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The Contracts (Rights of Third Parties) Bill: How Could it Help or Hinder Employers?

In Hong Kong, the ‘privity of contract’ rule ordinarily prevents a third party from directly enforcing the terms of a contract to which it is not a party. One situation where this sometimes arises in an employment context is where a third party (for example, a company related to the employer) wants to enforce a non-compete in a contract to which it is not a party. The non-compete may prohibit an individual from working for a competitor of that third party (as well as the former employer) for a period of time after termination of employment.

The Contracts (Rights of Third Parties) Bill (“**Bill**”) which will be debated in LegCo this year, proposes reform to this rule so that parties to a contract may confer a benefit on a third party, who is then able to directly enforce it. In this newsletter we discuss the potential impact of the Bill on contracts in the employment context, the key features of the Bill in its current form, and useful steps that employers can take in preparation for the Bill’s enactment.

What does the Bill aim to do?

The Bill proposes to reform the aspect of the ‘privity of contract’ rule that ordinarily prevents a person who is not a party to a contract from enforcing the terms of the contract. The rule operates so that if one party (A) to a contract promises to the other party (B) to the contract that it will do something for a third party who is not a party to the contract (C), C cannot enforce the contract against A if A fails to fulfill the promise.

This aspect of the privity rule has often been criticised as frustrating the intentions of the contracting parties who wish for a benefit to be conferred on a third party. The Law Reform Commission of Hong Kong (“LRC”) recommended that the rule be reformed so that if parties to a contract wished to confer a benefit on a third party, their freedom to do so should be respected and given legal effect. The Bill has been introduced to give effect to the LRC’s recommendations. It follows closely the Contracts (Rights of Third Parties) Act 1999 in England.

How might the Bill be relevant to the employment context?

The Bill, like the English legislation, excludes a number of contracts from its scope. One of these exclusions is the enforcement of a “contract of employment” (as defined by the Employment Ordinance) against an employee. This exclusion is said to be justified by “sound policy reasons” and

means that a third party will not be able to enforce a term of a contract of employment against an employee.

However, there are at least two ways in which the Bill may have an impact in the employment context.

1. Third party enforcement of contracts that are not “contracts of employment” against the employee

The first, and most significant, way is the fact that the Bill could apply to other types of contracts that an employer may have with an employee.

As noted above, the Bill excludes “contracts of employment”, defined in the Employment Ordinance as follows:

Any agreement, whether in writing or oral, express or implied, whereby one person agrees to employ another and that other agrees to serve his employer as an employee and also a contract of apprenticeship.

However, there are other contracts in the employment context which may not fall within this definition, and may therefore be impacted by the Bill. There is a legitimate argument to support the view that certain contracts that an employer enters with an employee are not contracts of employment. Notable examples include settlement agreements, employee share or equity plan agreements, and standalone confidentiality agreements or restrictive covenant agreements. Much depends on the precise wording of the particular agreement in question.

In this regard, the Bill could prove very useful to an employer. Often, under such agreements, it is intended that one or more members of the employer’s group (i.e. related companies) should benefit from the promises made by the employee. For example:

- in a settlement agreement, the employee may agree to release the employer *and other related companies* from claims;
- in a confidentiality agreement, the employee may agree to keep confidential information about the employer *and other related companies* that he or she learns during the course of employment; and
- in a restrictive covenant agreement, the employee may agree not to compete with or solicit clients or employees of the former employer and *certain related companies*;

Ordinarily, unless those related companies are made party to such agreements (which would be rare), it would be necessary to resort to complicated devices such as agency or trust to enable those related companies to enforce the rights conferred on them.

The Bill will solve this problem. If the contract expressly identifies those companies and the term is expressly stated to be enforceable by them or

confers a benefit on them, the Bill will enable them to enforce it directly. This is the case, even if the relevant company is not yet in existence at the time the contract is made.

Another problem which the Bill addresses is where a third party has not provided consideration for the employee's promises under a contract but still wishes to enjoy the contract's benefits. As an example, in an employee share plan agreement, where shares might be issued by the employer's related company, the consideration provided to the employee comes from the related company, not the employer. If the employer itself wants to benefit from the promises the employee makes in the share plan agreement, this can sometimes necessitate complicated drafting to ensure that the employer can be regarded as providing consideration in return for the promises made by the employee.

