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Legal Service Division Report on Contracts (Rights of Third Parties) Bill

I. SUMMARY

1. **The Bill**

The doctrine of privity has long been criticized as artificial and contrary to the parties' intention to benefit a third party. The Bill seeks to provide for the enforcement of contractual terms by third parties and for related matters. Under the Bill, a third party who is not a party to the contract may enforce a term of a contract if (a) the contract expressly provides that the third party may do so, or (b) the contract contains a term which 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.

A third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description. Rights may be conferred on a third party even if the third party was not in existence when the contract was entered into.

The new statutory scheme only applies to contracts entered into on or after the commencement of the Bill if enacted.

2. **Public Consultation**

In October 2012, the draft Bill was sent, for consultation, to various stakeholders including the legal professional bodies, academics, political organizations, business associations as well as the banking, insurance, shipping and construction sectors.

3. **Consultation with LegCo Panel**

The Panel on Administration of Justice and Legal Services was consulted on 26 November 2013 and members did not raise objection to the proposal.

4. **Conclusion**

The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the proposed change to an important doctrine in the law of contract, it is recommended that a Bills Committee be formed to study the Bill in detail.

II. REPORT

The date of First Reading of the Contracts (Rights of Third Parties) Bill (the Bill) is 26 March 2014. Members may refer to the LegCo Brief (File Ref. : LP 5019/11C) issued by the Department of Justice on 26 February 2014 for further details.

Object of the Bill

2. The Bill seeks to provide for the enforcement of contractual terms by third parties and for related matters.

Background

3. The doctrine of privity has long been criticized as artificial and contrary to the parties' intention to benefit a third party. One aspect of the doctrine of privity is that a person cannot acquire and enforce rights under a contract to which the person is not a party. The Law Reform Commission of Hong Kong (LRC) published the report on "Privity of Contract" in September 2005 recommending a reform of the doctrine of privity of contract by way of a detailed legislative scheme. The Administration introduces the Bill to implement the recommendations of the LRC.

4. According to paragraph 4 of the LegCo Brief, various common law jurisdictions have reformed the doctrine of privity by way of legislation, including Australia (Western Australia, Northern Territory and Queensland), Canada (New Brunswick), England, New Zealand and Singapore. The Administration is of the view that the Bill would enhance Hong Kong's contractual law regime and align it with developments in other major common law jurisdictions.

Provisions of the Bill

5. The Bill seeks to enable a person who is not a party to a contract (i.e. a third party) to enforce a term of the contract under certain circumstances. The main provisions of the Bill are summarized below.

<u>Scope of application</u>

6. The new statutory scheme only applies to contracts entered into on or after the commencement of the Bill if enacted so that existing rights or remedies of a third party will not be affected (clause 3(1)).

7. Under clause 3(2) and (4), certain classes or terms of contracts are excluded from the application of the Bill: -

(a) a bill of exchange, a promissory note or any other negotiable instrument;

(b) a covenant relating to land, including a deed of mutual covenant;

(c) a contract for the carriage of goods by sea or by air;

(d) a letter of credit;

(e) a company's articles having effect as a contract under seal; and

(f) a term of a contract of employment against an employee.

Test of enforceability

8. Clause 4(1) and (3) sets out the limits within which a third party can enforce a term of a contract. It provides for a two-limb test and the satisfaction of either limb will permit a third party who is not a party to the contract to enforce it: (a) a third party may enforce a term of a contract if the contract expressly provides that the third party may do so; or (b) if the contract contains a term which purports to confer a benefit on the third party, that party may enforce that term unless on a proper construction of the contract, the term is not intended to be enforceable by the third party.

9. A third party may enforce a term of a contract whether or not the third party has given consideration for the term (clause 4(5)).

Remedies available to a third party

10. Clause 5 provides that a third party is entitled to any remedy that would have been available to the third party if the third party had been a party to the contract (including a remedy under the rules of equity). It also provides that a right or remedy of a third party that exists or is available apart from the Bill is not affected.

Who is a third party

11. Clause 4(2) provides that a third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description. Rights may be conferred on a third party even if the third party was not in existence when the contract was entered into.

Assignment of third party rights

12. Under clause 14, a third party may assign to another person a right under a term of a contract enforceable by the third party unless the contract expressly provides otherwise or on a proper construction of the contract, the right is personal to the third party and is not assignable.

