



# Third-Party Beneficiaries of Contracts Entered into by Local Governments

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Normally someone who is not a party to a contract has no standing to enforce or challenge the validity of the contract, nor any right to seek damages for its breach. Occasionally, however, courts recognize and enforce nonparty rights in a contract, as third-party beneficiaries. This *Local Government Law Bulletin* explores the application of third-party beneficiary rules to contracts entered into by local governments in North Carolina. The bulletin begins by reviewing the general rules for determining whether third parties are intended beneficiaries of contracts, both as to contracts generally and as to contracts in which at least one party is a governmental entity. It next considers third-party rights in contracts between local governments and private persons or entities. The bulletin concludes by considering third-party rights in contracts between local governments (that is, *interlocal contracts*). A recurrent point made in the discussion is that whether there are third-party rights in a contract is a matter of the intention of the actual parties to the contract. For that reason, local governments should consider making the rights of third parties in the contract an explicit part of the negotiation process and then of the contract itself. This can mean either affirmatively providing for such rights or explicitly excluding them. As noted in the bulletin, a local government's position on this issue may depend upon the type of contract involved and, particularly, the extent to which the contract is intended to provide direct benefits to particular customers rather than services to the unit at large.

## Third-Party Rights under a Contract Generally

Whether someone is a third-party beneficiary of a contract is very much a matter of fact—the intentions of the actual parties to the contract. If the parties' intentions are not clear from the contract itself, however, it is up to a court to determine those intentions from whatever language is in the contract and by any relevant circumstances that surrounded the negotiation and execution of the contract.<sup>1</sup> In undertaking that task, courts have relied to a considerable extent

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1. In *Vogel v. Reed Supply Co.*, 277 N.C. 119, 128, 177 S.E.2d 273, 279 (1970), the court wrote that the "intention of the parties to the [contract] is of paramount importance"; and in *Raritan River Steel Co. v. Cheery, Bekaert & Holland*, 329 N.C. 646, 652, 407 S.E.2d 178, 182 (1991), the court added that the "Court, in determining the parties' intentions, should consider circumstances surrounding the transaction as well as the actual language of the contract."

upon the summary of third-party beneficiary law set out in the first and second Restatement of Contracts.

The first Restatement divided possible third-party beneficiaries into three groups—*donee* beneficiaries, *creditor* beneficiaries, and *incidental* beneficiaries—and gave enforcement rights under a contract to the first two groups but not the third.<sup>2</sup> The Restatement’s usage of “donee beneficiaries” and “creditor beneficiaries” was widely followed, and in 1970 the North Carolina Supreme Court stated that it “expressly approve[d] the Restatement formula.”<sup>3</sup>

When the Restatement (Second) was approved in 1981, the terms *donee beneficiary* and *creditor beneficiary* were dropped because they “carr[ied] overtones of obsolete doctrinal difficulties” and instead were combined into a single category—*intended beneficiary*. The current Restatement principles are set out in Section 302, which reads as follows:

**§ 302. Intended and Incidental Beneficiaries**

(1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if 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.

(2) An incidental beneficiary is a beneficiary who is not an intended beneficiary.<sup>4</sup>

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2. Section 133 of the Restatement of Contracts read as follows:

(1) Where performance of a promise in a contract will benefit a person other than the promisee, that person is, except as stated in Subsection (3):

- (a) a donee beneficiary if it appears from the terms of the promise in view of the accompanying circumstances that the purpose of the promisee in obtaining the promise of all or part of the performance thereof is to make a gift to the beneficiary or to confer upon him a right against the promisor to some performance neither due nor supposed or asserted to be due from the promisee to the beneficiary;
- (b) a creditor beneficiary if no purpose to make a gift appears from the terms of the promise in view of the accompanying circumstances and performance of the promise will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary, or a right of the beneficiary against the promisee which has been barred by the statute of Limitations or by a discharge in bankruptcy, or which is unenforceable because of the Statute of Frauds;
- (c) an incidental beneficiary if neither the facts stated in Clause (a) nor those stated in Clause (b) exist.

(2) Such a promise as is described in Subsection (1a) is a gift promise. Such a promise as is described in Subsection (1b) is a promise to discharge the promisee’s duty.

(3) Where it appears from the terms of the promise in view of the accompanying circumstances that the purpose of the promisee is to benefit a beneficiary under a trust and the promise is to render performance to the trustee, the trustee, and not the beneficiary under the trust, is a beneficiary within the meaning of this Section.

3. *Vogel*, 277 N.C. at 128, 177 S.E.2d at 278.

4. The comments to this section indicate that the “donee” and “creditor” usage is not entirely dead. Comment *b* specifies that the “type of beneficiary covered by Subsection (1)(a) is often referred to as a ‘creditor beneficiary’” and specifies that Subsection (1)(b) involves “gift promises” and that the “beneficiary of such a promise is often referred to as a ‘donee beneficiary.’”

