Giving Third Parties Contractual Rights – The New Rules

Hong Kong’s Contracts (Rights of Third Parties) Ordinance No. 17 of 2014 (the “Ordinance”) was passed in December 2014, and is expected to come into force as Cap. 623 later this year. We are advising clients to treat now as a lead-in period, and take practical steps to get ready. In this Legal Update, we consider the implications of one of the most important reforms to the Hong Kong law of contract in recent times.

General

The Ordinance reforms the long established rule that a person can only enforce a contract if they are a party to it (the “privity of contract” rule). Broadly, the new rules provide a mechanism for parties to a contract expressly to agree in that contract that persons who are not parties to it will have rights under it. More importantly, the new legislation will also make it possible, in some circumstances, for third parties to enforce terms of a contract, even where there is no express statement by the contracting parties giving them any rights.

The Ordinance implements, in full with necessary modifications, the recommendations of the Law Reform Commission of Hong Kong’s report on Privity of Contract (2005). It has wide ranging implications for all contractual arrangements, whether oral or in writing, from standard terms of business, agency and distribution arrangements, construction contracts and software licences, to sale and purchase agreements and insurance contracts; to name but a few. Some types of contracts are excluded, as we explain later.

The Government has indicated a target date of bringing the Ordinance into operation one year after the passage of the Bill (i.e., December 2015), giving time to run publicity to assist the general public and stakeholders prepare. While the date is not yet confirmed, once it is in operation then the Ordinance will be fully effective immediately (although without any retrospective effect). Thus, we are advising our clients to spend time now formulating a house view, and preparing standard clauses to include in contracts as soon as the Ordinance is brought into operation.

What does the law say now?

The privity of contract rule says that only a party to a contract can acquire rights and obligations under it. This is the case even where the contract is made with the specific intention of giving benefits to, or imposing obligations on, a third party. There is also a related rule that, in most circumstances, a person can only recover damages to compensate for his own loss and not the loss suffered by another person.

At first glance these rules may seem logical but they can sometimes give rise to unsatisfactory commercial results. This means traditionally lawyers have had to come up with alternative devices for conferring contractual benefits (although not necessarily rights of direct enforcement) on third parties such as:

- a deed poll – a type of deed made by and expressing the intentions of one party only, such as a power of attorney or a loan note instrument;
- agency arrangements – where a party enters into a contract as agent for its disclosed or undisclosed principal;
- trust arrangements – where a party accepts the benefit of a contract or a particular term for itself and as trustee for named third parties such as its employees, agents and sub-contractors;
- collateral contracts/warranties – a contract between two parties may also be accompanied by a collateral contract or warranties between one of them and a third party in relation to the...
same subject-matter. Collateral warranties are extremely common in the construction industry. In addition, the courts have on occasions found limited specific exceptions to the rule that a party cannot recover more than the amount necessary to compensate it for its own loss.

The new law

The Ordinance is substantially the same as United Kingdom’s Contracts (Rights of Third Parties) Act 1999 (the “Act”), although there are some notable differences (which are flagged in this Legal Update). The Ordinance says that a third party can enforce a term of a contract if:

1. The contract expressly provides that it may; or
2. The contract purports to confer the benefit of that term on it; and, in either case
3. It is expressly identified in the contract by name or as a member of a class or as answering to a particular description.

In the case of the second qualifying limb, no rights of enforcement will arise where, on a proper construction of the contract, it appears that the parties did not intend the term to be enforceable by third parties. In practice, unless the parties wish the new rules to apply, the safest course will be to exclude them using express and clear wording in the contract. Similarly, if the parties wish to invoke the new rules, this intention will need to be clearly specified and detailed parameters for their application set.

Identifying the third party

The third qualifying limb is particularly wide and highlights the need for clear and careful drafting when invoking the provisions of the new rules. It will be possible to confer benefits on third parties by class or type such as all the employees of a business, all occupiers of a building, all members of a group of companies, or all users of licensed software. Importantly, third parties do not have to be in existence when the contract is entered into, so that benefits can also be conferred on future members of a class.

Available remedies

Assuming that a third party is granted rights, the remedies available to it are the same as they would have been had it actually been a party to the contract itself. Therefore, the third party will be entitled to claim damages and seek injunctions and specific performance. The availability of remedies will be subject to the usual rules governing their application under general law. So, for example, in the case of injunctions (which are available only at the discretion of the court and not as a matter of absolute right), the third party will still need to satisfy the court of the merits of exercising that discretion in favour of the third party. Similarly, the usual rules relating to recoverability of loss (for example, that losses are not recoverable if they are too remote) will apply to third party claims.

