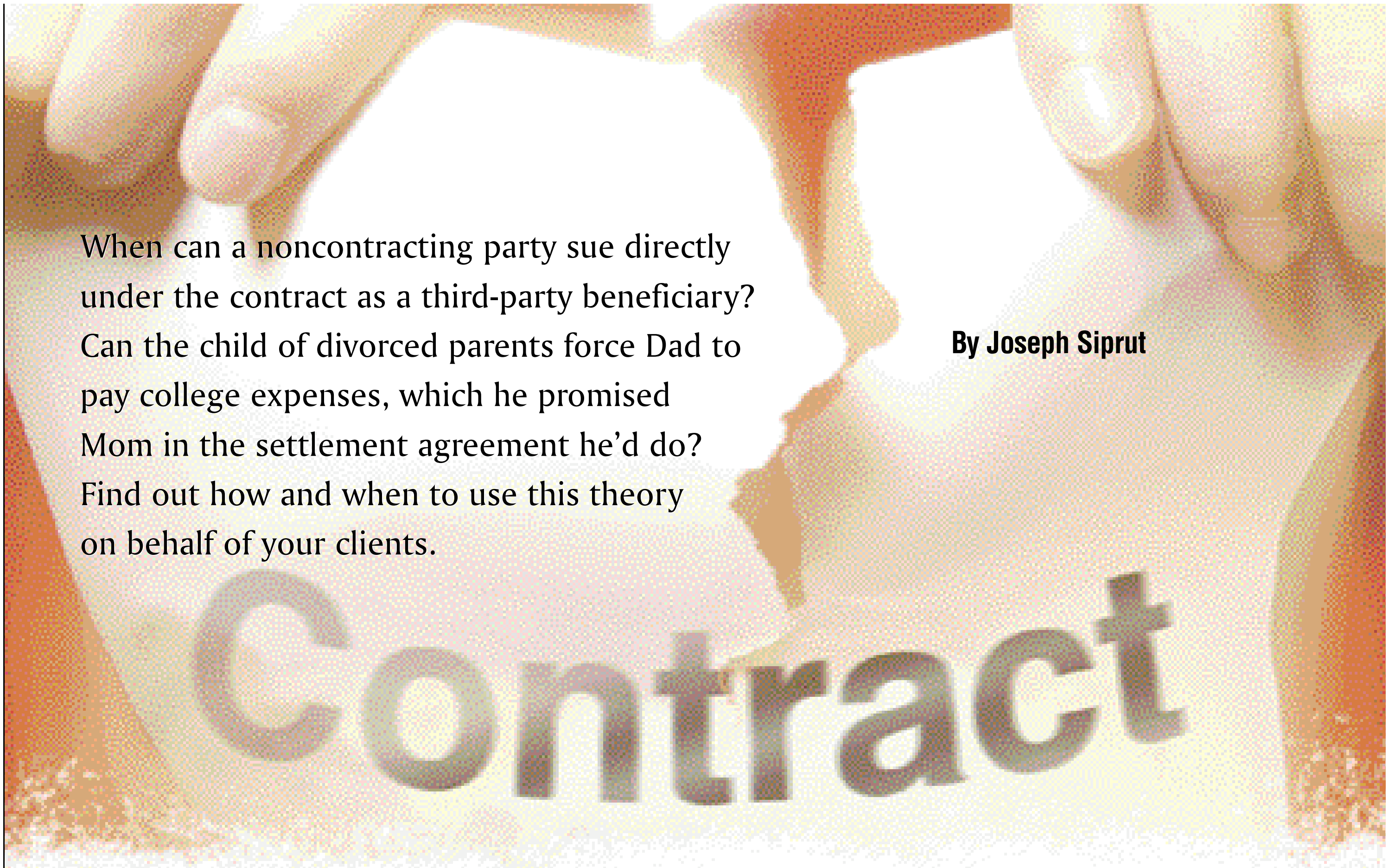


When can a noncontracting party sue directly under the contract as a third-party beneficiary? Can the child of divorced parents force Dad to pay college expenses, which he promised Mom in the settlement agreement he'd do? Find out how and when to use this theory on behalf of your clients.

By Joseph Siprut

# Third-Party Beneficiary Basics:

## When Can Noncontracting Parties Sue for Breach?

**Suppose that a company enters into an agreement with a developer to rent space in a new building currently under design. Suppose further that the contract between the developer and his architect contains a provision stating that the new building will be for the use of all "future tenants," and provides that the architect must consult jointly with the developer and tenants concerning certain design issues. If the architect subsequently breaches the agreement with the developer and the building is never constructed, can the company sue the architect for damages?**

Consider also the case of a once happy husband and wife who now seek a divorce, and whose marriage has produced three children. The settlement agreement between the husband and wife obligates the husband to provide for the educational expenses of "the children." Later, before and while the children attend college, the husband suffers great financial hardship and makes no payments toward the children's college educations.

