Second Circuit Provides Cautionary Tale For Contractual Provisions Negating Third Party Enforcement

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It has long been the case that third party beneficiaries may, under certain circumstances, enforce a contract to which they are not a party. This is a well-recognized exception to the general rule that only parties to the contract, i.e. those in privity, can sue to enforce it. Under New York law, a third party is an intended beneficiary entitled to enforce a contract where “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.” To determine the intention of the parties, courts will look to the language of the contract at issue as well as the circumstances surrounding the transaction.

Accordingly, to make their intentions clear, many contracting parties will include in their agreements “no third party beneficiary” clauses. These clauses typically state, in varying forms, that the agreement is for the benefit of certain parties only and that no other party shall have any rights under the agreement. Provisions such as these are considered “controlling” when determining whether an agreement is enforceable by a third party. Importantly, this is true even where the contract is intended to benefit a third party. Indeed, “courts applying New York law have consistently found that, even where a contract expressly sets forth obligations to specific individuals or categories of individuals, those individuals do not have standing to enforce those obligations by suing as third-party beneficiaries when the contract contains a negating clause.” To be controlling, however, the clauses must be “complete, clear, and unambiguous.”

In that regard, the recent Second Circuit decision in Bayerische Landesbank v. Aladdin Capital Mgmt. LLC (“Aladdin”) provides a cautionary tale for practitioners who regularly include such clauses in agreements. In Aladdin, the plaintiffs were banks who purchased notes in a collateralized debt obligation (“CDO”). The defendant was the portfolio manager for the CDO. As portfolio manager, the defendant selected the various securities underlying a credit default swap linked to the CDO. The credit default swap was between the issuer of the CDO and Goldman Sachs Capital Markets, L.P. (“GSCM”). The defendant’s responsibilities as portfolio manager were contained in a Portfolio Management Agreement (“PMA”) between it and the issuer of the CDO. The plaintiffs were not parties to the credit default swap or the PMA. In fact, the plaintiffs had no direct contracts with the defendant.
The plaintiffs alleged that after closing, the defendant mismanaged the portfolio, causing the plaintiffs to lose their entire investment. The plaintiffs sued the defendant for, among other things, breaching the PMA. The defendant moved to dismiss on the basis that the following language from section 29 of the PMA required dismissal of the breach of contract claim:

This Agreement is made solely for the benefit of the Issuers and the Portfolio Manager, their successors and assigns, and no other person shall have any right, benefit or interest under or because of this Agreement, except as otherwise specifically provided herein. The Swap Counterparty [GSCM] shall be an intended third party beneficiary of this Agreement.

The district court agreed with the defendant, finding “because section 29 expressly names GSCM, the Swap Counterparty, as an intended third-party beneficiary, but does not expressly name the Noteholders anywhere in the section, the Noteholders were not ‘otherwise specifically provided herein,’ and therefore the parties to the Agreement did not intend for the Noteholders to be third-party beneficiaries of the PMA.”

The Second Circuit reversed, finding that the plaintiffs could plausibly be intended third-party beneficiaries under the PMA. The Court determined that section 29 of the PMA was ambiguous because the word “herein” could refer to either section 29 or the entire PMA. Since it was possible that “herein” referred to the entire PMA, the Court was required to examine the contract as a whole. When examining the entire contract, the Court concluded that “other portions of the PMA evince an intent to benefit the Noteholders by defining [the portfolio manager’s] obligations and delineating the scope of its liability to the Noteholders.” For example, the Court noted that section 6 of the PMA stated that “the Portfolio Manager shall use all reasonable efforts to ensure that [it takes no action that would] … adversely affect the interests of the holders of the Notes in any material respect (other than as permitted under the Transaction Documents).” The Court reasoned that this provision could support the plaintiffs’ theory that it was the parties’ intent to have the plaintiffs and other Noteholders benefit from the PMA.

In reaching its decision, the Court analyzed and distinguished two other Second Circuit decisions relied upon by the district court that upheld no third party beneficiary clauses, India.com, Inc. v. Dalal and Morse/Diesel, Inc. v. Trinity Indus., Inc. The plaintiff subsequently sued one its subcontractors. The subcontractor in turn filed third-party negligence counterclaims against other subcontractors. Relying in part on the no third party beneficiary clause, the Morse/Diesel court dismissed the negligence claims because “nothing in the parties’ obligations to perform ‘discrete, circumscribed roles in the overall construction..."
project’ indicated that the subcontracts were intended to benefit the other subcontractors as opposed to the general contractor.”

