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DAMAGES TO PROTECT PERFORMANCE INTEREST AND THE REASONABLENESS REQUIREMENT

Alfred McAlpine v *Panatown*[1]

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I. INTRODUCTION

WHERE a person (A) contracts with another (B) to perform acts for the benefit of a third party (C), can A claim substantial damages in his own right when B either fails to perform or performs defectively? This was one of the issues that came before the House of Lords in *Panatown*. The issue had previously been tackled by the House in *Woodar* v *Wimpey*;[2] in *Woodar*, the House had decided that A had no claim to substantial damages in the postulated circumstance. As C was not privy to the contract, he had no right to sue B. The result was a "legal black hole"[3] through which B escaped substantial liability. Lord Griffith reopened the question in *Linden Gardens* v *Lenesta Sludge Disposal; St Martins Property* v *Robert McAlpine*[4] and argued persuasively that A suffers a substantial loss of bargain. Three other Law Lords in *St Martins* case found the argument attractive but refrained from adopting it, citing, *inter alia*, the desirability of exposing the argument to academic consideration.[5] Subsequent academic discourse did not proffer substantial criticism of Lord Griffith's argument. By the time of the *Panatown* litigation, the time was ripe for clear guidance on the issue. Unfortunately, the majority in *Panatown* did not embrace the opportunity to reconceptualize what A had lost. Thus, a valuable opportunity to rectify a defect in the present law was lost. This is lamentable. This note seeks to show that the concerns which detained the majority in *Panatown* can readily be addressed by the present law,

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1 [2001] 1 AC 518 ("*Panatown*").

2 [1980] 1 WLR 277 ("*Woodar*").

3 A term coined by Lord Keith: *GUS Property Management Ltd* v *Littlewoods Mail Stores Ltd* 1982 SC (HL) 157, at 177.

4 [1994] 1 AC 85 ("*St Martins*").

5 *Ibid*, at p 112, per Lord Browne Wilkinson.

particularly through the 'control mechanism' of reasonableness in *Ruxley Electronics* v *Forsyth*.[6]

In *Panatown*, Panatown employed McAlpine to construct certain buildings on land belonging to UIPL. Panatown and UIPL belonged to the Unex group of companies. In addition to the building contract, McAlpine executed a Duty of Care Deed ("DCD") giving UIPL the right to sue McAlpine for failure to exercise reasonable skill, care and attention in respect of any matter within the scope of responsibilities under the building contract. Subsequently, Panatown sued McAlpine for defective work and delay. Panatown's claim sought the cost of demolition and rebuilding. The issue which arose was whether Panatown could claim against McAlpine substantial damages for defective performance in view of the fact that the bargained for performance was for the benefit of a third party, UIPL.

The House of Lords was presented with two principal arguments - termed the 'narrow ground' and the 'broad ground' in the judgments. The narrow ground relies on the *Albazero* exception, the exceptional rule which allows a contracting party to claim damages on behalf of a third party.[7] It thus proceeds from the premise that the damages claimed by the contracting party are not for his own benefit but for the account of the third party. In contrast, the broad ground conceptualizes the claim as one for the claimant's personal loss. The loss consists in the failure to receive the bargain contracted for, a loss in the obligee's performance interest.[8] And the measure of the loss is the cost of securing the performance that would provide to the claimant what he expected under the contract.

The House of Lords was split three to two. For the majority (Lord Clyde, Lord Browne-Wilkinson and Lord Jauncey), the DCD was fatal to Panatown's claim for substantial damages. The *Albazero* exception was created to avoid an eventuality in which the obligor escapes liability for substantial damages because the loss, seen to be suffered by the third party, cannot be claimed by the innocent party to the contract, while at the same time the third party is incapable of suing for the loss as he is not privy to the contract. The existence of the DCD meant that there was no "legal black hole" calling into application the *Albazero* exception. The minority, consisting of Lord Goff and Lord Millett, were of the opinion that Panatown should succeed on the claim for substantial damages on the basis of the broad ground. The majority held differing opinions on why the claim could not succeed on the broad ground. Lord Clyde had in principle objections to the broad ground; amongst other things, he found it difficult to equate the loss with the cost of rectification. Lord Jauncey, while not expressly objecting to the broad ground, did not appear to agree with its premise *ie*

6 [1996] AC 344 ("*Ruxley*").