The wife ultimately sympathizes with the husband's plight, and the two of them modify the settlement agreement to relieve the husband of his obligation. Can the children nevertheless sue their father for breach of the settlement agreement with their mother and recover their college expenses?

These hypotheticals raise a fundamental and important question of contract law: when can a third-party stranger to a contract acquire legally cognizable rights under the contract? This article addresses these and related issues concerning such third-party beneficiary claims.

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## Third-party beneficiaries generally

The well-established rule in the vast majority of jurisdictions is this: if a contract is entered into for the direct benefit of a third person, that 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 contractual consideration.

This principle is widely accepted throughout the United States because – in those limited situations in which third-party beneficiary rights are found to exist – allowing a third-party beneficiary to sue the promisor directly is said to increase judicial efficiency by removing the privity requirement, under which the beneficiary must sue the promisee, who then in turn must sue the promisor.[1]

With that said, the more difficult question becomes under what circumstances such third-party claims may be brought. Indeed, while third-party claims are generally permitted in all jurisdictions, the criteria allowing them are rigorous.

As a threshold matter, to recover as a third-party beneficiary, the plaintiff must first plead facts that establish the existence of a contract. The elements of a legally binding contract are (i) an offer, (ii) acceptance of that offer, and (iii) consideration – i.e., any act or promise which is of benefit to one party or disadvantage to the other. Moreover, there must be mutual assent, or a "meeting of the minds," by the contracting parties on the essential terms and conditions of the subject about which they are contracting.

Having established the existence of a contract, the plaintiff must then prove that it was breached. After all, if the underlying contract has not been breached – and neither of the actual parties to the contract has claims under it – a stranger to the contract certainly cannot bring claims.

Thus far we have seen that any potential third-party plaintiff must, if he chooses to bring claims under a contract between two other parties, first establish the existence of a valid contract as between those two parties and that the contract has been breached. But the third-party plaintiff's work is just beginning.

The law draws a distinction between *intended* beneficiaries and *incidental* beneficiaries to a contract. Although the former have contractual rights (and can bring suit), the latter do not.[2] The test a non party must meet to qualify as an intended beneficiary is strict:

> [T]here is a strong presumption that parties to a contract intend that the contract's provisions apply to only them and not to third parties. In order to overcome that presumption, the implication that the contract applies to third parties must be so strong as to be practically an express declaration….Liability to a third-party must affirmatively appear from the contract's language and from the circumstances… at the time of its execution, and cannot be expanded or enlarged simply because the situation and circumstances justify or demand further or other liability.[3]

**While third-party claims are permitted in all jurisdictions, third-party claimants must meet rigorous standards.**

Put simply, a third-party to a contract may qualify as a third-party beneficiary when the promisor's liability to that third-party affirmatively appears from the contract's language and from the circumstances at the time of its execution.

A word of caution is also in order. It is often said that for a third party to have the right to sue, the language of the contract must affirmatively make it clear that the contract was made for the third party's direct benefit.[4] This is not to be taken lightly. Even when a third-party clearly benefits from a contract, that person will not be deemed a *direct* beneficiary unless the promisor evidences intent to be directly liable to that third-party.[5]

## Defenses to a third-party claim and the rule of vesting

The promisor may assert against the third-party beneficiary any defense that the promisor could assert against the promisee if the promisee himself were suing on the contract.[6] Thus, not only must any potential third-party beneficiary establish the existence – and breach – of a contract for which he was an intended direct beneficiary, but he must also deal with any defenses to the alleged breach that the defendant-promisor may have.

There is, however, an exception to the rule that the promisor may assert any defense against the beneficiary that he or she could against the promisee. Under the so-called "vesting" 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 whether a third-party beneficiary's rights have vested arises when the promisor and promisee – the contracting parties – attempt to vary or discharge the rights of the beneficiary.[7]

The majority rule is that in the absence of language in a contract making the rights of a third-party beneficiary irrevocable, the parties to the contract retain the ability to discharge or modify the rights of third-party beneficiaries, without that third-party's assent, until those rights vest in the third-party. Importantly, vesting occurs only when the third-party, without notice of the discharge or modification, (i) materially changes his position in justifiable reliance on the promise, (ii) brings suit on the promise, or (iii) manifests assent to the promise at the request of the promisor or promisee.[8]

