

Rights of Third Parties in Hong Kong: What you need to know

Introduction

The Contracts (Rights of Third Parties) Ordinance (Cap. 623) (the "**Ordinance**") reforms the long-standing common law doctrine of privity of contract by enabling persons who are not parties to a contract to enforce rights under that contract. This will bring Hong Kong's contract law regime more into line with other major common law jurisdictions, such as England, Singapore and New Zealand, which already have third party contractual rights legislation in place. The Ordinance comes into force on 1 January 2016 and will apply to all Hong Kong law-governed contracts entered into on or after that date (but it will not apply to contracts entered into before that date).

What is the current position?

The "privity of contract" rule means that (i) a person cannot acquire and enforce rights under a contract to which it is not a party; and (ii) a person who is not a party to a contract cannot be made liable under it. In other words, even if a contract includes a provision conferring a benefit on someone who is not a party to it, that person (a "third party") generally has no right to enforce that provision.

This rule is sometimes seen as not giving sufficient recognition to the intention of the contracting parties and has caused significant commercial inconvenience. For example, where a manufacturer sells a product to a distributor who then sells it onto a consumer, there is no contractual relationship between the manufacturer and the consumer. The consumer will have no contractual right of action against the manufacturer if the product is defective. A variety of techniques have been deployed to overcome the privity of contract rule. These include the use of trusts, deeds poll, agency arrangements and assignment and novation provisions. These techniques will continue to be employed even after the Ordinance has come into force (for example, in circumstances where the operation of the Ordinance is excluded).

To which contracts does the Ordinance apply?

The Ordinance will apply to all contracts governed by Hong Kong law entered into on or after 1 January 2016 (but not to contracts entered into before then) other than:

- letters of credit;
- contracts for the carriage of goods by sea or by air;
- bills of exchange, promissory notes or other negotiable instruments;
- deeds of mutual covenant;

Key Points to Note

- *The Ordinance applies to all contracts governed by Hong Kong law entered into on or after 1 January 2016 save for certain types of contracts which are expressly excluded*
- *The parties to a contract may agree in that contract that a third party (identified specifically or as a class) can have the benefit of, and can enforce, a term of that contract*
- *The Ordinance cannot be used to impose liabilities and obligations upon third parties*
- *The consent of the intended third party beneficiary will be required in order to amend the contract in a way which may affect the rights conferred on that third party, unless the contract contains a provision to the contrary and the third party is aware of it or the amendment takes place before the rights of that third party are "crystallised"*
- *In respect of the enforcement of its rights under the contract, the third party beneficiary will, in relation to the remedies, be treated as if it were a contracting party*
- *The contracting party who is the promisor will be protected against double liability (to the other contracting party who is the promisee, and to the third party)*
- *The parties to a contract may expressly exclude the operation of the Ordinance from the contract, in which case the privity of contract rule under common law shall continue to apply*

- contracts of employment; and
- articles of association of Hong Kong-incorporated companies.

When will third parties have rights under the Ordinance?

Section 4 of the Ordinance gives a third party a right to enforce a term of a contract (including a term that excludes or limits liability) where:

- (i) the contract expressly provides that the third party may do so; or
- (ii) 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).

This right applies whether or not the third party has given consideration. In both cases, the third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description, but does not have to be in existence at the time the contract was entered into.

When enforcing a term, the third party is entitled to a remedy that would have been available to it in an action for breach of contract as if that third party had been a party to the contract, including a remedy under the rules of equity (e.g. an injunction or specific performance). Such rights supplement and do not take away any rights that the third party would otherwise have under the existing law.

The Ordinance cannot be used to impose liabilities and obligations on third parties. However, the contract can require third parties to comply with conditions if they want to enforce the rights conferred on them.

The parties may expressly exclude the operation of the Ordinance from the contract, in which case the privity of contract rule under common law continues to apply.

Can the contract be varied or rescinded without the third party's consent?

The Ordinance attempts to respect the freedom of the contracting parties to amend the terms of the contract while also taking into account the interests of a third party who may be prejudiced as a result of any amendment. Therefore, the contracting parties will not be able to rescind or vary the third party's rights without the third party's consent once those rights have "crystallised". This "crystallisation" happens when the third party communicates to the relevant contracting party the third party's assent to the contractual term or the relevant contracting party becomes aware that the third party has relied (or can reasonably be expected to have foreseen that the third party would rely) on the contractual term.

However, the contracting parties can, by an express term in the contract, extend or limit the third party's right to veto an amendment, provided that the third party is aware of such term - or one of the contracting parties has taken reasonable steps to make the third party aware of such term - prior to "crystallisation". In practice, this requirement may be difficult to comply with.

What about defences and set-offs?

The relevant contracting party will generally have the same defences and set-offs against the third party that would have been available if the proceedings had been brought by the other contracting party, as well as defences, set-offs and counterclaims that would have been available to it if the third party had been a party to the contract. However, these can be extended or limited by express terms in the contract. There are also provisions to ensure the promisor is only liable once for the same loss in situations where both the promisee and the third party are each permitted to enforce the same term.

Can the third party assign its rights?

The Ordinance provides that a third party may assign to another person its right to enforce a term of a contract unless the contract expressly provides otherwise or, on a proper construction of the contract, the right is personal to the third party and is therefore not assignable.

Conclusion - what does this mean in practice?

Clients should review their Hong Kong law-governed documentation to identify whether they wish to take advantage of the new law as well as to determine whether they might wish to exclude its effects.

Exclusionary approach: This would involve inserting a new clause into the documentation which disapplies the Ordinance so that no third party rights are unintentionally created. The effect of this approach is that a third party cannot rely on the Ordinance even if such party is mentioned in the contract. Any issues that may arise between the contracting parties (and any relevant third party) would be in effect subject to the common law privity of contract rule (as well as any other legislation) that exists apart from the Ordinance.

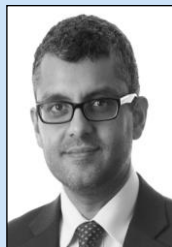
"Partial Exclusionary" approach: This approach can be used where the contracting parties wish to avail themselves of the Ordinance in order to give rights to a third party in relation to one or more specified terms of the contract. In this case, a clause would be inserted into the documentation excluding the operation of the Ordinance except in relation to those specified terms. In this scenario, the contracting parties may also wish to expressly reserve their rights to amend or even cancel such terms without the consent of the third party (bearing in mind the need to take reasonable steps to make the third party aware of such provisions), and they may also wish to expressly exclude or limit the ability of the third party to assign its rights under the contract.

In practice, it is likely that most Hong Kong entities and transaction documentation governed by Hong Kong law will follow the approach initially adopted in England, which is to exclude the operation of the legislation entirely. However, developments in recent years in, for example, the financial markets suggest that there may be circumstances in which it might be desirable or necessary, for commercial reasons, to utilise the legislation to grant rights to third parties: this will need to be considered in light of the particular transaction, the intentions of the parties involved, and prevailing practice in the particular market.

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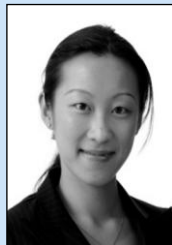
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