



Hong Kong

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THE CONTRACTS (RIGHTS OF THIRD PARTIES) ORDINANCE – THE IMPACT ON HONG KONG CONTRACTS

Introduction

The Contracts (Rights of Third Parties) Ordinance (Cap. 623) (the **Ordinance**) came into force on 1 January 2016. It amends the doctrine of privity of contract, according to which “only a person who is a party to a contract can sue on it”.¹ The doctrine had long been criticised as unfair since it applied even when the contracting parties intended to benefit a third party. Under the Ordinance, a person who is not party to a Hong Kong contract (a **third party**) now has the right to enforce a term of a contract if: (i) this is expressly provided for in the contract; or (ii) on a proper construction of the contract, the term purports to confer a benefit on the third party.

It is however possible to contract out of the effect of the Ordinance and this may be desirable in many cases given the potentially broad scope of “purports to confer a benefit” under the second limb of the enforceability test. In England, where similar legislation has been in place since 1999, contracts commonly include clauses excluding its operation and it is expected that this practice will be followed in Hong Kong. However, a blanket exclusion clause will not be appropriate where the contracting parties wish to give a third party the right to enforce a term of the contract, e.g. giving the benefit of an indemnity to a group company. In these cases, the contract should expressly identify the third party and the specific term(s) that it may enforce. The operation of the Ordinance can then be excluded with respect to all other third parties. It will therefore be important to identify at the drafting stage whether

the operation of the Ordinance should be excluded completely or preserved in relation to specific terms for specified third parties.

Scope of Application

The Ordinance applies to contracts that are entered into on or after 1 January 2016. It does not affect contracts entered into prior to that date.

Certain contracts are excluded from the operation of the Ordinance, including bills of exchange, promissory notes and other negotiable instruments, letters of credit, covenants relating to land, contracts for the carriage of goods by air or sea, and a company’s articles of association having effect as a contract under seal (Section 3). The Ordinance does not confer a right on a third party to enforce a term of an employment contract against an employee, but is silent on whether a third party may enforce an employment contract against an employer.

Rights of Third Parties

Under the Ordinance, a third party may enforce a term of a contract (including a term which excludes or limits liability) if:

- a) the contract expressly provides that the third party may do so; or
- b) the term purports to confer a benefit on the third party, unless on a proper construction of the contract, the term is not intended to be enforceable by the third party (Section 4).

¹ B + B Construction Ltd v Sun Alliance and London Insurance Plc [2000] 2 HKC 295 at [301B]-[301F] quoting Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd [1915] AC 847 at [853].

The Ordinance only confers the benefit of contractual terms on third parties – it does not impose any burden on the third party. Thus while the third party can enforce a contractual term which confers a benefit on it – a party to the contract cannot enforce a contractual term against a third party.

The third party must be expressly identified in the contract by name, as a member of a class (e.g. subsequent owners) or as answering a particular description (e.g. A's nominee).² The third party does not have to be in existence when the contract is entered into (e.g. a company not yet incorporated). A third party does not need to have given consideration in order to enforce its rights.

A third party may seek any remedy that would have been available to the third party in an action for breach of contract if the third party had been a party to the contract. The Ordinance explicitly provides that this includes a remedy under the rules of equity, which would include injunctions and specific performance.

The enforcement of the term by a third party is subject to any other term of the contract relevant to the term. It is therefore possible to contract out of the effect of the Ordinance and this is discussed further below.

Rescission and Variation of Contracts

Where a third party has the right to enforce a term of a contract, the parties to the contract may not, without the third party's consent, agree to rescind the contract or vary it so that the third party's right under the term is altered or extinguished. This restriction on variation and rescission applies only once the third party's rights have "crystallised", which occurs when:

- a) the third party has assented to the term and the promisor has received notice of the assent; or
- b) the third party has relied on the term and the promisor is aware of the reliance, or can reasonably be expected to have foreseen that the third party would rely on the term.

The above requirement can be overridden by an express term in the contract which:

- a) provides for the contract to be rescinded or varied without the third party's consent; or

- b) specifies circumstances in which the third party's consent is required for the rescission or variation of the contract.