Status of other relevant terms

However, the third party cannot enforce a term of a contract otherwise than in accordance with the other terms of that contract. For example, if there is a term which requires contractual disputes to be dealt with in a particular way (e.g., by reference to an expert or mediator), or provides for legal proceedings to be served in a particular way, the third party will be bound to follow that route except to the extent the contract provides otherwise. Even so, in practice, it will still be sensible to specify expressly which provisions apply to the third party and to what extent. Special rules apply which ensure that where a third party seeks to enforce a contractual term and the contracting parties have agreed that disputes in relation to that term are subject to an arbitration agreement, then the third party is treated as a party to the arbitration agreement for the purposes of the Arbitration Ordinance (Cap. 609) and is also bound to make any claim in relation to that term by means of arbitration proceedings.

Likewise, where the contracting parties have included an exclusive jurisdiction clause in their contract, then a third party is also bound by the exclusive jurisdiction clause as regards a dispute between it and a contracting party relating to the enforcement of the term. Here, the Ordinance differs from the UK Act which does not expressly deal with jurisdiction clauses.

Benefit not burden

It should be emphasised that the Ordinance only confers the benefit of contracts on third parties. It does not impose any burdens. Therefore, a third party cannot be bound by a contract or have obligations imposed on it against its will. This is the
case even if the parties expressly purport to confer obligations on third parties.

Also, the benefits conferred on a third party can be restricted e.g., damages limited to a certain sum.

**Variation and rescission**

To prevent contracting parties from undermining the rights granted to a third party by revoking or varying the terms of a contract without reference to the third party, the Ordinance states that the contracting parties may not by agreement rescind or vary the contract (without the consent of the third party) so as to extinguish or alter its rights.

A third party’s right of veto only applies to acts done by agreement between the contracting parties. It appears that consent is not required for unilateral acts and there seems to be nothing to stop a party to the contract exercising (in a proper and lawful fashion) unilateral rights such as rights of termination for material breach. The intention appears to be to prevent changes to the terms of a contract by further agreement between the parties (not, for example, changes made in accordance with mechanics set out in the contract, such as a variation to a construction contract).

The Ordinance recognises to some extent the practical difficulties inherent in obtaining third party consent to variations and rescission. The right of veto only applies if certain conditions are met and is subject to other controls.

- First, the obligation to obtain the third party’s consent only applies if one of three conditions is met. These are that:
  - the third party has assented to the term and the promisor has received notice of the assent (whether in writing or orally); or
  - the third party has relied on the term; and
  - the promisor is aware of the reliance; or
  - the promisor can reasonably be expected to have realised that the third party would rely on the term.

The safest course for third parties will be, where practicable, to send a clear and unambiguous written notice to the promisor as soon as the contract is signed identifying the contract and the third party’s agreement to the terms it is seeking to rely on.

- Second, the right of veto is subject to any express term of the contract which specifies that it can be rescinded or varied without the third party’s consent or provides for different circumstances in which consent is required.

- Third, the Ordinance provides that the contracting parties may apply for a court or tribunal order dispensing with consent in certain circumstances. This is where:
  - the other contracting parties agrees to rescind or vary the contract; and
  - the court thinks it is just and practicable to make the order.

The court may also impose any condition it thinks fit, including a condition that the third party be compensated.

While helpful in getting round the issue of a third party who cannot give consent, such as an infant or a third party that has not come into existence yet, these provisions are of little assistance if the parties wish to terminate or vary the contract as a matter of urgency.

In view of the various areas of uncertainty, it seems likely that many contracting parties will simply dispense with the prescribed rules about variation and rescission in the new legislation and instead specify in the contract the extent to which they can terminate and vary it without reference to the third party and/or the circumstances and manner in which any consent has to be obtained. This is particularly important where the third parties in question form a large class and obtaining their individual consent would be time consuming and complicated.

**Defences and double recovery**

The Ordinance builds in a number of protections for a contracting party who confers benefits on a third party. In defending a third party claim, a contracting party may raise all defences and rights of set-off that:

- arise from or in connection with the contract which are relevant to the term in question; or
- are made expressly available to it in case of proceedings brought by the third party; and

which would have been available if the claim had been brought by the other original contracting party, or the third party had been a party to the contract.

Again, to some extent, the rules on the availability of defences and rights of set-off can be varied by express agreement between the contracting parties. This is a complicated area and is bound to give rise to drafting issues.
The legislators have also sought to protect contracting parties against double liability for the same loss. To the extent that a contracting party has performed an obligation to a third party, then it is discharged from performing the same obligation to the other contracting party. Likewise, if a contracting party has already recovered damages for a loss before the third party has done so on its own behalf, then the court or tribunal in any proceedings brought by the third party must reduce any award to the third party to the extent it thinks appropriate to take account of the sum. This is logical and fair. For example, it will prevent a situation where a contracting party claims damages on behalf of, say, its employees and those employees also try to claim damages for the same loss.