7 *The Albazero* [1977] AC 774 at 845, per Lord Diplock.

8 The concept of "performance interest" was given currency by Daniel Friedman in "The Performance Interest in Contract Damages" (1995) 111 LQR 628.

that the innocent contracting party himself suffers a real substantial loss. Lord Jauncey saw the broad ground as another manner by which to address the problem of the "legal black hole"; accordingly, the existence of the direct cause of action in the third party was fatal to any argument on the broad ground[9]. Lord Browne-Wilkinson seemed prepared - if not too enthusiastically - to assume that the broad ground is sound in law.[10] Insofar as the DCD was part of the contractual arrangements and a constituent component of Panatown's performance interest, there was, in Lord Browne-Wilkinson's opinion, no substantial damage to Panatown's performance interest.

II. THE NARROW GROUND

My observations on the narrow ground will be brief since my concern lies with the notion that Panatown suffers a nominal and not a substantial loss.

The majority's holding that the presence of the DCD prevented reliance on the *Albazero* exception is, in principle, a correct one.[11] The raison d'être for the *Albazero* exception is the legal black hole, the prospect of an obligor escaping substantial liability despite rendering defective performance. Since the DCD provides the third party a direct right of action against the obligor, the spring from which the exception derives life dries. Despite the fact that the DCD requires proof of negligence and is not premised on strict liability like the contract claim, the justification for the *Albazero* exception vanishes; with it, the room for application of the exception.

What is perhaps more interesting is Lord Clyde and Lord Millett's repudiation of the notion that the *Albazero* exception is based on the intention of parties *ie* contract based.[12] This was the proposition put forward by the Court of Appeal.[13] The repudiation means that the allowance for a contracting party to sue for and on behalf of a third party is a rule of law. It does not arise out of the party's intention, though the law can take the parties' intentions into account in restricting the operation of the exception. Nonetheless, the existence of the exception does not spring from the contract made between parties; rather, it comes into being because the law sees the need to fill an unacceptable lacuna. It is the common law - and not the parties intentions - that determines whether a contracting party can sue for and on behalf of a third party.

9 *Supra*, n 1, at 574.
10 *Ibid*, at 577-578.
11 See Treitel, "Damages in Respect of a Third Party's Loss", (1998) 114 LQR 527 at 533-534. For a contrary view, see Coote, "The Performance Interest, *Panatown*, and the Problem of Loss", (2001) 117 LQR 81 at 86-89.
12 *Supra*, n 1, per Lord Clyde at 530-531 and per Lord Millett at 582-583.
13 (1998) 14 Const LJ 267.

III. THE BROAD GROUND: RECONCEPTUALIZING THE CONTRACTUAL OBLIGEE'S LOSS

The broad ground requires reconceptualising Panatown's loss. Where a contract imposes a duty on one party to perform acts for the benefit of a third party, the failure to render due performance is normally conceived as a (substantial) loss to the third party, not to the counterparty in the contract. The broad ground entails a revision to this conception. Nonetheless it is a revision for which the groundwork has been laid - solidly - by *Radford* v *De Froberville*[14] and *Ruxley*. It does not upset the fundamental principles of contract law. Indeed, it more fully effectuates the principle in *Robinson* v *Harman* that the plaintiff is "so far as money can do it, to be placed in the same situation with respect to damages, as if the contract had been performed."[15] The starting point is to inquire whether the orthodox ascription of the loss to the third party, rather than to the innocent contracting party, is an altogether accurate one.

In *Radford*, the plaintiff sued for the cost of building a brick wall which the defendants had promised but did not provide. Oliver J had little difficulty in awarding to the plaintiff the cost of remedial performance rather than the diminution in market value measure argued by the defendant. The crux of the decision was that the plaintiff did not obtain the covenanted-for performance; as the due performance was genuinely and reasonably sought, the court awarded the cost of obtaining substitutionary performance. In doing so, the court affirmed in a real and effective manner the plaintiff's entitlement to the state of affairs contemplated under the contract. More than that, it affirmed the primacy of due performance - performance interest - over the construction of a loss from the economic position of the plaintiff.

