



Hogan  
Lovells

# Hong Kong Law Contract Guide



# Contents

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Introduction	2
Formation of contract	4
Terms, representations, and warranties	10
Best endeavours/ reasonable endeavours	18
Limitation and exclusion of liability clauses	24
Termination	32
Consent	38
Damages	44
Enforcement	50
Assignment, novation, variation	58
Doctrine of privity	62
Governing law, jurisdiction or arbitration	68
Interpretation	74
Contacts	76

## Introduction

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We are pleased to present you with this guide, which we hope will guide you through the basic principles of Hong Kong contract law and the points to consider when you draft your next contract. This guide discusses the relevant legal principles behind the most commonly used contractual clauses, and includes some sample clauses that can be a useful reference when drafting a contract.

The guide also covers the key legal principles related to implied terms, including the situations in which such terms would be implied, and the law on exclusion of implied terms. We will also provide an overview of the doctrine of privity of contract, which is important when it comes to the enforceability of contracts by, or against, third parties.





# Formation of contract



While for most contracts there is no requirement to follow a particular form or format,<sup>1</sup> in practice most contracts tend to be in written form. At a basic level, a contract must be offered and accepted, with the support of consideration.

## Offer and acceptance

The basic elements of a contract are 1) offer, 2) acceptance of the specific offer, 3) consideration and 4) intention to create legal obligations.

## Offer, invitation to treat and unilateral contract

An offer is an expression of willingness to enter into a contract on specified terms. Once an offer is accepted by the other party, the offer will turn into a binding contract. It is important to distinguish an offer from an invitation to treat, as the latter is merely regarded as the invitation to make an offer.

Generally, advertisements,<sup>2</sup> brochures, catalogues,<sup>3</sup> price lists,<sup>4</sup> and menus constitute invitations to treat instead of offers. Nevertheless, an exception to this general rule is a unilateral contract. A unilateral contract usually will arise when one party promises to offer the other party a reward if the other party performs a specific act. In such a case, the promisee is not under any obligation to perform the act. However, if the promisee decides to perform the act, the promisor will be obliged to fulfil the promise.

## Acceptance

A valid acceptance must be unequivocal. For an acceptance to be unequivocal, the offeree must agree to all of the terms of the offer. For example, if 50 apples were offered and the offeree only accepts 25 apples, this will not constitute a valid acceptance. Instead, this would be regarded as a counter-offer that supersedes the original offer.

A contract is made when the offeree properly communicates their unequivocal acceptance to the offeror.

1. Different rules govern contracts relating to transfer of interests in land, personal contracts and those that must be executed by deed.

2. *Partridge v Crittenden* [1968] 1 WLR 1204

3. *Grainger & Son v Gough* [1896] AC 325

4. *Grainger & Son v Gough* [1896] AC 325

## Consideration

A mere promise will not be binding unless it is either under seal or supported by consideration. The purpose of this requirement is to limit the enforceability of all promises and agreements. Unless it is supported by consideration (of a kind that the law recognises as valid – see below), an unsealed agreement is not legally binding on the contracting parties and will not be enforced by the courts. Therefore, consideration must be included in a contract.

For consideration to be valid, it does not necessarily need to be in monetary form, although in practice this is the most common form of consideration in contracts. Valid consideration may take the form of some right, interest, profit or benefit that is transferred to one party, or of some "forbearance, detriment or loss"<sup>5</sup> that is granted or suffered by the other.

The four conditions below must be satisfied in order to establish proper consideration:

- Consideration must be either a benefit to the promisor or detriment to the promisee;
- Consideration does not have to be adequate, but it must be sufficient;
- Consideration must not be in the past; and
- Consideration must move from the promisee at the promisor's request.

## Certainty of contract

Contractual terms must be certain for the contract to be valid. If the terms of the agreement are ambiguous or meaningless – for example, the phrase "the usual conditions of acceptance" was held to be uncertain as there were no such usual conditions in the context<sup>6</sup> – or if the agreement is incomplete, the contract may be considered uncertain.

Courts may declare a contract void for uncertainty. However, in such circumstances the courts also may order that any benefit that was purportedly transferred pursuant to the void contract be returned so as to prevent one of the parties from being unjustly enriched at the expense of the other.<sup>7</sup>

5. *Currie v Misa* (1874-1875) LR 10 Ex 153

6. *Anstalt Nybro v Hong Kong Resort Co Ltd* [1980] HKLR 76

7. *British Steel Corp v Cleveland Bridge & Engineering Co Ltd* [1984] 1 All ER 504 applied by the English Court of Appeal in *Whittle Movers Ltd v Hollywood Express Ltd* [2009] EWCA Civ 1189



## Types of contracts

### Letter of intent

A letter of intent (also known as "heads of terms" or "memorandum of understanding") contains the key commercial or legal terms agreed between the parties, which are intended to be incorporated into the final binding formal contract. Letters of intent usually are drafted during the initial negotiations to record key issues agreed between the parties, such as the scope of work, the price and the terms of the deal, which are then drawn up in the final formal agreement. There is no standard format.

A letter of intent shows an intention to establish a contractual relationship, yet whether its terms are legally binding will depend on the circumstances. To avoid disputes further down the line, the letter should clearly stipulate whether it is intended to be legally binding or whether only some of its provisions, such as the confidentiality provisions, are binding.

### "Subject to contract"

The inclusion of the words "subject to contract" in a letter of intent is not always viewed as conclusive evidence that the parties did not intend to be bound until a formal agreement is entered into, especially if the parties then go on to perform the obligations contained within the letter. In *Proforce Recruit Ltd v The Rugby Group Ltd*,<sup>8</sup> a term sheet that was said to be "subject to contract" was held to be binding, as the parties already had started to perform the obligations agreed in the letter. The court therefore found that the parties had entered into an implied contract by conduct.

