The Contracts (Rights of Third Parties) Ordinance: Beware - statutory third party rights are coming your way!
1. Outline

- Doctrine of privity and its limitations
- Third party rights in the construction industry
- Specific sections in Contracts (Rights of Third Parties) Ordinance
- Case law in the UK
- Implications for the construction industry
- General drafting tips
2. Doctrine of privity and its limitation

- The doctrine of privity of contract

  A contract cannot confer rights or impose obligations on any persons other than the parties to the contract (Tweddle v Atkinson [1861] 1 B&S 393)

1. A person cannot acquire or enforce rights under a contract to which he is not a party
   - ie. a third party to a contract, not having provided consideration himself, cannot enforce the contract even if it has been entered into for his benefit

2. A person who is not party to a contract cannot be made liable under it
2. Doctrine of privity and its limitation (cont.)

- Strict application of the doctrine of privity can be artificial and contrary to parties’ intention to benefit third party.

- Remedy rule – need to prove loss for breach of contract, but sometimes party to contract not the one who suffered loss.

  - Eg. A and B enter into an agreement under which A agrees to pay a sum of money to C (third party). Both parties fully intend that C should take the benefit of A’s promise. If A defaults, C cannot sue A. Also does not help for B to sue A for damages.
2. Doctrine of privity and its limitation (cont.)

- Parties have used various ways to circumvent the doctrine of privity
- Exceptions to privity
  - Agency
  - Trust
  - Collateral warranties
  - Tort of negligence
  - Assignment
  - Covenant concerning land
2. Doctrine of privity and its limitation (cont.)

- Exceptions – pros and cons

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tr>
<td><strong>Agency</strong></td>
<td><strong>Trust</strong></td>
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<tr>
<td>Principal can sue directly</td>
<td>Beneficiary can sue directly</td>
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<td>Problem if agent acts outside authority</td>
<td>Limited and uncertain scope</td>
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<td>Require manifest intention to create a trust</td>
<td>Add to administrative burden</td>
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3. Third party rights in the construction industry

Third party rights are commonly used in construction projects. For example,

1. Lender exercising **step-in rights** in the event of the contractor's default
2. Employer enforcing a **collateral warranty** against a sub-contractor in relation to the quality of works
3. Successor in title suing the builder for **defects**
4. Contracting party's agents or employees relying on a **limitation of liability clause** or an **indemnity clause**
4. Contracts (Rights of Third Parties) Ordinance

- Commencement date is 1 January 2016
- Provides statutory exception to the doctrine of privity of contract
- Ordinance only confers benefit of contracts on third parties, does not impose any burden – third parties not bound by contract or have obligations imposed on it against its will
  - Gives effect to parties’ intention to benefit a third party
  - Provides the third party with a right to enforce his rights in contract terms directly
- Similar legislation enacted in other common law jurisdictions including England & Wales, Australia (QLD, WA & NT only), New Zealand, Singapore, Canada (New Brunswick only)
4. Contracts (Rights of Third Parties) Ordinance – Scope

- Applies to all contracts entered into on or after 1 January 2016 (s3(1))

- Existing contracts will not be affected – Ordinance has no retrospective effect

- Does not affect any other right or remedy of a third party that exists or is available apart from the Ordinance (s5(4)), e.g.
  - Common law (eg tort, agency, trust)
  - Legislation (eg Third Parties (Rights Against Insurers) Ordinance)
4. Contracts (Rights of Third Parties) Ordinance – Scope (cont.)

- Wide application

- Rationale for exclusion:
  - There is existing common law or statutory regime which governs third party rights under relevant contracts; or
  - There are sound policy reasons for not applying the Ordinance

- Following contracts are excluded (s3(2)):
  - Bill of exchange, promissory note or any other negotiable instrument
  - DMC (as defined by section 2 of the Building Management Ordinance)
  - Land covenant
4. Contracts (Rights of Third Parties) Ordinance – Scope (cont.)

- Contract of carriage (but exclusion or limitation of liability clauses are covered)
- Contract for the carriage of goods by air governed by the Carriage by Air Ordinance
- Letter of credit
- Company’s articles (under section 86 of the Companies Ordinance)
- No third party to enforce a term of an employment contract against an employee (s3(4))
- Construction contracts are generally covered
5. Key provisions – s4 – Third party’s right to enforce a contract

- Third party can enforce a term of a contract if:

1. **Express provision** – The contract expressly provides that the third party may do so (s4(1)(a)); or

2. **Rebuttable presumption** – The term purports to confer a benefit on the third party (s4(1)(b)), unless on a proper construction of the contract, this was not the parties’ intention (s4(3))

- “Purports to confer a benefit” - a direct benefit, not just a consequential or incidental benefit (*Dolphin Maritime* [2009] EWHC 716 (Comm))

- “On a proper construction of the contract” – objective test – the extent to which surrounding circumstances can be taken into account would best be left to the courts to decide
5. Key provisions – s4 – Third party’s right to enforce a contract (cont.)