This approach translates readily into the context of a contract for the provision of a benefit to a third party. Insofar as the obligee covenanted with the obligor for the latter to bring about a particular state of affairs and the obligor has failed to do so, any meaningful remedy should respect the obligee's entitlement to that state of affairs. This *Radford* has done, as has *Ruxley* when it affirmed *Radford*. In these cases, the common law has not shown itself bound to a rigid objective measure of loss based on one's supposed economic interest. In characterizing the obligee's loss as unsubstantial in the three party scenario, one is implicitly using his economic interest as the measure. Such a characterization runs counter to the recognition of the obligee's performance interest in *Radford* and *Ruxley*. The obligee in a three party scenario should be no less entitled to the cost of rectification than the plaintiff in *Radford* was entitled to the cost of substitutionary performance.

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[14] [1977] 1 WLR 1262 ("*Radford*").
[15] [1848] 1 Exch 850 at 855.

IV. ADDRESSING CONCERNS

Several matters detained the Law Lords forming the majority in *Panatown*. First, the relationship between the failure to "receive the bargain for which he had contracted"[16] and the cost of repair. Lord Clyde found difficulty in measuring the "disappointment at … not being provided what was contracted for" by the cost of repair[17]; he thought that it was better measured by the difference in value between what was contracted for and what was supplied. Lord Clyde's thinking is correct if the law's sole concern is with the obligee's economic position. Lord Griffith was, however, concerned with *performance*, not merely with the economic position of the obligee. As *Radford* and *Ruxley* have shown, the common law has not been so myopic as to construct the loss solely from the difference in economic position between due performance and defective performance. The cost of cure measure recognises that the obligee is entitled to the performance promised under the contract. The cost of cure measure is not a measure of the obligee's disappointed economic expectations. Rather it is intended to give the innocent party *the means* to effect rectification and thereby, to bring about the state of affairs contemplated under the contract. It does not measure the loss of one's economic expectations so much as it measures the amount of money it would take to bring about the performance expected. Lord Griffith's underlying premise in *St Martins'* case is worth reiterating. The failure to obtain one's entitlement is a substantial loss. To characterize it as a nominal loss merely because the economic benefit accrues to a third party would be in error. Insofar as the failure is capable of remedy by an award of damages for the cost of cure, there is a concrete measure of what it takes to protect the obligee's performance interest. There is, therefore, nothing fundamentally wrong with an award of damages based on the cost of cure.

The problem lies more with conferring on the plaintiff an uncovenanted profit - the prospect of the successful plaintiff pocketing the damages and not spending them to remedy the defects on the third party's property. Lord Goff and Lord Millett were not inclined to the view that the successful plaintiff should be obliged to spend the damages awarded on the "cost of cure" basis to effect the rectification.[18] The reluctance to adopt "intention to effect remedial works" as a necessary pre-condition to awarding the cost of cure derives from the notion that the law is generally not concerned with how the successful plaintiff uses the damages awarded.[19] As the present commentator has pointed out elsewhere,[20] it is theoretically defensible to

16 *St Martins*, *supra*, n 4, at 97, per Lord Griffith.
17 *Supra*, n 1, at 533.
18 *Ibid*, per Lord Goff at 556 and Lord Millett at 592-593.
19 *Darlington BC* v *Wiltshier Northern Ltd* [1995] 1 WLR 68 at 80, per Steyn LJ.
20 Loke, "Cost of Cure or Difference in Market Value? Toward a Sound Choice in the Basis for Quantifying Expectation Damages", (1996) 10 JCL 189 at 204-210.