The principles regarding the effect of the inclusion of the words "subject to contract" in a letter of intent were summarised in *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co*,<sup>9</sup> which the court in *Kwang Qian Wen Marie v Kwan Kit Yuk* cited with approval.<sup>10</sup>

In *RTS v Muller*,<sup>11</sup> the parties entered into a letter of intent that was intended to expire after a fixed period, by which time the parties envisaged a formal contract would be put in place. The Plaintiff began work on the basis of this letter of intent. However, the negotiations took longer than expected, and the letter of intent expired without the parties ever signing a formal contract. When a dispute arose as to whether the parties were contractually bound, the court found that, in that case, the unequivocal conduct of the parties warranted the

8. [2006] EWCA Civ 69

10. [2016] HKEC 17

9. [2010] 1 WLR 753

11. [2010] 1 WLR 753

conclusion that they had made a binding agreement to waive the “subject to contract” provision. The court emphasised the perils of commencing work without agreeing the precise basis on which it is to be done.

In *Anchor 2020 Ltd v Midas Construction Ltd*,<sup>12</sup> the court held that the parties had entered into, and were bound by, the contract even though the employer had not signed it. The court rejected "the contention that the parties intended to be legally bound only when both signed the contract".

These cases serve as a reminder that, when a letter of intent is intended only as an interim measure, the parties must continue with their negotiations and enter into a formal contract. If they do not, they run the risk of having their rights and obligations determined on the basis of the letter of intent should a dispute arise.

### Points to note

- A letter of intent usually outlines the key commercial or legal terms that are agreed between the parties and are intended to be incorporated into the eventual binding formal contract. It should not be treated as a fully drafted agreement.
- The legal effect of a letter of intent depends on the circumstances. Including the words "subject to contract" merely creates a rebuttable presumption that the parties do not want to be bound by its terms.
- Agree the formal contract first before starting work.

### Practical tips

- Ensure you specify which terms are intended to be legally binding, such as provisions on governing law and confidentiality.
- Time limits included in a letter of intent should be realistic and allow sufficient time to negotiate a formal contract. Any extension to the validity of the letter of intent should be documented.
- As different countries have varied approaches to whether a letter of intent is regarded as binding, parties should take local advice when other jurisdictions are involved.



# Terms, representations, and warranties



The rights and obligations of the contracting parties often are set out as terms in a contract: they specify what a party must do or refrain from doing. However, not all communications between the parties become terms of the contract with which the parties must then comply. Therefore, it is important to differentiate what constitutes a term and what does not.

Terms can be expressed or implied. An express term is a term that the parties expressly agreed either in writing or orally. An implied term, in contrast, is a term that the parties did not expressly agree upon but which nevertheless is incorporated into the contract. Violating either type of term can constitute a breach of contract, and the innocent party will be entitled to claim for damages or, in some cases, terminate the contract.

## Express terms

Express terms are those that are expressly agreed upon orally or in written format and are intended to be incorporated into the contract by both parties. However, in some cases, such as *Yuen Shek Sang v Hung Ching Travel & Enterprise Ltd*,<sup>13</sup> terms can be incorporated into the contract as express terms even though they are not set out in any agreement signed by the parties.

Express terms often are proved by introducing evidence of what was written and said by the parties. However, depending on the circumstances, such communications could be classified as either contractual terms (non-compliance with which will result in a breach of contract), representations (as explained below) or mere puffs.

In the latter case, any non-compliance with a statement that is regarded as a "mere puff" – or a relatively meaningless statement for advertising purposes – does not attract legal liability.

## Representations

Representations are statements made in the course of negotiating the contract which are not promissory in nature. Representations are pre-contractual statements of fact, made in hope of inducing the other party to enter into the contract. If a representation turns out to be untrue, it will constitute a misrepresentation.

13. [1980] HKC 450 at 453 (DC)

However, misrepresentation is different from a breach of contract: instead of being able to claim damages for breach of contract, the innocent party usually will be entitled to rescind the contract or, in some cases, claim damages for misrepresentation under the relevant statutory provisions.

## Warranties and conditions

Contractual terms (whether express or implied) can be classified as conditions, warranties or intermediate (or innominate) terms.

A condition is a term of a contract that goes to the root of the contract. If a condition is breached, the innocent party has the right to treat the breach as "repudiatory" and terminate the contract, in addition to claiming damages.

Warranties, on the other hand, are contractual terms that are secondary to the main terms of the contract. For example, in a contract for selling goods, a warranty can be the condition of the goods being sold. A breach of a warranty allows the innocent party to claim damages for breach of contract, but the innocent party is not entitled to terminate the contract.

In the case of an intermediate term, the remedy available to the innocent party will depend on the nature and effect of the breach at the time it occurs. If, for example, the effect of the breach substantially deprives the innocent party of the whole of the benefit of the contract, then it will be a serious, or fundamental, breach of the term and the remedies available to the innocent party will be the same as for breach of a condition.

## Implied terms

Courts interpret contractual terms by looking at the ordinary meaning of the words used, taking into account the relevant surrounding context. In some cases, when interpreting a contract, the courts also can "imply" certain terms. Implied terms are terms that are not expressly written in a contract but are nevertheless incorporated through the operation of common law or statute.

Courts are generally reluctant to imply terms, especially in business-to-business contracts. However, there are circumstances where they are much more willing to do so. Certain terms may also be implied into the contract through the operation of certain statutes, as explained below.

## 1. Terms implied by law

Terms may be implied by statute, regardless of whether the parties intended to do so. For example, sections 14 to 17 of the Sales of Goods Ordinance (Cap. 26, Laws of Hong Kong) ("**SOGO**"), which is similar to sections 9 to 14 of the UK Consumer Rights Act ("**CRA**"),<sup>14</sup> specifies that in some circumstances suppliers have an implied obligation to ensure that the seller has good title (section 14), that the goods correspond with the description (section 15), are of satisfactory quality and a fit for purpose (section 16) and correspond with the sample (section 17).

The Ordinance states that these are implied conditions rather than warranties, meaning that a breach of these terms will entitle the other party to claim damages and treat the contract as terminated. (In the case of breach of warranty, the innocent party would only be entitled to recover damages.)