- Conditions:
  - The third party must be expressly identified in the contract - by name, as a member of a class or as answering a particular description (s4(2))
  - Enforcement of the term is subject to any other term in the contract that is relevant to the term (s4(4))
  - Effective even if third party did not give consideration for its rights under the term (s4(5))
  - Effective even if third party was not in existence at the time the underlying contract was entered into (s4(6))
  - Parties can expressly exclude the application of the Ordinance
5. Key provisions – s5 – Third party’s right to enforce a contract (cont.)

- Third party may seek the same remedy as would have been available to him if he had been a party to the contract (including under the rules of equity)
  - Eg. claim damages, seek injunctions, specific performance
5. Key provisions – ss6 & 7 – Rescission and variation

- A ‘crystallisation’ test – once third party rights are crystallised, cannot be rescinded or varied without the third party’s consent (s6(1) & (2)). Crystallisation occurs upon:
  - ‘acceptance’ – third party communicates his assent – postal acceptance rule does not apply; or
  - ‘reliance’ – third party relies on the term conferring third party right and promisor is aware of (or reasonable expected to have foreseen) the reliance

- Important to balance between two considerations:
  - Protect third parties’ interests who may suffer as a result of the variation or rescission
  - Parties’ freedom of contract

- Need for a cut-off point to put an end to the contracting parties’ right to vary or cancel the contract
5. Key provisions – ss6 & 7 – Rescission and variation (cont.)

- Parties can set their own ‘crystallisation’ test:
  
  1. Include an express term prior to crystallization to reserve parties’ right to vary or rescind the contract without requiring third party’s consent, or
  
  2. require third party’s consent to be obtained under specified circumstances (s6(3))

- But subject to conditions (s6(4)): third party is aware of such term; or parties have taken reasonable steps to make third party aware of such term

- Alternatively, apply for court order to rescind or vary the contract (s7)
5. Key provisions – s12 – Arbitration provisions

- Third party may enforce an arbitration agreement in two situations:

  1. Third party has a right to enforce a term under s4 and that substantive term is subject to an arbitration agreement (s12(1) – (3))

  2. Arbitration agreement provides that third party may enforce it by referring its dispute with the promisor to arbitration (s12(4) – (6))
5. Key provisions – s14 – Assignment

- Third party may assign his third party right unless:
  - (A) the contract expressly provides otherwise, or
  - (B) the right is personal to the third party and is not assignable.
5. Key provisions – Other provisions

- Section 8 – Proceedings brought by third party
  - Eg. Employer sues sub-contractor for defective work, and sub-contractor raises counterclaim for the progress payment main contractor failed to pay

Under sub-contract, main contractor is liable to sub-contractor for failure to pay progress payment
5. Key provisions – Other provisions

- Section 9 – Proceedings brought against third party

- Two possible scenarios as regards exclusion/limitation of liability

1. Third party (eg employees, agents, sub-contractors) seeks to rely on an exclusion/limitation of liability clause procured for the promisee (eg employer, principal, main contractor) – third party can rely on the clause subject to restrictions in the Control of Exemption Clauses Ordinance (CECO)

2. Promisor seeks to rely on an exclusion/limitation of liability clause contained in a contract which confers third party rights – third party can mount an attack on the validity of the clause under the CECO
5. Key provisions – Other provisions (cont.)

- Section 10 – Enforcement of contract by promisee
- Section 11 – Protection of promisor from double liability

Under sub-contract, main contractor sues sub-contractor for costs of rectifying defects.
5. Key provisions – Other provisions (cont.)

- Section 13 – Exclusive jurisdiction clause

Under main contract, HK courts have exclusive jurisdiction to hear disputes.

Sub-contractor’s dispute with employer concerning its third party rights will also be bound by the same exclusive jurisdiction clause.
6. Case law in other jurisdictions

- **Avraamides v Colwill** [2006] EWCA Civ 1533 – UK Court of Appeal

Third party who is to be conferred third party rights ought to be 'expressly identified' in the contract by name, class membership or description, as the court would not identify him as such by implication.