For the express term to prevail, before the third party's rights are "crystallised", either (a) the third party should be aware of the express term; or (b) one or more parties to the contract should take reasonable steps to make the third party aware of the term.

Where third parties are to be given a right to enforce specified terms of a contract, consideration needs to be given to whether the contracting parties wish to retain their right to rescind or vary the agreement without the consent of the third parties.

On application by a party to the contract, the court may make an order dispensing with the third party's consent if: (a) the other party agrees to rescind or vary the contract; and (b) the court thinks it just and practicable to make the order.

The relevant section of the Ordinance (Section 6) applies to acts carried out "by agreement" between the parties, but it is uncertain as to its application to acts which are not carried out "by agreement" and affect the interests of a third party, for example termination by breach.

Rights of Defence and Set-Off

In proceedings brought by a third party, a party to a contract can raise a defence or set-off which would have been available to him:

- a) if the proceedings had been brought by the other party to the contract, and:
 - i) the matter raised by way of defence or set-off arises from or in connection with the contract, and is relevant to the term to be enforced; or
 - ii) an express term of the contract provides for the defence or set-off to be available to him in proceedings brought by the third party; or
- b) if the third party had been a party to the contract.

A contracting party will have a counterclaim against a third party if that counterclaim would have been available if the third party had been a party to the contract.

² Examples taken from Department of Justice <http://www.doj.gov.hk/eng/public/rightsofThirdParties.html>.

An express term can be included in the contract to restrict the defences, rights of set-off or counterclaims available to the parties in an action brought by a third party.

Protection against Double Liability

The Ordinance protects a party to the contract from double liability in certain circumstances. If a party to the contract has wholly or partly performed its obligations to the third party, it is discharged from the obligations it owes to the other party to the contract to the extent of having performed the same obligations to the third party.

If one party to a contract has recovered from the other a sum for: (i) the third party's loss in relation to the term; or (ii) the expense of making good to the third party the default of the other contracting party, then a court or arbitral tribunal must reduce any award to the third party to the extent it thinks appropriate to take account of the sum recovered.

Clauses Excluding or Limiting Liability

A contractual term excluding or limiting the liability of the contracting parties may expressly extend the benefit of the term to third parties such as group companies, employees, agents or sub-contractors. The third party's right to enforce the term is subject to the Control of Exemption Clauses Ordinance (Cap. 71) under which liability for death or personal injury cannot be excluded and other types of exemption clauses are subject to a reasonableness test.

Assignment of Third Party Right

A third party may assign its right to enforce a term of a contract to another person, unless: (a) the contract expressly provides otherwise; or (b) on a proper construction of the contract, the right is personal to the third party and is not assignable. In most cases, contracting parties will probably exclude a third party's right to assign such rights. If they do not, the contract should require a third party to give notice to the contracting parties of any assignment.

Arbitration and Jurisdiction

If a third party's right to enforce a term of a contract is subject to an arbitration agreement, the third party is treated as a party to the arbitration agreement for the purposes of the Arbitration Ordinance (Cap. 609) unless, on a proper construction of the contract, the third party is not intended to be so treated (Section 12).

If the contract contains an exclusive jurisdiction clause, the third party is bound by the exclusive jurisdiction clause in any dispute between the third party and a party to the contract relating to the enforcement of the term, unless on a proper construction of the contract, the third party is not intended to be so bound (Section 13).

Other Jurisdictions

The Ordinance aligns Hong Kong with other common law jurisdictions which have undertaken similar reform to the privity doctrine, including England and Wales, Canada (New Brunswick), Australia (Western Australia, Northern Territory and Queensland), New Zealand and Singapore. The Ordinance is modelled on the Contracts (Rights of Third Parties) Act 1999 of England and Wales. The English statute has not had a significant impact due to the use of contracting out provisions, which are discussed below.