## 2. The provision of services

Terms also may be implied by the courts due to the needs of a particular type of contract, such as services contracts. In *Anglo Group plc v Winther Brown & Co Limited*,<sup>15</sup> the Court held that in a standard computer contract there was an implied duty of co-operation, which in turn encompassed various implied terms:

- the purchaser must clearly communicate its special needs to the supplier;
- the purchaser must take reasonable steps to ensure that the supplier understands those needs; and
- the supplier should communicate to the purchaser whether the precise needs can be met, and if so, how. If they cannot be met precisely, the supplier should set out the options available.

In *Feerni Development Ltd v Daniel Wong & Partners*,<sup>16</sup> the Court ruled that a solicitor owes a duty to his client to provide professional services with reasonable care and skill pursuant to section 5 of the Supply of Services (Implied Terms) Ordinance (Cap. 457, Laws of Hong Kong). The Court cited *Graybriar Industries Ltd v Davies & Co*,<sup>17</sup> where it was held that, in the context of a land transaction, there is an implied term that the lawyer will investigate the state of any title that is relevant to the matter and explain to his client what is portrayed

14. The CRA consolidated the UK Sale of Goods Act 1979, the Supply of Goods and Services Act 1982 and the Unfair Terms in Consumer Contracts Regulations 1999 with amendments.

15. [2000] ITCLR 559

16. [2001] 2 HKLRD 13

17. [1990] CanLII 1572

by the state of the title. The standard expected of a solicitor therefore differs depending on the circumstances and nature of the problem, as articulated in *Bannerman Brydone Folster & Co v Murray & Anor*.<sup>18</sup>

The duty arising under section 5 will vary according to the circumstances and nature of the parties. The Court of Appeal in *Chang Pui Yin v Bank of Singapore*, held that the bank had a contractual duty of care to (i) have regard to their client's objectives and risk appetite; (ii) only offer suitable products and (iii) warn clients of the risks inherent in the investments being offered.<sup>19</sup>

In *Nam Cheuk Yin v Ng Yim Hing*,<sup>20</sup> cited in *Xie Qiuyun v Arche Beauty Therapy Ltd*,<sup>21</sup> the court ruled that a beautician had a duty pursuant to section 5 to exercise reasonable care and skill in providing services to customers. She also had a duty to take such precautions and remedial measures as were necessary to minimise harm or injury.

### 3. Terms implied in fact

Terms implied in fact are implied to reflect the parties' intentions, which are inferred from the language of the contract and the circumstances in which the contract was entered into. Two principal tests have been developed by the courts:

- **The officious bystander test:** the court will imply a term if it is "so obvious that it goes without saying; so that, if while the parties were making their bargain, an officious bystander were to suggest some express provision for it in the agreement, they would testily suppress him with a common 'Oh, of course!' ..." (*Shirlaw v Southern Foundries*<sup>22</sup> per MacKinnon LJ, cited in *Faranrah Ltd v Cherry Garments Co Ltd*<sup>23</sup>); and
- **The business efficacy test:** a term is incorporated based on "an implication from the presumed intention of the parties with the object of giving to the transaction such efficacy as both parties must have intended" (*The Moorcock*<sup>24</sup> per Bowen LJ, cited in *Faranrah Ltd v Cherry Garments Co Ltd*<sup>25</sup>).

Both tests were applied by the Court of Appeal in *Lo Yuk Sui v Fubon Bank (Hong Kong) Ltd*. The bank was able to rely on an implied term that it could choose refinancing options that were not available in the market at the time of the contract.<sup>26</sup>

18. [1972] NZLR 411

19. [2017] 4 HKLRD 458

20. [2003] 2 HKLRD 195

21. [2015] HKEC 2709

22. [1940] AC 701

23. [2005] HKEC 1050

24. [1889] 14 PD 64

25. [2005] HKEC 1050

26. [2019] HKCA 261



A term can be implied by industry practice or the parties' historical course of dealing. A term will not be implied if it contradicts an express term of the contract. Moreover, in order to be implied, a term also must be equitable, reasonable, and capable of clear expression. The court does not imply a term merely because it would improve the contract or that doing so would be reasonable. The court must be satisfied that both parties intended the term to be part of the contract and that its inclusion is necessary to ensure that the contract fulfils the parties' intended commercial purpose.

In *Attorney General of Belize v Belize Telecom Ltd*,<sup>27</sup> Lord Hoffman set out the following as the correct test for implying terms in fact: "There is only one question: is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?" The case has had mixed judicial treatment, being cited with approval in the recent Hong Kong case of *SNE Engineering Co Ltd v Chim Kee Machinery Co Ltd*<sup>28</sup> but not being followed on a number of occasions in the Court of Appeal in Singapore, such as in *Sembcorp Marine Ltd v PPL Holdings Pte Ltd*<sup>29</sup>, citing the earlier decision in *Peng v Mai*.<sup>30</sup>

Examples of implied terms include:

- A term that a party to a contract will not do anything by his own act that prevents the other party from performing the agreed contract (*Stirling v Maitland*,<sup>31</sup> cited in *South China Cold Storage & Industrial Co Ltd v Incorporated Owners of Gold King Industrial Building*<sup>32</sup>).
- In a services contract, a warranty by the service provider that the services will achieve a specified result (*Platform Funding Ltd v Bank of Scotland Plc (formerly Halifax Plc)*<sup>33</sup>).
- Where the contract provides for the exercise of some power, an obligation to do so in good faith and not capriciously or arbitrarily (*Nash & Ors v Paragon Finance Plc (formerly the National Home Loans Corporation)*,<sup>34</sup> *Socimer International Bank Ltd v Standard Bank London Ltd*,<sup>35</sup> and *Tadjudin Sunny v Bank of America, National Association*<sup>36</sup>).