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1. *Olson v Etheridge*, 177 Ill 2d 396, 404 (1997). See generally 17A Am Jur 2d Contracts § 437 (2004).
2. *Ball Corp v Bohlin Bldg Corp*, 187 Ill App 3d 175, 177, 543 NE2d 106, 107 (1st D 1989). See, e.g., *Prouty v Gores Tech Group*, 121 Cal App 4th 1225, 1232 (3d D 2004); *Zelber v Lewoc*, 6 AD3d 1043, 1045, 776 NYS2d 134, 136 (3d Dept 2004).
3. *Ball Corp* at 177, 543 NE2d at 107 (internal citations omitted).
4. *Barney v Unity Paving, Inc*, 266 Ill App 3d 13, 19, 639 NE2d 592, 596 (1st D 1994), relying on *Waterford Condo Assn v Dunbar Corp*, 104 Ill App 3d 371, 373, 432 NE2d 1009, 1011 (1st D 1982).
5. See, e.g., *Kelleher v Kelleher*, 21 Ill App 3d 601, 316 NE2d 212 (1st D 1974). There, the plaintiff child petitioned the court to compel his father to pay past-due child support. The court found that because the payments at issue were to be made to the mother – albeit for the benefit of the child – the child did not have third-party standing. The benefits were deemed to flow directly to the mother and only indirectly to the child, and no third-party action by the child could be maintained.
6. *Olson* at 404, 686 NE2d at 566-67.
7. Id.
8. Id at 408-09, 686 NE2d at 568 (noting the rationale underlying this rule is that "parties to a contract should remain free to amend or rescind their agreement as long as there is no detriment to a third party who has provided no consideration for the benefit received") (internal citations omitted). Id. at 410, 686 NE2d at 569, quoting *Board of Ed of Community School Dist No 220 v Village of Hoffman Estates*, 126 Ill App 3d 625, 628, 467 NE2d 1064, 1067 (1st D 1984). See generally 16 Am Jur Proof of Facts 2d 55 (2004).

## Third-party beneficiary law in action

**Hypothetical #1: must the tenant be named?** Armed now with this foundational knowledge, let's return to the hypotheticals that introduced this article. Can the tenant in the first hypothetical bring suit against the architect for breach of the architect's contract with the developer? Probably yes.

The facts of the first hypothetical are based on *Resnik v Curtis & Davis, Architects & Planners, Inc.*[9] There, the Illinois Building Authority contracted for architectural and other services in connection with the construction of a building to be leased *by* the Authority *to* the Illinois Department of Public Safety for use as a correctional center. The contract made frequent reference to the IDPS, and directed that the architects consult with IDPS in designing the building. The court held that the IDPS could maintain an action to recover damages for breach of contract as a third-party beneficiary based on the "unequivocally clear provisions in the contract."[10]

Thus, like the IDPS, the tenant in the first hypothetical may be deemed a third-party beneficiary of the contract between the developer and architect, and can therefore bring suit against the architect directly for breach of the underlying contract. But there is an additional wrinkle in the hypothetical. The underlying contract between the developer and architect refers only to "the tenants" – no particular tenant, including the hypothetical plaintiff, is named individually. Is it an obstacle to potential third-party plaintiff claims that the third parties are referred to as a collective class, rather than individually or by name?

Strictly speaking, the answer is no: the contract on which the third-party grounds his rights need not specifically name a particular third-party beneficiary if it adequately defines a *class* of individual beneficiaries of which the plaintiff is a member.[11] It is sufficient if the plaintiff is identifiable at the time performance is due as a member of the class intended to be benefited.[12] But practically speaking, the fact that the third-party was not named is a factor that cuts against the idea that the third-party was an intended beneficiary in the first place.

For example, in *Altevogt v Brinkoetter*,[13] plaintiff real estate purchasers brought a third-party beneficiary claim against a real estate developer based on contractual warranties between the developer and the seller of that real estate. The contract at issue was not made part of the record, and the plaintiffs based their claim on the allegation that the developer "knew" the house would be purchased and occupied by third parties, and the plaintiffs were members of that class of third-party purchasers.

Taking that allegation on its face, the court noted the general rule that third-parties need not be named in the underlying contract in order to have standing as third-party beneficiaries, but nevertheless held that the purchaser must "allege facts which show an intent on the part of the developer to confer the benefit" on the third-party plaintiffs.[14] Because such intent was lacking, the plaintiff's third-party beneficiary claims failed.

**A third-party beneficiary's rights vest when he or she (i) changes position in reliance on the promise, (ii) brings suit on the promise, or (iii) assents to the promise at the promisor or promisee's request.**

**Hypothetical #2: have the children's rights vested?** Let us now consider the second hypothetical, and whether the children of the father in breach of his divorce settlement can bring suit to fund their college educations. Here again, the answer is probably yes – but we must now deal with the issue of vesting.

