The new Contracts (Rights of Third Parties) Ordinance, Cap. 623 (the "Ordinance") took effect from 1 January 2016 in Hong Kong.

The Ordinance makes important changes to Hong Kong's contract law that will allow contracting parties to agree that third parties may enforce the terms of the contract. These reforms mark a significant change to the common law "privity of contract" doctrine, introducing helpful flexibility that will assist contracting parties in achieving their commercial objectives, in particular with respect to more complex commercial arrangements.

Every contract agreed under Hong Kong law from 1 January 2016 (whether a new contract or an amendment to an existing contract) should take the Ordinance into account – whether by expressly excluding the Ordinance or by drafting carefully to achieve your desired effect. Failure to be clear on this issue may mean that third parties cannot enforce terms as the contracting parties intend or give rise to situations in which a third party may enforce terms of contract where one or both parties do not intend this to be the case.

Our previous overview of the Ordinance and its history, including the development of the privity doctrine, can be found here. This update will focus on implications for the construction industry.

1. HOW THE ORDINANCE MAY AFFECT THE CONSTRUCTION INDUSTRY

Imagine the following scenario:

- a) The Buyer enters into a Sale and Purchase Agreement of a construction project with the Employer;
- b) The Employer enters into a Design & Build Contract with the Contractor
- c) The Contractor enters into a Design Contract with the Design Consultant

Previously, under the doctrine of privity a person could not acquire or enforce rights under the contract to which he/she is not a party. Therefore in the above scenario, parties' recourse was limited to the blue arrows, where the Buyer's only recourse was under a). The Buyer could neither sue the Contractor nor the Design Consultant in contract even if they are responsible for defects in the project because the Buyer was not a party to their contracts.

It was also difficult for the Buyer to recover damages in tort, since recovery for pure economic loss is only allowed in very limited circumstances. Collateral warranties have been used to protect third party rights but they have greatly complicated the negotiations and documentation of new construction projects.

Now, the Ordinance offers an alternative to the complexities of collateral warranties. In the above scenario, the dotted red routes are available to the Buyer. The Buyer may be given the right to enforce terms in the Design & Build Contract or the Design Contract. Hence, the Buyer may have a direct cause of action in contract against the Contractor (eg. for failure of property to be fit for purpose) or the Design Consultant (eg. for failure to exercise reasonable care and skill in design) if it can be shown that those contracts are also intended to benefit the affected third parties.

2. APPLICATION TO CONSTRUCTION CONTRACTS

The practical effect of the applying the Ordinance may either bring unintended consequences or, if carefully applied, be beneficial to many areas of the construction industry:
• Contracting parties to a main contract may agree to a payment mechanism where the sub-contractor can be paid directly by the employer. The sub-contractor may then pursue the employer directly for payment of its works.

• Third parties rights may enable the employer to bring a claim directly against a sub-contractor or supplier for poor quality of work or supplies.

• Successors in property rights of a building may have the right to bring an action against the builder for defects.

3. KEY FEATURES OF THE ORDINANCE

(a) The Ordinance only confers benefits on identified third parties – not obligations. Therefore, you still cannot impose obligations on identified third parties via contracts. Note that:

(i) the identification must be clear in relation to an individual or a class of individuals receiving the benefit; and

(ii) even if the third party is not in existence at the time the contract is entered into, so long as it can be identified by its description in the contract, the benefits of the contract may still be enforced by that third party.

(b) No retrospective effect. The Ordinance will apply to all contracts executed from 1 January 2016 onwards – whether new agreements or amendment agreements to existing agreements. It does not have retrospective effect on any contracts executed prior to that date; however, amending and restating an existing agreement may allow for pre-2016 agreements to be caught under the new law.

(c) No “double liability” arising from the Ordinance. Contracting parties are protected against "double liability" when a contracting party is sued by a third party and another contracting party under the contract. The general rule is that parties can only sue for their own loss, but courts have allowed (in some circumstances) for a contracting party to sue for losses suffered by the third party. Therefore, section 11 of the Ordinance stipulates that if the promisee has already recovered a sum taking into account third party’s loss, the court may accordingly reduce the award to the third party as it sees appropriate.

(d) Arbitration / jurisdiction clause may bind third parties. 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 enforcement of the term, unless this is not so intended on a proper construction of the contract. If a contract contains a term enforceable by third parties and an exclusive jurisdiction clause, the third party is also bound by the exclusive jurisdiction clause in relation to its dispute with the promisor relating to enforcement of the term. The freedom for contracting parties to impose an enforcement mechanism or jurisdiction on third parties can obviously impact the practical effectiveness of enforcement by third parties of their rights conferred by the Ordinance.

(e) You can “opt-out” of the Ordinance’s application (and should expressly do so if you do not intend it to apply). A third party may not enforce a term of a contract if the term is not intended to be enforceable by that third party – i.e. contracting parties could select certain contractual terms that are enforceable by a third party. In other common law jurisdictions who have adopted laws similar to the Ordinance, our experience has been that most agreements have included opt-out clauses to prevent the application of such third party rights or the Ordinance altogether.

(f) Certain types of contracts are excluded from the Ordinance’s application. These contracts include bills of exchange, deeds of mutual covenant and company’s articles of association.

4. ADDITIONAL ASPECTS OF THE ORDINANCE

4.1. Use of Limitation clauses

A contract can expressly extend a limitation clause to third parties. An example of such clause with a contract between the Contractor and the Employer is provided below:

“The liability of the [Contractor], its sub-contractors and/or agents under or in connection with the [Design & Build Contract] howsoever arising and including any liability for negligence shall be limited to $1,000,000 to each and every claim…”
The Ordinance expressly extends to exclusion/limitation of liability clauses. However, such a clause cannot exclude or restrict liability for death or personal injury and will still be subject to the reasonableness test under the Control of Exemption Clauses Ordinance (Cap 71) and Supply of Services (Implied Terms) Ordinance (Cap 457).

4.2. Altering Third Party's rights

The Ordinance protects third parties, who may rely on their third party rights under a contract, by prohibiting parties to the contract from rescinding or varying a contract that alters the third party's rights where the third party has assented to or relied on such rights. In practice, the parties to the contract can draft the contract so that they retain the right to modify the contractual terms by expressly stating that the requirement for third party consent is unnecessary.

However if you are a third party to the contract, you may consider controlling the exercise of this right. For example, as if you are the buyer of a completed project and realise that the terms of a building contract give you a third party right but may be altered or rescinded without your consent, you may look to include an express term in the sale and purchase agreement with the developer that requires the developer to seek your approval for any changes to the building contract that will affect your third party right.

5. WHAT SHOULD YOU DO?

In light of the Ordinance recently coming into force, you may wish to consider re-evaluating your standard commercial contracts. Careful drafting is vital to achieve the desired effect under the Ordinance.

Below are a series of considerations:

- Is there a third party (individual or class of individuals) named in the contract?
- Does the third party have rights under the contract?
- Do you want any third party to be able to enforce any term of the contract?
- Is the third party enforcement right to be subject to any special limitations?

Careful consideration should be made before making changes to your contracts. You may also wish to include boilerplate clauses to exclude the application of the Ordinance altogether.

If you would like further information on the Contracts (Rights of Third Parties) Ordinance and its application in Hong Kong, please consult your usual Hogan Lovells contact.

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