27. [2009] 1 WLR 1988

28. [2016] HKEC 710

29. [2013] SGCA 43

30. [2012] SGCA 55

31. [1864] 122 ER 1043

32. [2013] HKEC 1931

33. [2009] 2 WLR 1016

34. [2001] EWCA Civ 1466

35. [2008] EWCA Civ 116

36. [2016] HKEC 1128

- Where the articles of association stated that certain holders of shares can appoint and remove directors, but were silent on what would happen to the appointed directors if the class of shareholders they represented no longer existed, a term that the director should resign (*Belize v Belize*,<sup>37</sup> cited in *SNE Engineering Co Ltd v Chim Kee Machinery Co Ltd*<sup>38</sup>).

#### 4. Terms implied by custom or usage

A term can be implied into a contract by custom or usage if it is certain, legal and reasonable, and generally known in the market or trade where the contract is concerned. No term will be implied if it is inconsistent with an express term or an implied term in fact.

A term also can be implied based on previous dealings between the parties. Where a transaction is part of a series of transactions on certain terms, it will be taken to be subject to those previous terms, even if they are not expressly adopted.

#### Exclusion of implied terms

Contracting parties often try to exclude implied terms to reduce the scope of their liability. Statutory implied terms may be expressly excluded by the parties in their contract, subject to the requirements under the Control of Exemption Clauses Ordinance (Cap. 71, Laws of Hong Kong) ("CECO"). For example, section 57 of SOGO provides that:

- If a right, duty or liability is implied by law in a contract of sale of goods, it may (subject to CECO) be excluded or varied by express agreement, by the parties' course of dealing, or by usage, provided the usage is such as to bind both parties to the contract; and
- An express condition or warranty does not exclude a condition or warranty implied by the Ordinance unless the two are inconsistent.

#### Points to note

- The courts have limited power to imply terms into a contract. They may do so in certain circumstances for example to give business efficacy to the contract or if the term is obvious.
- Certain terms are implied through the operation of law. These include: a seller's implied undertaking as to title, implied terms as to the goods' conformity with description or sample, or as to their quality and fitness for a particular purpose, under SOGO.

37. [2009] 1 WLR 1988

38. [2016] HKEC 710

- Parties can expressly exclude statutory implied terms. However, it is necessary to check the statute to make sure that this can be done. Liability for breach of a seller's implied undertaking as to title cannot be excluded, for example.

### Sample clause

The following is a sample “entire agreement” clause that prevents any statements or representations (including pre-contractual representations) from having contractual force:

- This Agreement (together with any documents referred to in it) sets out the entire agreement between the parties and supersedes any previous agreement or arrangement between the parties relating to the subject matter of it (and any document referred to in this Agreement).
- Each party agrees and acknowledges that it has not relied on or been induced to enter into this Agreement by warranty, statement, representation or undertaking that is not expressly included in this Agreement.
- No party has any claim or remedy in respect of a warranty, statement, misrepresentation (whether negligent or innocent) or undertaking made to it by or on behalf of [any/the] other party in connection with or relating to the subject matter of this Agreement and that is not expressly included in this Agreement.

# Best endeavours/ reasonable endeavours



Parties usually include clauses to limit the degree of performance that is required in order to comply with their respective obligations under a contract. These types of clauses are especially important where the obligor lacks complete control over performance. Parties will include "endeavours" wording to qualify their obligations and decrease their potential liability for non-performance. The wording of such clauses ranges from "best endeavours", which is the most stringent obligation, to "reasonable endeavours", which is the least stringent.

The range reflects the lengths to which the party performing the obligation is prepared or required to go in order to achieve the specified objective. If you are the party performing the obligation, you are likely to argue for a requirement to use "reasonable endeavours" and the other party will argue for the use of "best endeavours".

Despite some references to the English approach in recent cases, the English approach has not been definitively adopted in Hong Kong.<sup>39</sup> The Hong Kong courts have tended to adopt the Australian approach, which regards "best endeavours", "all reasonable endeavours" and "reasonable endeavours" as synonymous. These court interpretations merely create a presumption of intended meaning on the part of the parties, and so a measure of unpredictability remains with future litigation over this type of contract language.

## The English position

### "Best endeavours"

The term "best endeavours" entails the highest standard of obligation, but it does not equate to an absolute obligation or a guarantee. The wording only requires a party to act in a commercially practicable manner, considering the cost and degree of difficulty, but not to act in a manner that undermines the commercial standing or goodwill of the company or that requires the company to incur vastly onerous financial liabilities. The following principles apply when considering the requirements under a "best endeavours" obligation:

- Significant (but not ruinous) expenditure by the obligor may be required. In the case of *Jet2.com v Blackpool Airport Ltd*, the airport was obliged to open outside of its normal operating hours despite the fact it made a loss in doing so, given the importance of the airport to Jet2.com's business model;<sup>40</sup>

39. J. Young, 'An Endeavour to Understand 'Endeavours' Undertakings' [2014] HKLJ 95

40. [2012] EWCA Civ 417

- A requirement that the party takes steps that a prudent, determined and reasonable obligee, acting in his own interest and desiring to achieve that result, would take, but is not an absolute obligation;
- The obligor must put himself in the shoes of the obligee but may have some regard for its own commercial interests;
- The requirement to use "best endeavours" may be overridden by other duties, for example, duties to shareholders or directors' duties to act in the best interests of the company. In *Rackham v Peek Food*, an obligation on company directors to use best endeavours to pass a resolution did not require them to continue to recommend the resolution once it was no longer in the company's interests to do so.<sup>41</sup>

Note that the term "best efforts" often is used in US contracts, but it should be avoided in contracts governed by common law as there is uncertainty as to how the courts might interpret these words. There has yet to be any common law authority on the meaning of "best efforts".

### "Reasonable endeavours"

The requirements for "reasonable endeavours" are less burdensome than that under a "best endeavours" clause. The former only imposes a duty to take limited action that should not disadvantage a party's commercial interests, so a lesser effort is required as compared to "best endeavours". The recent case of *Minerva (Wandsworth) Ltd v Greenland Ram (London) Ltd*, stated the test as "what would a reasonable and prudent person acting properly in their own commercial interest and applying their minds to their contractual obligation have done to try" to achieve the objective.<sup>42</sup>

The following principles are relevant when considering the use of "reasonable endeavours":

- There is a possibility that limited expenditure would be needed but the obligor is not required to sacrifice its commercial interests;
- Less effort is needed as compared to "best endeavours"; and
- The requirement primarily should be considered in light of the obligor's circumstances and interest.