Rescission and variation of contracts

13. To strike a balance between the contracting parties' freedom to alter the terms of the contract in accordance with their intention on the one hand and the interests of a third party who may suffer as a result of the alteration on the other, clause 6 provides for the circumstances in which a third party's rights are "crystallized", so that when those circumstances exist, the contracting parties may not, without the third party's consent, rescind the contract or vary it in a way that alters or extinguishes the third party's right.

Defences available to promisor and protection against double liability

14. Clause 8 provides for defences, set-offs and counterclaims to be available to a promisor[1] in proceedings brought by a third party to enforce a term of a contract. Clause 11 protects a promisor against double liability, i.e. the promisor is discharged from the obligations owed by the promisor to the promisee to the extent of having performed the same obligations to the third party.

Arbitration clauses

15. Under clause 12(1) to (3), 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.

16. Clause 12(4) to (6) deals with situations where clause 12(1) to (3) does not apply and where a third party is given an enforceable procedural right under a contract to submit disputes to arbitration. According to paragraph 13 of the LegCo Brief, clause 12(4) to (6) is introduced after having studied the comments raised by the legal sector and the relevant recent development in English jurisprudence and commentary, despite the view of the LRC that it did not see any strong reasons for such provisions which deal with a "rare situation". The Administration considers that it would be useful to include clause 12(4) to (6) which serves to give effect to the intention of the contracting parties to confer on a third party an enforceable procedural right.

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1 "Promisor" is defined in clause 2 of the Bill to mean, in relation to a term of a contract enforceable by a third party under the Bill, a party to the contract against whom a third party may enforce the term.

Commencement

17. The Bill, if passed, would come into operation on a day to be appointed by the Secretary for Justice by notice published in the Gazette.

Other Observations

18. It is noted that some of the provisions of the Bill are quite similar to the equivalent provisions of the United Kingdom's Contracts (Rights of Third Parties) Act 1999 (the UK provisions), e.g. those relating to the test of enforceability, definition of third party, remedies, rescission and variation of contracts, defences available to promisor etc. Members may wish to refer to the UK provisions for reference (http://www.legislation.gov.uk/ukpga/1999/31/data.pdf).

Public Consultation

19. According to paragraphs 20 to 22 of the LegCo Brief, in October 2012, the draft Bill was sent, for consultation, to various stakeholders including the legal professional bodies, academics, political organizations, business associations as well as the banking, insurance, shipping and construction sectors. The legal professional bodies did not raise any objection to the legislative proposal. The legal professional bodies and the academia raised various technical comments and drafting suggestions which have been carefully considered by the Administration. Notwithstanding LRC's recommendation not to exclude deeds of mutual covenants (DMCs) from the new statutory scheme, the Bar Association suggested that DMCs and land covenants should be so excluded because allowing third parties' right of enforceability under the Bill would contradict or prejudice the existing regime on DMCs and land covenants. The Administration agreed with the suggestions of the Bar Association which have been reflected in the Bill.

20. A few industry sectors also raised technical comments on the application and operation of the Bill. According to the Administration, some of the questions raised by the industries can be resolved by building in clear provisions in their contracts such as provisions stating expressly the class of insurance contracts to be excluded from the application of the Bill. While one respondent from the construction sector suggested that the whole construction industry should be excluded from the application of the Bill, another respondent from the same sector expressed a different view. The Administration considers that it would be best to allow contracting parties the freedom to contract out of the new statutory scheme if they so wish.

Consultation with LegCo Panel

21. The Clerk to the Panel on Administration of Justice and Legal Services has advised that the Panel was consulted on 26 November 2013 and members did not raise objection to the proposal. The Panel noted the view expressed by the Hong Kong Bar Association that consideration should be given to excluding contractual obligations contained in DMCs from the scope of application of the proposed legislative scheme, and the comments of the Law Society of Hong Kong on the drafting aspects of the proposed legislation. The Panel urged the Administration to consider carefully the views collected during its public consultation conducted in October 2012, including those from the two legal professional bodies. A member requested the Administration to exercise vigilance in drafting the interpretation of the term "third party", so as to avoid misunderstanding on who had a right to enforce the terms of a contract. On the implementation arrangements, a member asked the Administration to ensure that the public would be well informed of the new statutory scheme and allow sufficient time for various stakeholders to make due preparations for the changes.

Conclusion

22. In view of the proposed change to an important doctrine in the law of contract, it is recommended that a Bills Committee be formed to study the Bill in detail. Meanwhile, the Legal Service Division is scrutinizing the legal and drafting aspects of the Bill.

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