The North Carolina Supreme Court subsequently made clear that it would use the analytic approach of the Restatement (Second) in determining whether a person could enforce or challenge a contract to which that person was not a party.<sup>5</sup>

It should be reiterated, however, that it is the intention of the parties to the contract that is paramount. The formulas in the two Restatements are intended to help a court determine that contractual intent when the contract itself is not explicit. If the contract is explicit, recourse to the Restatement formulas is unnecessary.<sup>6</sup>

Both Restatements included a separate statement concerning certain contracts in which at least one of the parties is a governmental entity. The more recent statement is found in Section 313 of the Restatement (Second):

### § 313. Government Contracts

(1) The rules stated in this Chapter apply to contracts with a government or governmental agency except to the extent that application would contravene the policy of the law authorizing the contract or prescribing remedies for its breach.

(2) In particular, a promisor who contracts with a government or governmental agency to do an act for or render a service to the public is not subject to contractual liability to a member of the public for consequential damages resulting from performance or failure to perform unless

- (a) the terms of the promise provide for such liability; or
- (b) the promisee is subject to liability to the member of the public for the damages and a direct action against the promisor is consistent with the terms of the contract and with the policy of the law authorizing the contract and prescribing remedies for its breach.<sup>7</sup>

Note that this section of the Restatement (Second) applies only to contracts under which a party contracts with a government to “do an act for or render a service to the public.” Examples of this sort of contract include agreements to provide water or sewer service to a government’s citizens, to collect solid waste within a government, to enforce the building code on behalf of a government, to provide fire protection to a geographic area of a government, and so on. Contracts of this kind create a unique sort of analytic problem. Because governments exist to

5. *Raritan*, 329 N.C. at 651, 407 S.E.2d at 181 (citing *Snyder v. Freeman*, 300 N.C. 204, 221, 266 S.E.2d 593, 604 (1980)).

6. See *Broadway Maint. Corp. v. Rutgers*, 447 A.2d 906, 909 (1982): “Whether the third person is a creditor or donee of the contractual promisee is relevant only in ascertaining the intent of the contracting parties. The parties of course may expressly negate any legally enforceable right in a third party. Likewise they may expressly provide for that right. When the contract is silent, it is necessary to examine the pertinent provisions in the agreement and the surrounding circumstances to ascertain that intent.”

7. The comparable statement in original Restatement of Contracts was found in Section 145 and read as follows:

A promisor bound to the United States or to a State or municipality by contract to do an act or render a service to some or all of the members of the public, is subject to no duty under the contract to such members to give compensation for the injurious consequences of performing or attempting to perform it, or of failing to do so, unless,

- (a) an intention is manifested in the contract, as interpreted in the light of the circumstances surrounding its formation, that the promisor shall compensate members of the public for such injurious consequences, or
- (b) the promisor’s contract is with a municipality to render services the non-performance of which would subject the municipality to a duty to pay damages to those injured thereby.

serve the public, in a sense all these contracts are intended to benefit the members of the public. Does that therefore mean that all members of the public are intended beneficiaries of the contracts? Both Restatements generally answer this question in the negative. As can be seen above, Section 313 of Restatement (Second) states that such contracts are subject to the general rules stated in Section 302 and, importantly, that members of the public are not automatically intended beneficiaries of such contracts and therefore do not have third-party rights to challenge or enforce the contracts or to receive damages for their breach.

It is not clear, though, that North Carolina's appellate courts subscribe to this section of the Restatement. One of the illustrations given in the comment to this section of the Restatement conflicts with North Carolina case law. Here is the illustration:

B, a water company, contracts with A, a municipality, to maintain a certain pressure of water at the hydrants on the streets of the municipality. A owes no duty to the public to maintain that pressure. The house of C, an inhabitant of the municipality, is destroyed by fire, owing to B's failure to maintain the agreed pressure. B is under no contractual duty to C.

North Carolina is one of a small number of states that have permitted the owner of property damaged or destroyed because of inadequate hydrant pressure to bring a third-party beneficiary claim against a water provider who has a contract with the city under which the provider agrees to provide adequate pressure for fire protection. The first case in a series of such North Carolina cases is *Gorrell v. Greensboro Water-Supply Co.*,<sup>8</sup> in which the franchise agreement between the city and the water company included detailed specifications about the water pressure that was required for fire hydrants. The plaintiff's commercial property was destroyed by fire, allegedly as a direct result of the water company failing to meet those contractual specifications, and it sued the water company as a third-party beneficiary to the franchise contract. The trial court overruled the company's demurrer to the complaint, and the North Carolina Supreme Court affirmed, writing:

It is true, the plaintiff is neither a party nor privy to the contract, but it is impossible to read the same without seeing that, in warp and woof, in thread and filling, the object is the comfort, ease, and security from the fire of the people, the citizens of Greensboro. This is alleged by the eleventh paragraph of the complaint, and is admitted by the demurrer. The benefit to the nominal contracting party, the city of Greensboro, as a corporation, is small in comparison, and, taken alone, would never have justified the grants, concessions, privileges, benefits, and payments made to the water company. Upon the face of the contract, the principal beneficiaries of the contract in contemplation of both parties thereto were the water company on the one hand and the individual citizens of Greensboro on the other. The citizens were to pay the taxes to fulfill the money consideration named, and furnishing the individual citizens with adequate supply of water, and the protection of their property from fire, was the largest duty assumed by the company.<sup>9</sup>

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8. 124 N.C. 328, 32 S.E. 720 (1899).

9. *Id.* at 333, 32 S.E. at 721.

*Gorrell* has been explicitly confirmed in a number of later cases, most recently in *Potter v. Carolina Water Co.*,<sup>10</sup> which involved essentially identical facts.

After *Potter*, however, several judges on the court placed a limiting interpretation on *Gorrell* and seemed to move closer to the Restatement (Second)'s position on governmental contracts. In *Matternes v. City of Winston-Salem*, the city had entered into a contract with the State Highway Commission, under which the city agreed to maintain state highways within the city.<sup>11</sup> Under the contract the state had to approve any contract entered into by the city for highway maintenance and the city's annual obligations were limited by the amount of money made available each year by the state; in addition, under state policy such a contract was not intended to transfer to the city the state's liability for failing to maintain highways. On a snowy morning the plaintiff's mother was killed when her car skidded on Interstate 40 as it passed through the city, and the plaintiff, as her mother's executor, claimed to be a third-party beneficiary of the maintenance contract, which she alleged that the city had breached. The trial court entered a nonsuit against plaintiff, and the North Carolina Supreme Court affirmed.

The plaintiff relied specifically upon *Gorrell*, but in its plurality opinion the court first cited and quoted from a New York case that had reached the opposite conclusion from *Gorrell* and then moved on to distinguish *Gorrell* and limit it to a relatively narrow set of facts. The New York case was *Moch Co. v. Rensselaer Water Co.*, and the opinion was by Benjamin Cardozo, then chief judge of the New York Court of Appeals.<sup>12</sup> The facts of *Moch* were quite similar to those of *Gorrell*, but the New York court held that the property owner was *not* a third-party beneficiary to the water supply contract. The *Matternes* court included this quotation from the New York case, which reflects the policy choices of the Restatement (Second):

In a broad sense it is true that every city contract, not improvident or wasteful, is for the benefit of the public. More than this, however, must be shown to give a right of action to a member of the public not formally a party. The benefit, as it is sometimes said, must be one that is not merely incidental and secondary. . . . It must be primary and immediate in such a sense and to such a degree as to bespeak the assumption of a duty to make reparation directly to the individual members of the public if the benefit is lost. The field of obligation would be expanded beyond reasonable limits if less than this were to be demanded as a condition of liability. A promisor undertakes to supply fuel for heating a public building. He is not liable for breach of contract to a visitor who finds the building without fuel, and thus contracts a cold. The list of illustrations can be indefinitely extended. The carrier of the mails under contract with the government is not answerable to the merchant who has lost the benefit of a bargain through negligent delay.<sup>13</sup>

The opinion in *Matternes* went on to distinguish *Gorrell* by noting that it involved a utility franchise contract and stating that “[o]ne accepting and operating under such a franchise assumes

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10. 253 N.C. 112, 116 S.E.2d 374 (1960). The *Potter* court reviewed the entire series of earlier cases.

11. 286 N.C. 1, 209 S.E.2d 481 (1974).

12. 159 N.E. 896 (N.Y. 1928).

13. 286 N.C. at 13, 209 S.E.2d at 488.

duties and incurs obligations more extensive than those incurred by the promisor in an ordinary contract.”<sup>14</sup>

It is not clear, though, that *Matternes* brought North Carolina squarely within the law on governmental contracts as set out in Restatement (Second). Only six justices heard the case, and the main opinion was joined by only three of the six; thus it spoke for only a plurality of the sitting justices. One justice dissented, protesting against what he characterized as “in effect, overrul[ing]” *Gorrell*, arguing that “the *Gorrell* rule is the better reasoned one even though followed by a minority of jurisdictions.”<sup>15</sup> A second justice concurred in the result but without opinion, while the final sitting justice concurred in the outcome on statutory grounds but rejected the main opinion’s treatment of the third-party beneficiary issue.<sup>16</sup> Thus, despite the quoted language from the dissent, only three of six justices clearly supported the opinion’s treatment of third-party beneficiaries under government contracts, including the limiting of *Gorrell*. Thus, the status of *Gorrell* and that case’s approach to third-party beneficiaries of government contracts is not settled.