41. [1990] BCLC 895

42. [2017] EWHC 1457

In the case of *Arsenal Football Club Plc v Reed*,<sup>43</sup> Arsenal agreed to "use its reasonable endeavours to supply goods to [Reed] ... at prices which are comparable to the lowest wholesale prices charged by [Arsenal] to other market traders". The court held that the term would not relieve Arsenal of its obligation to supply the goods to Mr Reed, except if it stopped supplying other market traders.<sup>44</sup>

### "All reasonable endeavours"

This usually is seen as a compromise between "best" and "reasonable" endeavours. The meaning is more difficult to decipher and it is unsure whether, for example, the obligor is required to sacrifice its commercial interests and whether the assessment is based on the obligor's particular circumstances.

In the case of *Rhodia International Holdings Ltd v Huntsman International LLC*, the court took the view that "all reasonable endeavours" equates to an obligation to use "best endeavours".<sup>45</sup> An obligation to use reasonable endeavours probably only requires a party to take one reasonable course (not all reasonable courses available to them), whereas an obligation to use best endeavours probably requires a party to take all the reasonable courses he can.

The Scottish case of *EDI Central Ltd v National Car Parks Ltd* appears to be consistent with the English approach,<sup>46</sup> where the court held that a clause requiring a party to use all reasonable endeavours does not require that party to continue trying to comply if it is clear that any further effort would be futile. It also was held that "best endeavours" may not require much more effort than "all reasonable endeavours".

Nevertheless, some English courts qualify "all reasonable endeavours" with the limitation of "commercially prudent" endeavours. In *CPC Group Ltd v Qatari Diar Real Estate Investment Co*,<sup>47</sup> the court confirmed that an obligation to use "all reasonable endeavours" does not mean that the obligor has to sacrifice its own commercial interests. In this case, the court said that this was what the parties meant by "all reasonable endeavours", as the contract stipulated that the obligor only needed to use all reasonable endeavours that were "commercially prudent".

In the recent case of *Astor Management AG v Atalaya Mining Plc*, Atalaya was required to obtain "all reasonable endeavours" to obtain debt financing,

43. [2014] EWHC 781

44. [2014] EWHC 781

45. [2007] EWHC 292

46. [2010] CSOH 141

47. [2010] EWHC 1535

an event that would have triggered the payment of substantial deferred consideration to the plaintiff. It was held that Atalaya did not have to raise funding in this matter if it would render their operations commercially unviable.<sup>48</sup>

Other courts have limited this interpretation to situations where the obligor lacks control over performance of the obligation. In *Jet2.com v Blackpool Airport* (see above), the court held that if the performance of an obligation is dependent on the discretion or control of a third party (such as the grant of a planning permission from a third-party authority), then "all reasonable endeavours" does not require the obligor to sacrifice its own commercial interests. If, however, the performance of the obligation is in the control of the obligor, then it cannot take into account its own commercial interests or pressures. If it were otherwise, a party would be able to evade its responsibilities whenever this becomes commercially unprofitable.

Despite this disparity in how courts handle such language, it is important to note that English courts have given little consideration to other formulations such as "commercially reasonable endeavours". Similarly, there has been little consideration of the term "utmost endeavours", sometimes suggested as being superior to "best endeavours". Therefore, it would be wise for drafters not to get too creative when wording this type of clause if they intend to limit or expand the degree of performance required under the contract.

## The position in Hong Kong

The Hong Kong law position regarding "endeavours" clauses is far from clear. Hong Kong originally adopted the Australian approach, which regards "best endeavours", "all reasonable endeavours" and "reasonable endeavours" as synonymous because all imply an element of reasonableness.<sup>49</sup>

However, in *Hong Jing Co Ltd v Zhuhai Kwok Yuen Investment Co Ltd*,<sup>50</sup> the Court of Appeal seems to have acknowledged in *Rhodia v Huntsman*<sup>51</sup> by implying a "best or at least reasonable endeavours" obligation into the memorandum of understanding at issue there. This appears to suggest that "reasonable endeavours" would impose a lower standard on the obligor than "best endeavours". However, it still is worth bearing in mind the distinction

48. [2017] EWHC 425

50. [2013] 1 HKLRD 441

49. *Tin Shui Wai Development Ltd v Attorney General*, [1992] HKCFI 96

51. [2007] EWHC 292



between the terms, to ensure the standard of effort required by the contractual obligations is in line with the parties' intentions and expectations.