First, it should be noted that the agreement or contract at issue refers only to "the children" – i.e., none of the children is named individually. But as we saw in our first hypothetical, a third-party plaintiff claim will not necessarily be defeated simply because the third parties are referred to collectively rather than individually.

For example, in *Orr v Orr*,[15] the court considered whether a child of divorced parents has standing to enforce a provision in her parents' judgment for divorce that obligated the father to pro-

### Suing under the contract as a third party

To successfully sue under the contract, a third-party beneficiary must show that

- there was a valid, enforceable contract between the promisor and promisee
- the contract was for the direct benefit of the third-party plaintiff, as evidenced by the contract's language and the circumstances at the time of execution
- the promisor breached the contract
- the plaintiff can overcome all of the promisor's defenses to the breach, and
- if the promisor and promisee try to limit the rights of the third-party plaintiff, the plaintiff's rights have vested

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9. 78 Ill 2d 381, 400 NE2d 918 (1980).
10. Id at 384, 400 NE2d at 919. But see *Altevogt v Brinkoetter*, 85 Ill 2d 44, 421 NE2d 182 (1981) (purchasers of house were not third-party beneficiaries of any implied warranty by builder in favor of party who commissioned building of house because builder's knowledge that a third party would occupy the house did not in and of itself establish that the plaintiffs were direct beneficiaries).
11. Id at 55, 421 NE2d at 187.
12. In fact, a third-party beneficiary may even sue to enforce the terms of the contract even though the beneficiary did not exist at the time of the contract's creation. See, e.g., *Gold v Ziff Communications Co*, 322 Ill App 3d 32, 46, 748 NE2d 198, 208 (1st D 2001) (mail-order business not in existence at time of contract was a proper third-party when the contract's terms provided that any future businesses established by the appellant would be direct and intended beneficiaries).
13. *Altevogt*, cited in n. 10.
14. Id at 56, 421 NE2d at 187.
15. 228 Ill App 3d 234, 592 NE2d 553 (1st D 1992).

vide for the child's educational expenses. The court said yes: the agreement between the father and mother specifically provides that the father will pay the educational expenses of the "children," and the plaintiff is one of the father's two children born to the marriage.

But there is more to the story. In the second hypothetical, the children attend college while their father suffers financial hardship. He ultimately refuses altogether to fund their educations, and the wife, sympathetic to her ex-husband's plight, agrees to modify the agreement between the two of them such that the father is relieved of his duty to pay for the children's education. These facts directly implicate the issue of vesting.

As noted above, the original parties to the contract retain the right to discharge or modify the rights of third-party beneficiaries, without that third-party's assent, until those rights vest in the third-party. Thus, the attempt of the wife and husband to discharge the husband from his obligation to finance the children's education would be a valid revocation of third-party rights – *unless* those rights had already vested in the children. Had they?

Recall that a third-party beneficiary's rights vest only when he or she (i) materially changes position in justifiable reliance on the promise, (ii) brings suit on the promise, or (iii) manifests assent to the promise at the request of the promisor or promisee. In *Miller v Miller*,[16] a child of divorced parents brought suit against his father to enforce a settlement agreement incorporated into the divorce decree that obligated the father to pay the child's college expenses.

The court found the child to be an intended third-party beneficiary based on the fact that the liability of the promisor affirmatively appeared from the language of the agreement. Importantly, the court also found that the child's rights had vested, because the child had relied on the benefit of the agreement by enrolling in and graduating from college.

In our hypothetical, following *Miller*, the children's rights will be deemed vested if they can prove they relied on the provisions of the divorce settlement agreement by enrolling in, and ultimately financing, college. When the husband and wife later tried to modify those rights, it was too late, because the children's rights had already vested.

## Conclusion

To successfully maintain a third-party beneficiary claim, a third-party plaintiff must establish the following:

- There was a valid, legally enforceable contract between the promisor and promisee;
- The contract was undertaken for the direct benefit of the third-party plaintiff – i.e., the promisor's liability to that third-party affirmatively appears from the contract's language and from the circumstances at the time of its execution;
- The promisor breached that contract;
- The plaintiff can overcome all defenses to the breach of contract that the promisor might raise; and
- If the promisor and promisee have attempted to modify or discharge the rights of the third-party plaintiff, that the plaintiff's rights had vested before the attempted modification or discharge. ■

16. 163 Ill App 3d 602, 516 NE2d 837 (1st D 1987).