Many governmental contracts, probably most, are not of the sort addressed by Section 313. In this larger group of contracts—construction contracts, professional services contracts, property transactions, etc.—the contract does not involve acts for or services to *the public*, as set out in the examples above, but rather acts for or services to the *government itself*. For these sorts of contracts the basic rules of Section 302 apply, without reference to Section 313.<sup>17</sup>

### Governmental Contracts in North Carolina: Contracts with Private Parties

In many instances a government entering into a contract, particularly a contract with a private person or entity, may be indifferent to whether the contract creates rights in third parties. In most contracts with private persons or entities the government is the *promisee*, the party for whom some service is being performed or to whom some product is being delivered. The government’s obligation under the contract is simply to pay for the performance or the delivery. It is the other party to the contract who is the *promisor*. And it is the promisor, not the promisee, who might face a lawsuit from an outsider claiming to be a third-party beneficiary under the

14. *Id.* at 14, 209 S.E.2d at 488.

15. *Id.* at 22, 209 S.E.2d at 493 (Huskins, J., dissenting).

16. Justice Higgins concurred without opinion. Justice Sharp concurred but wrote:

From that portion of the majority opinion which discusses the rights of third party beneficiaries to a contract to maintain an action for its breach, I must disassociate myself. I do not agree that members of the traveling public are merely “incidental beneficiaries” of the contract which the City made with the Board. Further, it is not my intention to overrule or question *Gorrell v. Water Supply Co.* I adhere to the rule of law enunciated in that case, which is deeply embedded in our jurisprudence.

*Id.* at 16, 209 S.E.2d at 490 (citations omitted).

17. One large category of contracts entered into by local governments is those for the purchase of goods. With the exception of product liability actions, there are relatively few cases nationally that involve third-party claims under such purchase contracts. With respect to product liability, the North Carolina courts historically have required privity of contract in order to bring a product liability action, but that strict rule has become shakier; see *Bernick v. Jurden*, 306 N.C. 435, 293 S.E.2d 405 (1982). Passage of the Products Liability statute, Section 99B-2 of the North Carolina General Statutes (G.S.), has further considerably weakened the rule.

contract.<sup>18</sup> Therefore the government might conclude that third-party rights are a concern only for the promisor and leave it to that party to raise the issue in the contract negotiations. Of course, if the issue is raised, the government will have to decide if it really is indifferent to third-party rights under the contract and negotiate accordingly.

In some instances, though, a government may not be indifferent to the possible existence of third-party rights. First, the government's obligations under a contract might go beyond simply paying for the other party's performance. There might be mutual promises of performance. For example, in a contract to extend a water system or sewer system, the government may contractually promise to obtain and make available the easements necessary to run the utility lines. If the extension is to serve a specific community, the government might be concerned that property owners in that community could claim to be third-party beneficiaries of the contract. Second, sometimes a government will contract with another, for the other party to fulfill some sort of responsibility of the government; and the government might prefer that any litigation engendered by the contractor's failure to fulfill the responsibility be against the contractor rather than the government. In one case, for example, a local government construction contract required the government to prepare, or cause to be prepared, an environmental impact statement for the construction project. When the government met this requirement by entering into a separate requirement with a consulting engineer, the issue arose of whether the construction contractor could sue the engineer, as a third-party beneficiary of the consulting contract, because of the engineer's delay in preparing the report.<sup>19</sup> Third, performance of the contract by the other party, even if not negligent, might cause damage for which a damaged party might seek recompense from the government. For example, construction of a utility system might cause the earth-supporting abutting structures to collapse, even if the contractor is without negligence, and abutting property owners might seek compensation from the government. The government may wish to transfer that possible liability to the contractor constructing the utility system, identifying abutting property owners as third-party beneficiaries under the contract with a right to seek their compensation from the contractor rather than the government.<sup>20</sup> Fourth, even if it is clear

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18. See, e.g., *District of Columbia v. Campbell*, 580 A.2d 1295 (D.C. 1990). In this case, a subcontractor performed work on a public works project for a general contractor who had failed to obtain the payment bond required by statute and contract. The subcontractor claimed to be a third-party beneficiary of the contract between the District and the general contractor and sued both under the contract. The D.C. Court of Appeals held that even if the subcontractor was a third-party beneficiary under the contract, he could sue only the general contractor, as promisor, and not the District, as promisee. *Accord*, *Broadway Maint. Corp. v. Rutgers*, 447 A.2d 906 (N.J. 1982), in which the New Jersey Supreme Court held that because prime contractors in a university construction project were third-party beneficiaries of contract between the university and the general contractor, prime contractors could sue only the general contractor and not the university. *But see* *Anderson v. Rexroad*, 266 P.2d 320 (Kan. 1954), in which the Kansas Supreme Court held that a property owner whose property was destroyed during a street improvement project was a third-party beneficiary of the construction contract and could sue *either* the city or the contractor.