incorporate this element as a necessary pre-condition in certain circumstances. In the defective performance of a construction contract, the cost of cure is an 'enabling' award that does not at the same time measure the loss in one's economic expectations. That is, it does not measure one's economic loss, save where one has already spent monies to carry out the rectification works. By contrast, the cost of substitutionary performance in a case involving the sale of (generic) goods also captures the loss in one's economic expectations. If one contracted for goods which were not delivered, one could expect damages representing the increased cost of purchasing the same goods. This represents the cost of substitutionary performance; it also represents the loss in one's economic expectations if one were hoping to profit from a movement in the price of the goods. Where the cost of cure does not correspond to one's loss in economic expectations, the requirement for an intention to effect remedial works is defensible as a legitimate exercise in formal reasoning; it assures the court that the cost of cure does not become a windfall to the plaintiff. The cost of cure is a proxy to secure the performance interest; it avoids a loss to the plaintiff in the nature of the subjective value of the performance to him, a value which is difficult to measure.[21] An "intention" requirement is therefore an assurance that the damages premised on the *means* to restore the performance interest - which may very well exceed the loss based on the subjective value of the performance to the plaintiff - do not get converted into an windfall for the plaintiff. In other words, the intention requirement ties the damages award to securing the performance interest and avoids the conferment of a windfall on the plaintiff. Lord Griffith's dictum in *St Martins* case, which has been read as equating the loss of bargain with the cost of cure, should be read in this light - for it is premised on a requirement that the plaintiff carries out the remedial works.[22]

Although the House of Lords in *Ruxley* did not adopt "intention to effect remedial works" as a formal requirement for awarding the cost of cure measure, it appears at the very least to be a factor going toward the reasonableness of awarding this measure of damages.[23] In *Ruxley*, "reasonableness" was the mechanism used to decide which was the more appropriate measure of damages: the difference in market value measure or the cost of cure measure. If the burden sought to be imposed on the defendant is "out of all proportion" to the gain to be obtained by the rectification and hence unreasonable, the cost of cure measure will be

[21] In economic terms, the excess of the subjective value to the obligee over the market value is the consumer surplus: Harris, Ogus & Phillips, "Contract Remedies and the Consumer Surplus" (1979) 95 LQR 581. The concept was accepted by the House of Lords in *Ruxley*, *per* Lord Mustill [1996] AC 344, at 360.

[22] *St Martins, supra,* n 4, at 96-97. Cf. Lord Goff in *Panatown*, *supra*, n 1, at 547 (referring to the proposition that the obligee should have actually incurred financial expenses).

[23] Lord Jauncey, *supra*, n 6, at 359. Lord Lloyd was prepared to go further, viewing it as a necessary condition to "reasonableness", *ibid* at 372.

unavailable. In *Panatown*, Lord Goff and Lord Millett subscribed to the requirement of 'reasonableness' for awarding cost of cure.[24] It is a useful reminder that the obligee's performance interest in acts to be performed on a third party's property does not *ipso facto* translate into cost of cure damages; the disproportionality consideration that featured so prominently in *Ruxley* is similarly relevant.[25] But as was earlier pointed out, "reasonableness" can be more than a passive mechanism for deciding the more appropriate measure of damages. It can be used more actively, as a control mechanism against conferring on the defendant an uncovenanted benefit; this applies in both the two party scenario (like *Radford*) and the three party scenario (like *Panatown*). Unless satisfied that the plaintiff is sincere in securing his performance interest, the court may consider it unreasonable to award the cost of cure. In other words, "reasonableness" can be used in a more active fashion to provide the assurance against an uncovenanted benefit or an unwarranted windfall.

Further, the control mechanism in the form of 'reasonableness' can be used to address other issues with the broad ground raised in *Panatown*. One concern is that the obligor-contractor will be made to pay two sets of damages for the same wrong; he can be sued by Panatown under the contract and by UIPL (or its assignees) under the DCD. The 'reasonableness' requirement can avoid such double jeopardy. The court might find it unreasonable to award cost of cure to the plaintiff if it is not assured that the third party will not also at a later stage sue for the same breach. To assure the court, the claimant might be induced to provide an undertaking to effect remedial works, or to obtain a release of the third party's right against the defendant. The reasonableness requirement thus renders illusory the 'legal nonsense' postulated by Lord Browne Wilkinson[26] - the prospect of double liability when the right of action in the third party is assigned to another, X and both the obligee and X sue. Remedial works will render nugatory X's claim. Securing the third party or X's release requires their consent; in effect, it subordinates the obligee's

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[24] *Supra*, n 1, per Lord Goff at 556 and Lord Millett at 592. Lord Clyde agreed with the broad ground only to the extent that the obligee had paid to obtain alternative performance: *ibid* at 533.