Despite the similarity of the clause in Morse/Diesel, the Aladdin court distinguished Morse/Diesel on three grounds. First, it stated that while the subcontractors were working on behalf of the general contractor (not on behalf of each other), the defendant portfolio manager, in contrast, was undertaking an obligation to manage the securities on behalf of the plaintiffs. Second, the Aladdin court noted that Morse/Diesel was a tort case, not a contract case, and therefore, the decision "did not decide whether, as a matter of contract interpretation, ‘except as otherwise provided herein’ referred to provisions of the contract outside of the no-third party beneficiary clause, or whether it was limited to [the clause itself].” Finally, the Aladdin court found that the titles of the relevant provisions reflected the parties’ different intentions, since the subcontracts used the phrase “No Third Party Beneficiary” and section 29 of the PMA merely used the caption “Beneficiaries.”

Where does the Aladdin decision leave the enforceability of no third party beneficiary clauses? Fundamentally, Aladdin does not change the well-established rule that no third party beneficiary clauses can bar non-parties from asserting a breach of contract claim. The Aladdin Court’s approval of the holding in Dalal makes that clear. The case, however, does provide important guidance for how best to reflect contracting parties’ intent that benefits and enforcement rights under an agreement only flow to that agreement or specifically designated third-parties. First, parties should avoid using the word “herein” in no third party beneficiary clauses without clearly identifying whether the word refers to the clause itself or the contract as a whole. Otherwise, a court may find ambiguity in the agreement. Second, whenever possible it is advisable to clearly identify the intended beneficiaries of the agreement and state that all others are definitively being excluded. That way, courts are not left to guess what the parties’ intent was with respect to who would benefit from and be able to enforce the contract. Finally, parties to an agreement should minimize references to contractual benefits inuring to third parties unless the parties intend those third parties to have the benefit of, and the right to enforce, the promised performance.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 Subaru Dists. Corp. v. Subaru of Am., Inc., 425 F.3d 119, 124 (2d Cir. 2005) (quoting Restatement (2d) of Contracts § 302(1)).

2 Id.

3 See, e.g., Morse/Diesel, Inc. v. Trinity Indus., Inc., 859 F.2d 242, 249 (2d Cir. 1988) (“Under New York law, where a provision in a contract expressly negates enforcement by third parties, that provision is controlling.”).

4 In re Lehman Bros. Holdings Inc., No. 11-CIV-2792 JGK, 11-CIV-2985 JGK, 2012 WL 3047175 (S.D.N.Y. Jul. 26, 2012). See also 28 N.Y. Prac., Contract Law § 8:9.10 (“[t]he fact that a contract is intended to benefit a third party does not necessarily establish that the parties intended to give the third party the right to bring suit to enforce the contract. For such a right to be created, the language of the contract must clearly evidence an intent to permit enforcement by a third party.”).


6 No. 11-4306-cv, 2012 WL 3156441 (2d Cir. Aug. 6, 2012).

7 Id. at *1-*3.

8 Id. at *8.

9 The Second Circuit also reinstated plaintiffs’ gross negligence claim, which the district court dismissed as duplicative of the contract claim. This article only focuses on the contract claim.

10 Id. at *9.

11 Id. at *10.

12 Id.

13 412 F.3d 315 (2d Cir. 2005).

14 859 F.2d 242 (2d Cir. 1988).

15 The Dalal court, like the court in Morse/Diesel, recognized the principle that “[w]here a provision exists in an agreement expressly negating an intent to permit enforcement by third parties, ... that provision is decisive.” Dalal, 412 F.3d at 321 (citation omitted). For that reason, Dalal concluded that “the mention of [the appellee] in the contract as a broker entitled to a commission is insufficient to confer third-party status where the parties themselves are explicit that they did not intend to create third-party beneficiaries.” Id. at 322.

16 The Dalal clause states as follows: “Neither this Agreement or any provision hereof nor any Schedule, Exhibit, certificate or other instrument delivered pursuant hereto, nor any agreement to be entered into pursuant hereto or any provision hereof, is intended to create any right, claim or remedy in favor of any person or entity, other than the parties hereto and their respective successors and permitted assigns and any other parties indemnified under Article XI.” 2012 WL 3156441, at *10 (quoting Dalal, 412 F.3d at 10).

17 Id. at *10.

18 The Morse/Diesel clause states as follows: “ARTICLE 19-No Third Party Beneficiary Except as otherwise provided herein, no provision of this Agreement shall in any way inure to the benefit of any third person (including the public at large) so as to constitute any such person a third party beneficiary of this Agreement or any one or more of the terms hereof or otherwise give rise to any cause of action in any person not a party hereto.” Id. at *13 (quoting Morse/Diesel, 859 F.2d at 247-48).

19 Id. at *13.

20 Id. at *12 (emphasis omitted) (quoting Morse/Diesel, 859 F.2d at 247-248).

21 Id. at *13.

22 Id.