The Benefit Test

The Ordinance gives a third party the right to enforce a contractual term if either the contract expressly provides for this, or the term purports to confer a benefit on the third party. Although there is uncertainty as to what classifies as purporting to confer a benefit, English case law may provide some guidance. Justice Christopher Clarke in *Dolphin Maritime & Aviation Services Ltd* stated that a "contract does not purport to confer a benefit on a third party simply because the position of that third party will be improved if the contract is performed". Justice Clarke further stated that "purporting to 'confer' a benefit [benefit test] seems to me to connote that the language used by the parties shows that one of the purposes of their bargain (rather than one of its incidental effects if performed) was to benefit the third party". In *Prudential Assurance Co. Ltd*, Justice Lindsay stated that the benefit test is "satisfied if on a true construction of the term in question its sense has the effect of conferring a benefit on the third party in question", but there is "no requirement that the benefit on the third party shall be the predominant purpose or intent behind the term".

Given the potentially broad application of the concept of purporting to confer a benefit, contracts should be carefully drafted to ensure that rights are not unwittingly conferred upon third parties. Where the intention is to confer a benefit on third parties, this should be explicit – the contract should name the third parties and state which terms they can enforce. The contract can then exclude the operation of the Ordinance

in respect of all other third parties. If no third party rights are intended, the safest course is to contract out of the effects of the Ordinance completely.

Third Party Rights – Examples

Express terms as to the enforceability of contractual terms by third parties will be required whenever it is intended that a third party should benefit from the terms of a contract. Examples include:

- Contracts conferring the benefit of an indemnity on a third party such as an indemnity which is given in favour of a company and its group companies (e.g. in relation to a share or business acquisition);
- Contracts containing a confidentiality obligation which confers the benefit of non-disclosure on a third party, such as companies of a corporate group or other parties;
- Contracts with restrictive covenants, such as service agreements, which confer the benefits of the restrictive covenant on companies in a corporate group; and
- Contracts which confer the benefit of clauses limiting or excluding liability on third parties such as companies in the same corporate group or employees of the contracting party.

Assignees and successors in title are not usually parties to contracts, but under the Ordinance, they may acquire rights to enforce contractual terms. Contracts may expressly state that assignees and successors in title have the same rights as parties to the contract.

Negotiating Hong Kong Contracts

The Ordinance needs to be considered when negotiating contracts governed by Hong Kong law. Parties should examine the terms of the contract to determine whether the Ordinance will apply and to identify potential benefits conferred implicitly or explicitly on a third party. This is important to ensure that there are no rights that a party may want to protect before including a standard clause excluding the Ordinance.

In circumstances where parties wish to preserve the doctrine of privity and limit their liability to third parties, they should clearly and expressly exclude all provisions of the Ordinance in the contract and related contracts.

Where parties wish a third party to have the right to enforce a term of the contract, they should expressly identify the third party and state that the third party may enforce a specific term(s). The contract can also exclude the provisions of the Ordinance in relation to all other third parties.

Parties should also have regard to the following matters:

- The third parties must be expressly identified. If only certain third parties to the contract are to be able to enforce a contractual term, this should be made clear.
- The terms of the contract that are to be enforceable by the third parties should be clear. The Ordinance refers to enforcement of “a term of the contract”, rather than the contract as a whole.
- Whether the benefit or right to enforce the contractual term is conditional. Although a contract cannot impose an obligation on a third party, a condition to enforcement by a third party is permitted.
- Whether the parties should limit their liability to a third party and/or limit available remedies.
- Whether the contracting parties should include a provision maintaining their right to vary or rescind the contract without the third party’s consent, or whether there are specified circumstances in which the consent of the third party is required before rescission or variation of the contract.
- Whether the third party may assign their rights under the Ordinance. Contracting parties may wish for any assignment rights to be excluded.
- Whether to include an express term specifying (or restricting) the defences, rights of set-off or counterclaim to be available to the contracting party in proceedings brought by a third party.
- Whether to make the third party rights subject to an arbitration agreement or any other method for dealing with a dispute, such as mediation.
- Whether the third party is to be bound by an exclusive jurisdiction clause. Under the Ordinance, the third party will be bound by an exclusive jurisdiction clause unless, on a proper construction of the contract, this is not intended.

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