- Facts:
  - A builder sold its business to Colwill who agreed to pay 'any liabilities properly incurred' by the builder. Avraamides who previously engaged the builder to refurbish two bathrooms subsequently brought a claim against Colwill for the builder's defective work contending that Colwill's agreement to pay any liabilities properly incurred by the builder conferred third party rights on Avraamides entitling it to make the claim.

- Held:
  - Avraamides was not entitled to claim against Colwill as the sale agreement did not expressly identify Avraamides as a third party who would have that right.
6. Case law in other jurisdictions (cont.)

- **Hurley Palmer Flatt v Barclays Bank Plc** [2014] EWHC 3042 – UK High Court

  The court will not extend the scope of third party rights beyond what is expressly defined in the contract

- Facts:
  - Barclays PLC (an affiliate of Barclays Bank) engaged Hurley to provide mechanical and electrical engineering design services
  - Clause 14.3 of the engagement agreement allowed Barclays Bank (as Barclays PLC's affiliate) 'to enforce the terms of this Agreement as "Client" always provided that the Consulting Engineer shall be entitled [to] rely on the equivalent defences in respect of such liability which it has against the Client'
6. Case law in other jurisdictions (cont.)

- Barclays Bank sought to commence adjudication proceedings against Hurley contending that clause 14.3 conferred a right to adjudicate its dispute. Hurley applied for a declaration that Barclays Bank was not entitled to adjudicate.

- Held:

  - Reference to 'such liability' in clause 14.3 suggested that Barclays Bank's third party rights were those relating to liability, rather than procedural rights → Barclays Bank did not have the procedural right to commence adjudication proceedings.
6. Case law in other jurisdictions (cont.)

- **Fortress Value Recovery Fund v Blue Skye Special Opportunities Fund** [2013] EWCA Civ 367 – UK Court of Appeal

- ‘Very clear language' is needed if the intention is that a third party should have a right to arbitrate

- Facts:
  - Partnership deed to which Blue Skye et al were not party contained exclusion clauses the benefit of which Blue Skye was entitled to as third party
  - The deed also contained an arbitration clause on which Blue Skye et al sought to rely to stay court proceedings commenced against it by Fortress

- Held:
  - Whether the right of a third party to benefit from an exclusion clause in a contract is subject to an obligation to submit to arbitration pursuant to an arbitration clause in the contract is a matter of construction
  - Very clear language required for the right of a third party who benefits from an exclusion clause to be also subject to an arbitration clause in the same agreement. No such clear language was found in the deed
6. Case law in other jurisdictions (cont.)

- **Trident General Insurance Co Ltd v McNiece Bros Proprietary** [1987-1988] 165 CLR 107 – Australian High Court

- Where a promisor has unambiguously promised to confer a benefit on a third party, and the third party has relied on the promise and would suffer detriment if the promise is not performed – privity of contract unlikely to apply

- Facts:
  - Blue Circle Cement entered into a contract of insurance with Trident. The insurance policy covered liability for accidents occurring during the construction. “Assured parties” included all Blue Circle’s contractors and sub-contractors (which included McNiece). McNiece subsequently became principal contractor
  - One of McNiece’s workers was seriously injured. McNiece made a claim against Trident. Trident denied liability on the grounds that McNiece was not a party to the insurance contract and had not provided any consideration
6. Case law in other jurisdictions (cont.)

- Held:
  - Due to the nature of liability insurance, the contractual terms gave an unmistakable intention that each insured party should be entitled to the benefit of the insurer’s promise to indemnify it against the specified loss and should be entitled to have that promise enforced.
7. Implications for the construction industry

- **Challenges in applying Ordinance to construction contracts**
  - To ensure certainty – should list third parties or classes of third parties on whom the rights are to be conferred, at every level in the contracting chain.
  - Large number of stakeholders – difficult to identify all third parties that have rights because some rights may only be known at time of enforcement.
  - But if not done, unexpected third party claims will arise.
7. Implications for the construction industry (cont.)

- **Statutory third party rights v.s. collateral warranties**

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<tr>
<th>Collateral warranties</th>
<th>Statutory third party rights</th>
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<tbody>
<tr>
<td>Time consuming, expensive – delay in execution of one or two can delay execution of</td>
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<tr>
<td>project documents as a whole and hence the start of project</td>
<td>Identifying all potential third parties or classes of parties at the outset in a third-</td>
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<td>party rights schedule annexed to the main contract – save time and costs in creating the</td>
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<td>third party rights and executing the project</td>
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<tr>
<td>Rights may not be assigned to other parties down the contracting line without</td>
<td>May be assigned without promisor’s consent – no administrative burden of having to seek</td>
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<tr>
<td>promisor’s consent</td>
<td>consent for each assignment</td>
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[Image]
7. Implications for the construction industry (cont.)