Exclusions and limitations of liability

The Ordinance interacts with existing legislation regarding exclusion clauses and limitations of liability. There are two cases in which exclusions and limitations are relevant.

• First, a third party may itself seek to rely on an exclusion clause contained in a contract to which it is not a party. For example, a supplier of goods or services may purport in its supply contract to exclude or limit liability for the negligent acts both of itself and of its employees, agents and sub-contractors. In the past, if those third parties were sued by the customer for negligence (rather than under the contract), they would not have been able to rely on that exclusion of liability. If the Ordinance applies, they will now be able to do so (i.e., as third parties of a class in respect of which the contract purports to confer the benefit of the limitation of liability). However, the Control of Exemption Clauses Ordinance (Cap. 71) (“CECO”) imposes restrictions on exclusions and limitations of liability. The restrictions will also apply to those third parties.

• Second, a contract which a third party is seeking to enforce may contain an exclusion or limitation of liability on the part of the promisor (i.e., the party that has conferred the benefit). Importantly, the third party will be able to rely on the CECO to attack exclusions or limitations of the promisor’s liability for negligence, on the grounds they are not reasonable (this is different from the UK Act which disapplies the equivalent section of the CECO). In addition, the original contracting parties are prevented by the CECO from excluding or limiting their liability to a third party for death or personal injury.

Assignment

The Ordinance includes an express right for a third party to assign its right to enforce a term of a contract to another person (except where the contract expressly provides otherwise or where, on a proper construction of the contract, that right is not assignable). Again, this is a key difference with the UK Act. Contracting parties are advised therefore to exclude that right, or at least require prior written notice of any assignment, so that they can manage their exposure to third parties appropriately. For example, in the context of variation or rescission, unless the right to assign is modified or excluded, there could be confusion over whether there has been assent to or reliance on the contract (and thus the contracting parties may not vary or rescind the contract without consent) or whether or not an express term providing for variation or rescission has been brought to the attention of the correct party.

Which types of contract are covered?

The new legislation will be relevant to all contractual arrangements apart from the few listed below. It is worth remembering that contracts can be made in all sorts of ways; for example by deed, formal agreement, exchange of letters or orally. The parties should consider the impact of the new rules at an early stage in contractual negotiations to avoid the risk of inadvertently conferring benefits on third parties.

The following categories of contract are expressly excluded from the ambit of the new rules:

• a bill of exchange, promissory note or any other negotiable instrument;
• a deed of mutual covenant;
• a covenant relating to land;
• a contract of carriage by sea or by air under the Bills of Lading and Analogous Shipping Documents Ordinance (Cap. 440) and the Carriage by Air Ordinance (Cap. 500);
• a letter of credit;
• a company’s articles (which are treated by section 86 of the Companies Ordinance (Cap. 622) as having effect as a contract under seal); and
• a contract of employment (as against an employee).
Implications
Many of the benefits of the new legislation identified by the Law Reform Commission of Hong Kong as justifying the need for change relate to comparatively straightforward contractual arrangements involving private individuals as at least one contracting party. For example, if a person enters into a contract with a tour company for a holiday package for his parents, and the tour company fails to honour the contract, then the new rules could enable the parents to sue the tour company direct for breach of contract.

In terms of more complex commercial arrangements, the Ordinance also brings benefits, not least the opportunity to craft clear transparent third party rights (not always the case with the traditional workaround solutions), where such rights are intended to be given. However, commercial parties in particular should be alert to the consequences of inadvertent application of the Ordinance.

Excluding the new rules
If contracting parties do not intend to benefit third parties, they should, for safety, include in their contract a blanket exclusion of the new rules. We expect that blanket exclusion clauses will be used widely.

We continue to monitor for news of when the Ordinance will come into operation, and will keep you updated.

This is a summary of the law only. Specific advice should be sought in specific circumstances.

Invoking the new rules
Once the Ordinance comes into force, we recommend that parties use express wording to invoke the Ordinance, not least in an attempt to address some of the ambiguities we have highlighted. That express wording should at least:

• clearly identify the third party and the exact terms it will be able to enforce;
• clearly identify any conditions subject to which the right to enjoy the benefit of those terms is made;
• specify the circumstances in which the contract can or cannot be varied or rescinded without the third party’s consent;
• specify any restrictions on assignment;
• consider including any specific limitations on the extent of the promisor’s liability to the third party;
• specify which other terms of the contract are to apply to claims by the third party (e.g., exclusion clauses, dispute resolution where other than arbitration and notice provisions);
• set out any specific rights of defence or set-off which the party conferring the benefit can rely on as against the third party.