19. *Coac, Inc. v. Kennedy Eng'rs*, 136 Cal. Rptr. 890 (Cal. Ct. App. 1977) (construction contractor was creditor beneficiary under the consulting contract).

20. Examples of cases in which abutters who had been harmed by construction projects were held to be third-party beneficiaries of construction contracts include *Plantation Pipe Line v. 3-D Excavators, Inc.*, 287 S.E.2d 102 (Ga. Ct. App. 1981) (damage to pipeline next to construction site), *Bator v. Ford Motor Co.*, 257 N.W. 906 (Mich. 1934) (damage to building because of settlement during water tunnel construction), and *La Mourea v. Phude*, 295 N.W. 304 (Minn. 1940) (damage to abutting property caused by blasting).

Many of these construction contracts include provisions that the contractor often claims is an indemnity clause, which can only be enforced by the government as indemnitee. See, e.g., *Simons v. Tri-State*

that the government is simply a promisee under the contract, and it is clear there is no government liability if the contract is not performed, the contract may benefit a limited group of persons or property owners and the government may wish to entitle them to enforce the contract's obligations. If nothing else, allowing these third-party beneficiaries to enforce the contract may relieve the government of the burden of doing so. For example, a number of cases from other states have involved developer promises to the government to construct subdivision improvements, and the courts have recognized property owners within the subdivision as third-party beneficiaries of the promises and therefore allowed them to enforce the contract's obligations against the developer.<sup>21</sup>

If the government does have an interest in specifying whether or not third parties may be beneficiaries under a contract, the best course is to make third-party rights an issue in the negotiation of the contract and then to specifically spell out the results of that negotiation in the final contract.

### **Governmental Contracts in North Carolina: Contracts with Other Governments**

When one local government contracts with another, at least one of them will be a promisor and therefore potentially susceptible to a third-party claim. In addition, many such contracts involve services to the public or some portion of the public. A county might provide law enforcement services for a small town or enforce the building code on behalf of a town. A city might provide recreational programs for residents of the unincorporated area, provide a building to house a library operated by the county, or treat the sewage generated by the collection system of a nearby town. These are the sorts of contracts that are the focus of Section 313 of the Restatement (Second). Under Section 313, a member of the public would usually not be considered a third-party beneficiary of this sort of contract, but recall that it is currently unclear whether the North Carolina appellate courts accept the Restatement's approach on this issue. (There are no North Carolina cases involving third-party beneficiaries under contracts between two local governments.) Bearing that uncertainty in mind, it might be useful to review the cases from other states to gain a sense of their approach and their application of the Restatement principles.

*Cases in which the asserted third-party beneficiary represents the entire public of one of the contracting governments.* When the third-party plaintiff claims to be a beneficiary of a contract because he or she is a member of the entire public served by the promisee government, the courts have rejected the claim. All of the third-party beneficiary cases from other states arising from contracts between two local governments have involved the provision of utility services; in several of these cases, one government agrees to provide service that benefits the entire public

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Const. Co., 655 P.2d 703 (Wash. Ct. App. 1982). If a North Carolina provision is an indemnity clause of this sort, it does not run afoul of the prohibition on indemnification clauses in construction contracts in G.S. 22B-1, which does not apply to a clause in which party A agrees to indemnify party B for claims arising out of party A's negligence.

21. *E.g.*, *Villa Sierra Condo. Ass'n v. Field Corp.*, 878 P.2d 161 (Colo. App. 1994) (condominium association, along with one unit owner, held to be third-party beneficiaries of contract between condominium developer and city under which developer agreed to construct certain street improvements); *Vale Dean Canyon Homeowners Ass'n v. Dean*, 785 P.2d 772 (Or. App. 1990) (homeowners within development held to be third-party beneficiaries of contract between developer and county under which developer agreed to construct certain street improvements).

of the second government. In each such case, an attempt by a member of that broad benefited public to claim third-party beneficiary status under the contract has failed. Following are summaries of these cases.

*Gallo v. Division of Water Pollution Control.*<sup>22</sup> In the 1930s, the Metropolitan District Commission entered into contracts with a number of central Massachusetts cities, under which the commission agreed to construct sewer lines, one of the cities agreed to treat the sewage collected through those lines, and the other cities agreed to maintain the lines. Eventually there was so much infiltration and inflow into the lines that the Division of Water Pollution Control prohibited several cities from accepting new connections to the lines, and as a result the plaintiff developers were unable to build their housing developments. They sued the commission, the cities, and the division for damages, arguing that the failure of the cities to maintain the lines, and of the commission to make them comply with their contractual obligations, was a breach of the 1930s contracts and that the developers were third-party beneficiaries under those contracts.