- **Exclusion clauses and limitation of liability**

- Statutory third party rights allow sub-contractors to benefit from an exclusion clause and limitation of liability that a main contractor procures under the contract for its own benefit as well as that of the sub-contractors.

- Main contractor may purport in its contract to exclude or limit liability for the negligent acts both of itself and of its employees, agents and sub-contractors – sub-contractor can rely on clause to exclude liability for negligence now.

- Subject to the requirement of reasonableness under the Control of Exemption Clauses (CECO).
7. Implications for the construction industry (cont.)

- **Other possible uses:**

  - Contracting parties agree a payment mechanism by which a sub-contractor is to be paid directly by an employer thereby allowing the sub-contractor to sue the employer for non-payment for duly performed work.

  - Where an employer wants to be able to bring a claim against a sub-contractor or supplier directly, for poor work or supplies.

  - Give the later owners of a building a right to bring an action against the original builder, should building defects emerge.
7. Implications for the construction industry (cont.)

- In more complex commercial arrangements – essential to clearly draft third party right provisions, where such rights are intended to be given

- Parties must be alert to risks of (a) conferring unintended third party rights by drafting errors and (b) inadvertent exclusion of intended third party rights by blanket exclusion

- Statutory third party rights offer many benefits that will far outweigh the risks
8. Drafting tips for construction contracts

- Parties to contracts entered into from 1 January 2016 will be at liberty to contract out of the effect of the Ordinance

- May exclude the Ordinance if:
  - Do not want any risk of a third party having enforceable rights; high possibility of the agreement being interpreted as conferring a benefit on unintended third party

- May invoke the Ordinance if:
  - Want to confer a directly enforceable right on one or more third parties
  - Specific provision needs to be included, in order that it can be used in a controlled way
8. Drafting tips for construction contracts – Checklist for Drafting

1. Does the agreement expressly provide for third party rights or contain a term which purports to confer a benefit on a third party?

2. Should the Ordinance be excluded entirely or partially? Insert the following clause for any exclusion.

“[Except as expressly provided in ....,] a person who is not a party to this agreement shall not have any rights under the Contracts (Rights of Third Parties) Ordinance (Cap 623) to enforce any term of this agreement.”

- For blanket exclusion, remove the wording inside the square brackets. Otherwise, partial exclusion applies.
Checklist for Drafting (cont.)

3. If you determine that the Ordinance should apply to the agreement, consider the following questions:

i. Are third parties clearly defined in the agreement by their names, class membership or description?

ii. Which clauses confer the third party rights, and against whom can those rights be enforced?

“For the benefit of ..., such parties may enforce or enjoy the benefit of any of the terms under this agreement pursuant to the Contracts (Rights of Third Parties) Ordinance (Cap 623).”
Checklist for Drafting (cont.)

- But this clause is too broad and uncertain. Instead, recommended:

  A list identifying the third parties and their conferred rights should be provided in a separate clause or schedule with a reference made.

- Should the third party rights to enforce the term be in addition to, identical as, or different from the contracting parties’ rights to enforce the same?
Checklist for Drafting (cont.)

iv.  • Should the statutory restriction on the contracting parties’ right to vary or rescind the contract by agreement be excluded or varied (in which case there must be an express provision in the contract to this effect and such provision should be brought to the third party’s attention)?

“The rights of the parties to terminate, rescind or agree any variation, waiver or settlement under this agreement are not subject to the consent of any other person.”

- Or

Make the requirement of the third party’s consent condition on it not being unreasonably withheld
Checklist for Drafting (cont.)

- Or

Specify the circumstances under which third party consent is required

vi.

- Should the promisor have the full range of defences and rights of set-off and counterclaim, or should attempts be made to vary or restrict them?
Checklist for Drafting (cont.)

vii. Should the third party have the right to assign his rights to subsequent parties pursuant to section 14 or should this right be excluded

“Any rights under the Contracts (Rights of Third Parties) Ordinance (Cap 623) of a person who is not a party to this agreement may not be assigned without the prior written consent of…”

Or

“Nothing in this agreement operates to prevent or limit …’s right to assign, novate or otherwise confer any benefit or interest in favour of any other party.”
Checklist for Drafting (cont.)

viii.

• Should the third party rights be subject to an arbitration agreement (or any other dispute resolution mechanism specified in the contract), and if so has this been clearly indicated?

▪ Check to make sure there is no inconsistency between third party right provisions and the remaining part of the updated contract.
Questions?
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