[25] In *Ruxley*, the House of Lords decided that the cost of cure was unreasonable because of the disproportionality consideration. Recognizing that the diminution in market value measure does not compensate the plaintiff for his consumer surplus ("consumer surplus": see *supra* n 21), damages for loss of amenity were awarded. "Loss of amenity" should similarly be applicable where cost of cure is inappropriate in a three party scenario due to the disproportionality consideration e.g. where employer-husband pays for the contractor to build a pool for his wife's house and the pool is shallower though usable. Failure to satisfy the requirement of reasonableness does not therefore mean that the broad ground for substantial damages is undermined; where there is consumer surplus, substantial damages in the nature of loss of amenity should be claimable.

[26] *Supra*, n 1, at 578.

interest to their right to sue and hence, does not undermine the value of the asset in their hands.

The reasonableness requirement is a potent and yet subtle instrument. Lord Millett proposed that to avoid double jeopardy, the court should stay the action before it in order to allow the owner to initiate proceedings.[27] With the proper use of the reasonableness requirement, the real prospect of the court having to order a stay of action diminishes. Moreover, the reasonableness requirement avoids the conceptual knots that come with the notion that the obligee is accountable to the third party for the damages received, a notion found in the judgment of Lord Clyde.[28] (Why should this be? After all, the compensation is for the loss in the obligee's performance interest. Where the third party receives the performance as a gift, there are conceptual problems to conceiving the non-conforming performance as his loss; this is especially so if the performance is not a defect that necessitates rectification *eg* the delivery of a church with fewer seats than contractually stipulated.[29])

V. TRANSITIONAL PROBLEMS

Even without the 'reasonableness' safeguard, the concern about double jeopardy is probably only a transitional problem. Indeed the problem is one created by the unsatisfactory state of the law. The existence of the DCD in *Panatown* is attributable to *Murphy* v *Brentwood*,[30] the seminal case severely restricting the tortious action for negligent acts resulting in economic loss. At the time the arrangements were entered into between Panatown, UIPL and McAlpine, it was not clear whether the *Albazero* exception applies to a building contract. Had *St Martins* case been decided at the same time as *Murphy* v *Brentwood*, the parties might have assigned Panatown's contractual rights rather than executing the DCD. Or the parties, knowing of the employer's right of action, could have contractually provided for the avoidance of double liability (*eg* the abatement of a right should the right of action succeed). The spectre of double liability might then not have arisen. Indeed, with the prospect of Lord Griffith's proposition gaining wider acceptance, parties are likely to make provision against the prospect of double liability should they contemplate an instrument similar to the DCD.

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27 *Ibid*, at 595.

28 *Ibid*, at 534.

29 This problem is referred to by Lord Oliver of Aylmerton in *Murphy* v *Brentwood* [1991] AC 398 at 488.

30 *Ibid*. On the use of collateral warranties after *Murphy* v *Brentwood*, see D Wallace, "Third Party Damage: No Legal Black Hole?", (1999) 115 LQR 394, D Lewis, "Investigating the J.C.T. Standard Forms of Agreement for Collateral Warranty", (1997) 13 Const LJ 305.

VI. LAST WORDS

As Lord Goff has pointed out, the issue that underpins the broad ground is not resolved by the Contracts (Rights of Third Parties) Act 1999.[31] The issue - whether the obligee is entitled to claim substantial damages for non-performance or defective performance - continues to be determined by the common law. Lord Griffith's recharacterization of the obligee's loss is a sound one. More importantly, it re-orientates the law in the right direction: a further development of the concept of performance interest. With the existing safeguards, the undesirable consequences can be held in check. It is time to move forward.

[31] *Supra*, n 1, at 551-552. The same position obtains in Singapore; the Contracts (Rights of Third Parties) Act (Act 39/2001) is essentially a re-enactment of the UK Act.