Most of the Massachusetts supreme court's opinion concerned whether the plaintiffs had standing under the 1930s legislation that authorized the agreements. That legislation allowed suits by "interested persons" to enforce the obligations under the acts, and plaintiffs claimed that they were interested. Reviewing the legislation, the court determined that the legislative purpose was to protect nearby water supplies, through construction of a sewer system, rather than to provide sewer services to properties. Therefore the plaintiffs were not interested persons. That being the case, the court proceeded to hold that the plaintiffs were also not intended beneficiaries of the contracts and therefore could not claim third-party beneficiary status.

*Bodine v. Osage County Rural Water District No. 7.*<sup>23</sup> The water district purchased water from a nearby city under a forty-year contract executed in 1972. The contract set out the original price that the district would pay for the water and the circumstances under which the city could raise the price. In the years after the contract was first entered into, the city raised prices several times and the district passed these increases onto its customers. The plaintiff was a customer of the district who believed that the district was paying more for the water than was justified by the contract terms and therefore brought suit seeking various forms of relief.

The plaintiff first argued that the district was under a duty, enforceable by any customer, to enforce the contract and seek overcharges from the city, even though neither the city nor the district argued that the contract has been misapplied. The Kansas Supreme Court held that a customer is without standing to force one local government that is party to an agreement with another to interpret the contract in the same way as the customer. Having reached that conclusion, the court held that a utility customer was not an intended beneficiary of a contract under which the utility purchases water.

*South Texas Water Authority v. Lomas.*<sup>24</sup> The South Texas Water Authority (STWA) constructed a water transmission line from the city of Corpus Christi to provide water to municipal and industrial customers in an area of south Texas. In 1981 it entered into a contract with the city of Kingsville for that purpose. This action was brought by Lomas, an individual citizen of Kingsville, and by a nonprofit association titled Citizens for Water Acquired through Equal Rates (WATER), alleging that the rates charged under the contract were excessive and unreasonable and led to the citizens and customers of Kingsville paying a disproportionate share of the

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22. 372 N.E.2d 1258 (Mass. 1978).

23. 949 P.2d 1104 (Kan. 1997).

24. 223 S.W.3d 304 (Tex. 2007).

STWA operating costs. The action was brought against STWA, as supplier of the water; the city of Kingsville was not joined as a defendant.

Both plaintiffs claimed standing as third-party beneficiaries under the contract; in addition they claimed standing as customers and ratepayers of the city of Kingsville. The trial court held that they had no standing under either theory, but the court of appeals reversed. In an opinion found at 223 S.W.3d 389 (2005), it granted Lomas standing as a ratepayer to pursue monetary and declaratory relief and WATER standing as a ratepayer to pursue declaratory relief; both plaintiffs were granted standing as third-party beneficiaries of the water supply contract.

The Texas Supreme Court reversed, finding no language in the contract that demonstrated any intention of the parties to confer a benefit upon the residents of the city or its utility customers, and, indeed, neither had the court of appeals. Rather, the lower court relied on a statement of purpose in the enabling legislation under which the water authority operated, which stated that the authority existed “for the benefit of the people of this state and for the improvement of their properties and industries.” The supreme court rejected this argument as proving too much:

It is true that the Legislature, in creating STWA as a conservation and reclamation district, intended generally to benefit the people of this state, as presumably it intends with all legislation. But general beneficence does not create third-party rights, else every Texan could challenge or seek to enforce any government contract and the presumption against third-party-beneficiary agreements would disappear. The enabling statute upon which the court of appeals relied created no more than an incidental benefit to the public at large, the very type of benefit we have said is insufficient to confer third-party-beneficiary status.<sup>25</sup>

A similar case, with a similar outcome, though not involving a contract between two governments, is *Fifth Third Bank v. Cope*, a 2005 decision of the Ohio Court of Appeals.<sup>26</sup> The plaintiff was the unfortunate purchaser of a new home constructed upon the closed landfill of a roofing company. Within a year or so of the home’s construction it had literally sunk into the ground and fallen apart, and as a consequence it was condemned. The plaintiff, and her mortgagee bank, sued the developer of the subdivision, the builder of the home, the city which had been responsible for building code inspections of the home, and the consulting engineer who had actually made the inspections. This last defendant had had a contract with the city, under which the

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25. *Id.* at 307.

Other cases of interest, though not all involving contracts between two local governments, include *Federated Conservationists of Westchester County, Inc. v. City of Yonkers*, 117 F. Supp. 2d 371 (S.D.N.Y. 2000) (county and city entered into interlocal agreement under which county relinquished reversionary interest in parkland conveyed some years earlier to city and city agreed to locate twenty-five acres of new park space to replace that park; court holds that park users, who sought to block conversion of parkland to low-income housing, are not third-party beneficiaries of agreement); *Miree v. U.S.*, 249 S.E.2d 573 (Ga. 1978) (survivors of airplane passengers, who sought damages resulting from plane crash, held not to be third-party beneficiaries of airport development contract between county and Federal Aviation Administration); *Uhl v. City of Sioux City*, 490 N.W. 69 (Iowa Ct. App. 1992) (property owner who sought damages for lack of access to property because of state highway project held not to be third-party beneficiary to contract between state and city under which city agreed to construct replacement road that would have provided the desired access).