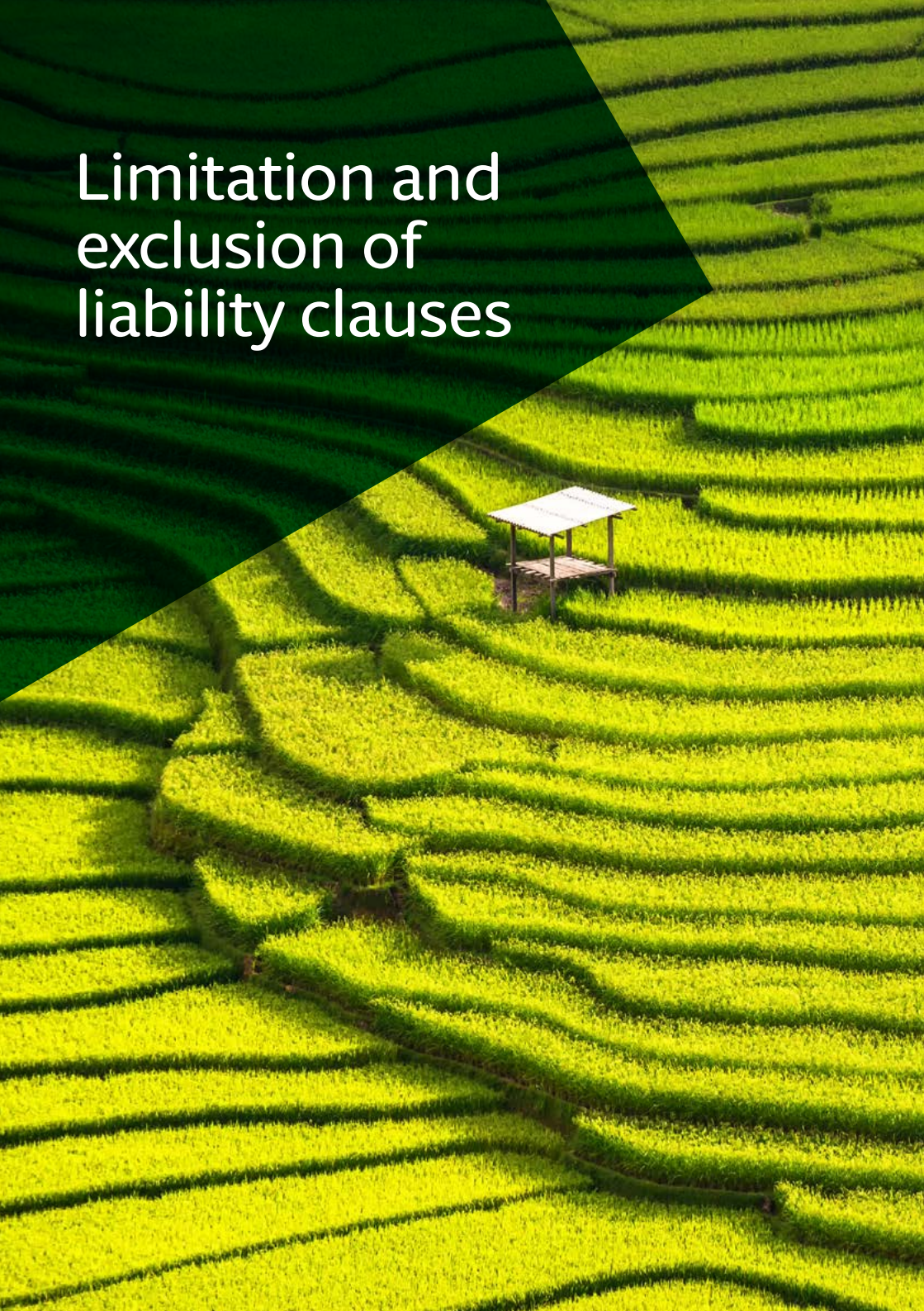
### Points to note

- "Best endeavours" does not require action that would undermine the commercial standing or goodwill of a company nor does it require one to incur onerous financial liabilities. It requires the party to take the steps that a prudent, determined and reasonable obligor would take, acting in his own interest and wanting to achieve the result.
- "Reasonable endeavours" generally is less burdensome than "best endeavours". The former may require limited expenditure but not the wholesale sacrifice of commercial interests.
- "All reasonable endeavours" normally is seen as a middle ground approach between "best" and "reasonable endeavours". However, one needs to be cautious when considering adopting this wording, as it has been interpreted as equating with "best endeavours".

### Practical tips

- If specific actions are required or expected (such as incurring expenditure or continuing to pursue a certain objective for a specified minimum time period), set these out as separate obligations rather than assuming these will fall within an "endeavours" obligation.
- From the point of view of the obligor, bear in mind that an obligation to use "reasonable endeavours" to achieve a particular result, followed by examples of specific activities, is likely to amount to an absolute obligation to carry out the specific activities listed.
- Obligors should maintain a record of steps taken to satisfy their obligations under endeavours clauses.
- Avoid wording such as "commercially reasonable endeavours", "utmost endeavours" and "best efforts" as the meaning of these terms is even less certain.

# Limitation and exclusion of liability clauses



Parties often try to achieve certainty as to their potential liability in the event of disputes by including limitation and exclusion of liability clauses in their contracts, sometimes known in Hong Kong as "exemption clauses". Such clauses are subject to the protection available to consumers and contracting parties under the CECO, under which a clause may be unenforceable if it is viewed as "unreasonable".

Parties also should bear in mind the legal meanings of words such as "condition", "direct loss" and "consequential loss" when drafting these clauses, as it is different from the usual commercial or natural meaning of these terms.

The section below aims to guide you through the basic elements of limitation and exclusion of liability clauses and outlines the main principles contained in the CECO.

## Construction

### Contract terms

Contract terms can be incorporated either as express terms or implied terms. As mentioned above, implied terms can be implied by industry practice, the parties' course of dealing or as a means to give business efficacy to a contract.

Parties should take note of the distinction between conditions and warranties when drafting exclusion clauses, as the exclusion of implied warranties will not be held to also exclude conditions.<sup>52</sup> Therefore, the safest approach is to exclude all implied "terms". However, parties should also bear in mind that certain implied terms cannot be excluded under the relevant statutory provisions.

### Contra proferentem

Any ambiguity in an exclusion clause is generally construed against the party seeking to rely on the clause.<sup>53</sup>

In *A Turtle Offshore SA and another v Superior Trading Inc*<sup>54</sup> and *Internet Broadcasting Corporation (trading as NETTV) v MAR LLC (trading as MARHedge)*,<sup>55</sup> the court held that there was no rule of law against the application of an exclusion clause to a deliberate repudiatory breach of contract. Therefore, the issue was simply one of construction of the relevant clause.

52. *Wallis, Son & Wells v Pratt & Haynes* [1911] AC 394 and *KG Bominflot v Petropulus Marketing AG* [2010] EWCA Civ 1145

53. See *Pegler Ltd v Wang* (UK) Ltd [2000] BLR 218 for an example. In that case, a clause purported to exclude liability for "indirect, special or consequential loss, howsoever arising (including but not limited to loss of

anticipated profits or of data)". The court held that the effect of the words in brackets was not to exclude all loss of profits. Only the loss of profits which are of the character of indirect, special or consequential loss were excluded.

