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Not All Third-Party Beneficiaries Are Alike

Only intended beneficiaries may assert claims under third-party contracts.

By Steven Nudelman

Imagine that a developer retains two contractors — Contractor A and Contractor B. In negotiating its contract with Contractor A, the developer requires Contractor A to rely on certain plans designed by Contractor B. Since Contractor A usually develops these plans in similar projects and here it does not have to, Contractor A is able to offer the developer a lower price. However, after Contractor A begins work, it realizes that Contractor B's plans are defective, resulting in higher costs for Contractor A.

May Contractor A sue Contractor B for breach of the developer's contract — that is, the contract between Contractor B and the developer? In Arco In ge nieros, S.A. de C.V. v. CDM Int'l Inc., 368 F. Supp. 3d 256 (D. Mass. 2019), a Massachusetts federal district court said no.

Background

The following facts are taken from the court's decision. In 2008, the United States Agency for International Development (USAID) entered into a long-term contract with CDM International (CDM), naming CDM as the primary architect and engineer for USAID's global projects. One year later, Tropical Storm Ida devastated El Salvador, causing flooding, landslides and destruction of infrastructure.

USAID provided $25 million to help rebuild facilities in El Salvador. In 2011, CDM entered into a Task Order (the Contract) with USAID, specifying CDM's duties for the El Salvador project. The Contract required CDM to perform various assessments and to create preliminary designs that constituted at least 30 percent of the final designs for each facility. The Contract also required CDM to participate in procuring a design-build contractor (to finish the plans and construct the facilities) and supervise the construction of the facilities.

In 2013 and 2014, USAID solicited Arco Ingenieros, S.A. de C.V. (Arco) to serve as the design-build contractor for eight schools and one health clinic. The solicitation explained that the final designs must be based on CDM's preliminary designs. Arco submitted two bids in reliance on USAID and CDM's representations that the preliminary designs amounted to 30 percent of the final designs. USAID accepted the bids and entered two contracts with Arco.

Shortly after it began work, Arco realized that CDM's designs were defective and did not constitute 30 percent of the final designs. The plans for the schools were not code-compliant and did not account for soil condition and subsurface problems. The designs for the clinic did not address flooding requirements, bio-infectious waste disposal and failed to note that the annex to the clinic was structurally unsound. These defects required Arco to spend more time and money on the projects than it intended to.

CDM and USAID also allegedly interfered with and delayed the projects in various ways. For instance, CDM and USAID were delayed in their response to the design defects, and CDM failed to approve documents promptly. Arco further alleged that CDM and USAID conspired to hide the design problems and then attempted to shift the blame to Arco. In response to these delays, USAID withheld $9 million in payments to which Arco believed it was entitled.

The Complaint

In 2018, Arco filed a Complaint against CDM in federal district court in Massachusetts, asserting seven claims for relief. Arco's first claim for relief alleged that CDM breached its contract with USAID by making faulty and unfinished designs and not correctly assessing the projects. CDM moved to dismiss this cause of action for "failure to state a claim" pursuant to Federal Rule of Civil Procedure 12(b)(6). A motion under Rule 12(b)(6) motion will be successful if the opposing party failed to plead the specific facts necessary for the claim to even be plausible. Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009).

Typically, for a plaintiff to bring a breach of contract claim, it must be in "contractual privity" with the defendant. Second Nat'l Bank v. Grand Lodge, 98 U.S. 123, 124 (1878). This means that if Party A breaches a contract it has with Party B, then Party C cannot bring a breach of contract claim against A. Party C lacks standing to assert a claim with respect to a contract where C is not a party to the agreement.

An exception to this privity requirement is if C is a third-party beneficiary to the contract between A and B. This means C stands to materially benefit from the execution of the A-B contract. Notably, there are two types of third-party beneficiaries: intended beneficiaries and incidental beneficiaries. The critical difference: Only intended beneficiaries may sue for breach of contract. Miller v. Mooney, 725 N.E.2d 545, 548-50 (Mass. 2000).

Intended or Incidental Beneficiary?

To determine whether a party is an intended beneficiary, one must look at the language and circumstances of the contract to see whether the agreement "clearly and definitively intended the beneficiary to benefit from the promised

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performance." Cumis Ins. Soc'y, Inc. v. BJ 's Wholesale Club, Inc., 918 N.E.2d 36, 44 (Mass. 2009). If the contract lacks this intent, the third party is merely an incidental beneficiary and cannot recover for breach of the other parties' contract. Arco, 368 F. Supp. 3d at 261. Thus, a breach of contract claim by an incidental beneficiary should be dismissed.

Here, CDM indicated it never entered into a contract with Arco; therefore, Arco's claim should be dismissed. Id. at 260. Arco, however, argued it was a third-party beneficiary to CDM's contract with USAID, and thus had a right to bring a claim against CDM for breaching that contract. Id. The question before the court was whether Arco was an intended beneficiary.

To assess parties' contractual intent to benefit a third party, a court must first look to the language of the contract. Id. If, however, the language is ambiguous as to the parties' intent, it may look to other evidence. Id.

In consulting the contract between CDM and USAID, the court noted that the express purpose of the contract merely stated, "provide professional architecture and engineering services for the technical tasks associated with USAID's Tropical Storm Ida Reconstruction Project." Id. The court held this did not indicate that the parties intended any benefit to Arco. Id.

The court concluded that while the contract required CDM to carry out various studies and create designs, these tasks were only intended to benefit the parties of the contract. Id. The benefit Arco derived from these tasks was only incidental. Id.

The court then found that even if the contract's language was ambiguous as to the parties' intent, Arco did not allege any facts, outside the contractual language, that it was an intended beneficiary. Id. at 261-62. The court held that statements by USAID and CDM indicating CDM would complete 30 percent of the design merely meant the parties intended Arco to use CDM's designs. Id. It did not suggest that USAID and CDM intended for Arco to benefit from their contract.

To bolster its decision, the court pointed to other jurisdictions that follow a similar test for third-party beneficiary rights, i.e., a requirement of clear intent for the third party to benefit. Id. at 262.

Specifically, the court cited to a factually similar New York case, where the district court held "a prime contractor was not an intended beneficiary of the contract between the architect and construction manager even though the architect was required to coordinate and produce the bidding documents which may have been relied on by the contractor in submitting its bids." Id. (citing Travelers Cas. & Sur. Co. v. Dormitory Auth. of State of N.Y., 734 F. Supp. 2d 368, 376-77 (S.D.N.Y. 2010)).

The court also distinguished the Arco case from a situation in which an owner-developer asserts rights as a third-party beneficiary of a contract between a contractor and subcontractor. In such a circumstance, there may be other factual considerations, such as whether the owner picked the subcontractor, which could indicate intent by the contractor and subcontractor for the owner to be a beneficiary. Id. (citing Chestnut Hill Dev. Corp. v. Otis Elevator Co., 653 F. Supp. 927 (D. Mass. 1987)). No such considerations exist here.

As construction projects become more complex and controlled by intertwining contracts, design professionals may find themselves as third-party beneficiaries of related agreements. This can be a dangerous position if those design professionals are not intended beneficiaries because while they may rely on those contracts, they will have no right to enforce them.

So, what should a design professional or contractor do to protect itself? For one thing, they should be aware of other contracts that may overlap with theirs (and request complete copies of these contracts from the owner). Second, if a design professional or contractor is expected to rely on work performed in overlapping contracts, it should negotiate before signing its own contract that the other agreements specifically include them as an intended third-party beneficiary.

By including this precise verbiage in its contract, the design professional or contractor is better positioned to enforce an adverse agreemenat to which it is not a party. ●

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