26. 835 N.E.2d 779 (Ohio Ct. App. 2005).

engineer agreed to do all building inspections for the city, and the plaintiff homeowner claimed that she was a third-party beneficiary of that contract. (The case is relevant to North Carolina interlocal agreements because many counties have contracted to do building inspections within smaller municipalities.)

Following the lead of Section 313 of the Restatement (Second), the court rejected the third-party claim. It held that the engineer had been hired to provide services to the community at large and not to specified home buyers and that membership in the community at large was inadequate to be an intended beneficiary of the contract.

*Cases in which the asserted third-party beneficiary represents a subset of the entire public of one of the contracting governments.* A smaller number of cases involve plaintiffs who come from subsets of less than the entire public of the promisee government, when the subset is established in the contract itself. The outcomes of these cases are more mixed. Again the cases involve the provision of utility services, but in two of the cases the plaintiffs were found to be third-party beneficiaries of the interlocal agreements. Let's begin with those two cases.

The first case is *Touchberry v. City of Florence*, a 1988 decision of the South Carolina Supreme Court.<sup>27</sup> The city had entered into an agreement with the county to provide water and sewer services to a municipal services area comprising unincorporated territory adjacent to the city. The plaintiff owned property within this services area and requested water and sewer from the city. The city refused to extend these services, however, unless the plaintiff agreed to city annexation of the property, and the plaintiff brought suit, claiming that the city's requirement was a breach of the contract with the county and that he was a third-party beneficiary of the contract. Without much analysis in the opinion, the court agreed with the plaintiff: the city's obligations under the contract were inconsistent with its annexation requirement, and the parties intended that property owners in the area be able to enforce the contract. In a later case, the South Carolina court allowed a third party to litigate the meaning of another interlocal utility agreement but held that the contract in question allowed the city to condition utility service upon annexation.<sup>28</sup>

The second case is *McAlmont Suburban Sewer Improvement District No. 242 v. McCain-Hwy. 161, LLC*, a 2007 case from an Arkansas appellate court.<sup>29</sup> The sewer committee of North Little Rock entered into an agreement with the sewer improvement district under which the city agreed to treat sewage generated within the district. The contract included the following provision regarding sewer service through district lines to nonresidents of the district:

The District shall have the right to make charges for connections to the District's trunk sewer lines by residents living outside the boundaries of the District, provided that such residents and the Committee have entered into an agreement with regard to services to be rendered to such residents by the Committee or the Committee has otherwise approved such charges.

The LLC owned property outside the district and wanted sewer service. When the district set forth its connection charges for such service, the LLC approached the city and was given a considerably lower price. When the district refused to make the connection at the city's price, the LLC brought this action and prevailed at the trial court. In affirming, the court held that the plaintiff was a member of a special class and therefore a third-party beneficiary of the contract:

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27. 367 S.E.2d 149 (S.C. 1988).

28. *Robarge v. City of Greenville* (S.C.), 675 S.E.2d 788 (2009).

29. 262 S.W.3d 185 (Ark. Ct. App. 2007).

The District and the Committee made their agreement about sewer services approximately fifteen years before McCain was even formed. And the District/Committee agreement does not name McCain or say that it was intended to benefit non-parties. The agreement, however, sufficiently described a class of which McCain is a member—non-residents of the District whom the District and the Committee were willing to serve. The opportunity for sewer service arises out of this agreement and benefits that class of non-residents. This benefit is more than incidental; sewer services are an essential of modern urban life. The District was willing to serve McCain, and indeed has done so on an interim basis before and during this litigation. McCain sought no damages. It sought only an injunction requiring the District to accept the connection fee set by the Committee. Considering all these circumstances, we hold that McCain was a beneficiary of the non-resident provision of the District/Committee agreement and thus had standing to litigate which entity had the power to set the connection fee under that agreement.<sup>30</sup>

The court concluded by holding that the contractual clause quoted above gave complete discretion to the sewer committee to set the connection fees for nonresidents.

In the South Carolina case, the third-party beneficiary was a resident of an area of less than the entire county, which was the focus of the contract, and in the Arkansas case the third-party beneficiary was a nonresident of the sewer district under a contract that made special provision for connections by nonresidents. But not all the cases involving such smaller classes of claimed beneficiaries have found these classes to be intended beneficiaries of the contracts. Following are discussions of three competing cases.

*Dateline Builders, Inc. v. City of Santa Rosa.*<sup>31</sup> The city and county had entered into a contract under which the city would be sole supplier of sewer services to a defined area outside the city. The parties' intention was to avoid a proliferation of small sewer systems in this area. The contract specifically provided that any development in the area had to conform to development plans adopted jointly by the city and county.