54. [2008] EWHC 3034

55. [2009] EWHC 844

It was found that there was a strong rebuttable presumption against an exclusion clause being construed to cover deliberate repudiatory breach, and "clear" and "strong" language was needed to rebut such presumption. This would be the case if, for example, the exclusion clause included wording such as "including deliberate repudiatory acts by [the parties to the contract] themselves".

In the Hong Kong case of *Chau Kei Man Rayman v Chaters Auction Ltd*,<sup>56</sup> the court ruled that losses resulting from deliberate or negligent acts were not covered by an exemption clause that purported to exempt an auctioneer from liability for loss or damages caused "under any circumstances". In that case, the defendant could not adduce any evidence as to how the acts or situations that led to the loss came within the situation or state of affairs covered by the exclusion clause. As a result, the defendant could not rely on the clause.

## Negligence

If an exclusion clause (distinguished from a limitation clause) does not contain any express reference to negligence, the court will only construe the clause as excluding liability for negligence if the words used are sufficiently wide.<sup>57</sup> In other words, a party who wishes to exclude liability for negligence should do so expressly.

Under the CECO, a party to a contract cannot be reference to any contract term or to a notice given to the other party exclude or restrict his liability for negligence except insofar as the term or notice satisfies the requirement of reasonableness (see below).

## Consequential loss and loss of profits

Loss of profits usually is considered as a type of consequential loss that can only be recovered if it was reasonable, at the time when the contract was entered into, for the parties to have contemplated that such loss could arise. The test of foreseeability is applied when considering the validity of exclusion clauses for consequential loss.

In *Hadley v Baxendale*,<sup>58</sup> which concerned a situation where a new mill shaft could not be made until the defendant had delivered the broken shaft to the company responsible for building the new one, the court set out the foreseeability test as a two-limb test:

56. [2018] HKEC 738

58. [1854] EWHC J70

57. *Canada Steamship Lines v The King* [1952] AC 192

- First limb (direct loss): such losses as may fairly and reasonably be considered as arising naturally from the breach, such as losses that would be expected to occur in the usual course of things; or
- Second limb (indirect loss or consequential loss): losses that may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract as the probable result of a breach.

The legal meaning of "consequential loss" refers to loss that may reasonably be foreseen by the parties as a result of special circumstances that actually had been communicated to the party in breach at the time of entering into the contract. The legal meaning is distinguished from the general commercial meaning ascribed to the term. On the specific facts of *Hadley v Baxendale*, the test was not met, and therefore loss of profits that arose as a result of the delay in transportation could not be recovered.

Financial loss can be classified as direct loss or consequential loss depending on the particular facts. A common type of financial loss is loss of profits. In order to exclude all loss of profit claims, an exclusion clause must state that it covers loss arising both directly and indirectly.

## Fraud

A party may not limit or exclude its liability for losses arising as a result of its fraud.

## Control of Exemption Clauses Ordinance (Cap.71)

Parties should take note of the requirements in the CECO, which vary depending on the type of liability that the parties intend to exclude or limit under a clause. Also, note that the requirement of "reasonableness" under the CECO is not limited to contracts on a party's standard terms and can apply to both consumer contracts and business-to-business contracts.

Pursuant to section 4 of the Misrepresentation Ordinance (Cap. 284, Laws of Hong Kong), the reasonableness requirement has to be satisfied for a party to be able to exclude or limit liability for misrepresentation.

## Reasonableness

The requirement of reasonableness is defined in section 3 of the CECO. In order for a term to be reasonable:

- It must be a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made (section 3(1) of the CECO).
- In the case of a clause imposing a cap on liability, special regard should be given to the resources available to the party seeking to enforce the cap should the liability arise, and how far it was open to that party to cover itself by insurance (section 3(5) of the CECO).

Parties also should take into consideration the non-exhaustive list of factors in Schedule 2 of the CECO, which includes:

- Relative bargaining positions of the parties;
- Whether customers were induced to agree to the terms;
- Whether the customer knew or ought reasonably to have known about the term;
- Where the term operates if a condition is not complied with, whether it was reasonable to expect compliance with the condition; and
- Whether the contract goods were provided to the special order of the customer.

## Burden of proof

Where an exclusion or limitation clause is subject to the reasonableness requirement, the party that wishes to rely on such a clause will bear the burden to show that the term is reasonable.

## Negligence (section 7 of the CECO)

Section 7 covers obligations to take reasonable care (whether contractual or tortious). The reasonableness requirement has to be satisfied in order for liability for loss or damage caused by negligence to be excluded or limited. On the other hand, liability for death or personal injury caused by negligence (contractual or tortious) cannot be excluded.

The fact that a person agrees to, or is aware of, a contract term or notice that purports to exclude or restrict liability for negligence should not be taken as voluntary acceptance of any risk.

### Liability for breach of terms implied by statute (section 11 of the CECO)

Liability for breach of implied terms as to title (section 14 of SOGO) cannot be excluded or limited.

As against a person dealing as a consumer, liability for breach of the following implied terms cannot be excluded or limited:

- implied terms as to correspondence with description (section 15 of SOGO);
- satisfactory quality (formerly merchantable quality) and fitness for purpose (section 16 of SOGO); and
- correspondence with sample (section 17 of SOGO).

In business-to-business contracts, the reasonableness requirement has to be satisfied in order for liability for breach of the above implied terms to be excluded or limited.

### Liability for breach of contract on "standard terms" (section 8 of the CECO)

The term "standard terms" is constructed broadly. The court will look at the changes made to the term in question, instead of changes made to the contract as a whole. In other words, if a clause excluding or limiting liability has not been subject to any amendments, it will be considered as "standard terms" even if other contractual clauses have been changed.

The reasonableness requirement has to be satisfied in order for liability under standard terms to be excluded or limited, even if it is a business-to-business contract.

In the case of consumer contracts, all clauses purporting to exclude or limit the supplier's liability for breach of contract are subject to the reasonableness requirement, regardless of whether or not the contract is on the supplier's standard terms.