Again, the Bill will simplify such issues. The Bill states that the ability of a third party to enforce a term in its favour applies *irrespective of whether it provides consideration* for the term, as long as the promisee (here, the related company) has provided consideration to the promisor (the employee).

2. Third party enforcement of contracts of employment against the employer

The less significant way in which the Bill may impact the employment context is the possibility that third parties mentioned in the contract of employment may be able to enforce the contract against the *employer*. This is because the Bill only excludes "contracts of employment" where third parties are seeking to enforce the contract *against the employee*. So, *employers* may still face a risk of third parties enforcing contracts against them as a result of the Bill.

It may be that this risk is unlikely for many employers to the extent that their contracts of employment deal exclusively with matters affecting the employee and the employer. However, some contracts of employment do mention third parties who could conceivably make use of the Bill to seek direct enforcement of the terms against the employer.

One example would be terms that entitle the employee *and his or her family members* to certain benefits, such as medical insurance coverage, club membership or relocation expenses. Another example might be terms that refer to a proposed secondment arrangement with a third party host company, which that host company may seek to enforce if, for example, the secondment does not proceed or some aspect of it goes wrong.

What are the key features of the Bill?

In thinking about the potential impact of the Bill to the employment context, some key features to note at this stage include the following:

- **Only prospective operation:** The Bill will apply to contracts entered into on or after the Bill's commencement date; it will not have retrospective operation on contracts already in existence.
- **Contracting out permitted:** The Bill will operate to confer enforcement rights on third parties if a contractual term expressly provides for this or purports to confer a benefit on that third party *unless* the parties have included terms to indicate a contrary intention. In other words, parties are free to "contract out" of the Bill by express terms if they wish.
- **Same remedies available as contractual parties:** The remedies available to a third party who enforces a contractual term pursuant to the Bill are the same remedies that would have been available to that third party in an action for breach of contract had the third party been a party to the contract.
- **Need consent to vary term once third party's rights have crystallised:** If a third party has a right to enforce a contractual term pursuant to the Bill, then once that third party's right has 'crystallised' (as described in the Bill), the parties to the contract may not rescind or vary the contract in a way that alters that third party's right without the third party's consent. Again, the parties are free to contract out of this requirement by express terms if they wish, or prescribe their own circumstances when the third party's consent is required.
- **Contractual parties' rights remain unchanged; no double liability:** The Bill does not affect the right of a party to the contract to enforce any term of the contract. However, it also protects a party against double liability to both a third party and another party to the contract.
- **Arbitration and/or jurisdiction requirements apply to third party:** If the contract includes a term requiring a dispute relating to a term of the contract to be resolved by arbitration, or to be resolved only in a particular jurisdiction, that requirement will also be binding on the third party seeking to enforce its rights pursuant to the Bill. Again, the parties may contract out of this requirement by indicating by express terms that the third party is not bound by the arbitration and/or jurisdiction requirements.

What can employers do now?

The Bill has only recently concluded public consultation and has yet to be debated by LegCo. We expect that, if passed, it will come into operation some time in 2014 at the earliest.

In the meantime, employers may usefully take the following preparatory steps:

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1. Start reviewing the range of agreements that you enter with your employees. Do any of those agreements contain terms that purport to benefit your related companies, or other third party associates? If so, you might like to:
 - consider whether those agreements would fall outside the definition of “contracts of employment” under the Employment Ordinance; and
 - if they *do* fall outside the definition, consider how the Bill could be used to improve, strengthen or simplify those agreements from the perspective of third party enforcement of terms; and
 - if they *do not* fall outside the definition, consider whether the aspects of the contract of employment that relate to the related companies or other third party associates could be separated out into a standalone agreement that would fall outside the definition so that the Bill could operate.
2. Start reviewing your template contracts of employment to check whether any terms purport to benefit third parties who might be able to rely on the Bill to enforce the terms against you directly. If there are, you might like to:
 - consider the likelihood that such third parties would be able to access the enforcement rights under the Bill in respect of those terms as currently drafted; and
 - if there is such a risk, consider how the terms could be re-drafted to remove the risk or whether it is appropriate to include a general exclusion clause to exclude the Bill.

We will update you on the progress of the Bill, including any changes made and any indications of the likely commencement date, as soon as the information is to hand.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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