Dateline sought to connect a new housing development to the city's system, but the city refused, alleging that the development was not in conformity to the development plan. The plan called for development to be compact and close to the city, and Dateline's site leapfrogged substantial undeveloped territory. When the development failed, Dateline brought suit against the city, claiming to be a third-party beneficiary of the city-county contract. The California court of appeals affirmed the trial court's judgment for the city, holding that the intention of the parties was to avoid proliferation of sewer systems rather than to extend sewer services to all parts of the service area. There was to be benefit to the general public of the service area, not to specific property owners.

*OFW Corp. v. City of Columbia.*<sup>32</sup> In 1992, the city and a sewer district entered into a contract under which the district would close its existing sewer treatment plant and transmit its collected sewage to an existing city plant via a new trunk line to be built pursuant to the agreement. One provision of the contract required the district to obtain city permission to

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30. *Id.* at 187.

31. 194 Cal. Rptr. 258 (Cal. Ct. App. 1983).

32. 893 S.W.2d 876 (Mo. Ct. App. 1995).

extend its sewer system beyond the existing service area, which the city agreed not to withhold unreasonably.

OFW wanted to develop a subdivision adjacent to the existing service area and asked the district to obtain city permission to do so. The city at first attempted to condition approval upon the developer's acceptance of annexation but later backed down. It subsequently gave approval but conditioned it upon the developer's following city development standards in the subdivision. OFW refused and brought suit. It claimed to be a third-party beneficiary under the contract and argued that the city was in breach by refusing to permit connection of OFW's property to the existing system.

The Missouri Court of Appeals approached the case through the structure of the original Restatement, differentiating between creditor, donee, and incidental beneficiaries. OFW claimed to be a creditor beneficiary, but the court disagreed. First, it could find no duty of the district to serve plaintiff's property with sewer. Nor could it find any language in the contract itself showing an intent by the parties to specifically benefit property owners near the service area. The contract was basically an agreement for the benefit of the two contracting parties.

*Page v. City of Conyers.*<sup>33</sup> For almost thirty years the city and the county operated under an agreement under which the city was given exclusive authority to operate water and sewer systems in the unincorporated areas of the county. When the agreement ended, this action was brought by ratepayers in the unincorporated area, alleging that the city violated the agreement over its final five years and overcharged customers. They sought more than \$10 million in damages. The appellate court affirmed a dismissal by the trial court, finding no basis in the agreement for holding that there was a primary intention to benefit utility customers. The plaintiffs' main argument was based on language in the agreement about serving the public, but the court determined that this was nowhere near specific enough to cause the customers to be considered intended beneficiaries.

## Conclusion

Because of the uncertain character of the North Carolina case law on the issue of whether a member of the public might be a third-party beneficiary of a contract with a local government, we cannot be sure whether the state's appellate courts would follow the lead of the cases set out above involving beneficiaries who represent the entire public of the contracting government. Nor can we judge which path the North Carolina courts might follow when the claimed beneficiaries represent a class of less than the entire public of the contracting government. This uncertainty, plus the fact that courts in at least two states have found certain citizens to be third-party beneficiaries of interlocal agreements involving utility services, suggests that governments entering into many sorts of contracts—whether with another government or with a private contractor—should consider the possibility of attempted third-party enforcement of the contracts and whether the government is indifferent to the possibility or not. If a government is not willing to leave resolution of this issue to a court, it should recall that the existence or nonexistence of third-party rights is first and foremost a matter of the intention of the actual parties to the contract. The parties can make it clear, in the contract itself, whether or not there is a class of nonparties who are intended to be beneficiaries under the contract. It should often,

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33. 499 S.E.2d 126 (Ga. Ct. App. 1998).

therefore, be a regular feature of government contract negotiations to consider the possibility of third-party beneficiaries, to negotiate a mutual position on such beneficiaries, and then to include the outcome of those negotiations in the written contract.<sup>34</sup>

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34. A successful example of contract language denying rights to third parties is found in *Mission Oaks v. County of Santa Barbara*, 77 Cal. Rptr. 2d 1 (Cal. Ct. App. 1998). The county had contracted with an engineering firm for the latter to prepare an environmental impact report on a proposed development. Because of the report, the county rejected the development, and the developer then brought suit for breach of contract, claiming to be a third-party beneficiary of the contract between the county and the engineer. The court rejected the claim, relying on the express language of the contract:

[T]he final responsibility and final authority on all questions concerning the content and quality of the EIR lies in the sole discretion of the County. . . . Consultant understands and agrees that its responsibility to provide a complete and accurate EIR is owed solely to County and that its accountability under this Contract shall likewise be solely to County and not to Applicant or to any other third-person or entity.

*Id.* at 7.

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