## Exceptions to the CECO

Note the following exceptions to the CECO:

- Certain types of contracts, such as insurance contracts, contracts for the creation or transfer of a right or interest in land or in any intellectual property (sections 7 to 9 of the CECO);
- Any contractual provision that is made to comply with an international agreement that applies to Hong Kong (section 18 of the CECO); and
- If, but for the parties' express choice of Hong Kong law, the contract would have been governed by the laws of another jurisdiction (but note that there is an anti-avoidance provisions that applies to situations where the parties' choice of a foreign governing law appears to have been made for the sole or dominant purpose of avoiding the application of the CECO).

## Severability

The unreasonable part of an exclusion clause is not severable from the remainder of the clause. In other words, failure to satisfy the reasonableness requirement will render the whole clause unenforceable.

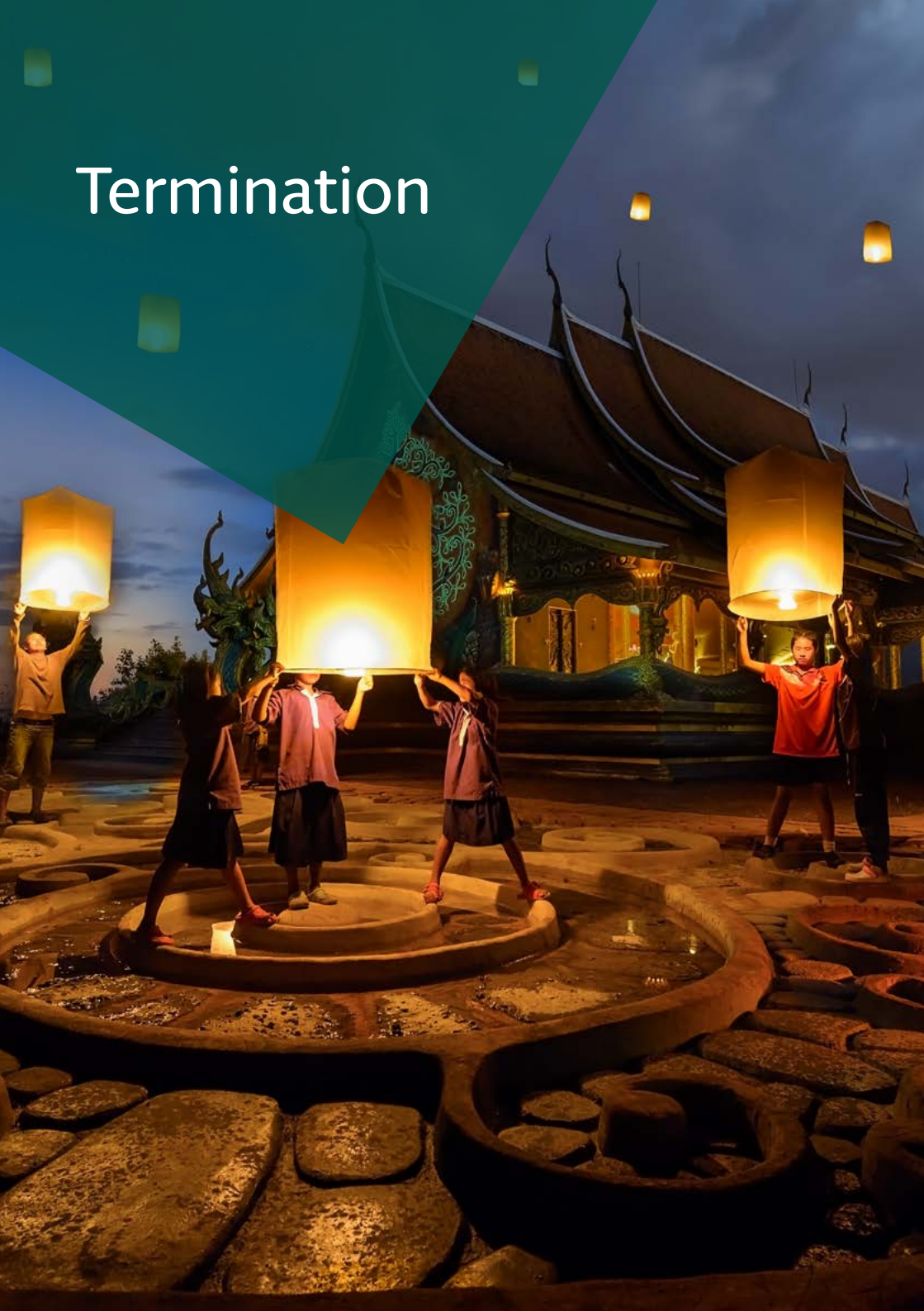
### Practical tips

- State that your exclusion or limitation clause does not cover any subject matter that cannot be excluded or limited under the statutory provisions.
- Expressly exclude liability for the particular subject matter you want to cover.
- Exclude loss of profits and any other consequential losses that are common in the commercial sense, and consider whether the scope of the clause would satisfy the requirements under the CECO.
- When amending financial caps in a standard documentation, consider the relevant provisions in the CECO and give justifications for why the caps are set where they are.
- Any financial caps should take into account the relevant party's insurance cover and the contract price, but note that the court still has discretion as to whether to uphold such caps.
- Properly consider the insurance position of both parties.
- Take into account issues of severability, and divide the clause into separate sub-clauses when appropriate.





# Termination



## Termination on reasonable notice

### Duration of contracts

Most contracts specify a term or end date. When a contract is silent as to duration, the courts traditionally have ruled that there was a rebuttable presumption the contract was intended to be permanent and irrevocable. However, in recent years, the courts have moved away from this approach and have instead started to look at the wording of the contract in order to ascertain the parties' intentions.

Where it is not possible to ascertain the parties' intentions with regard to termination from the contract, the contract generally will be regarded as terminable by reasonable notice, subject to any statutory exceptions.

### Reasonable notice

What amounts to "reasonable notice" will depend on the relevant factors and circumstances existing at the time when notice was given, not when the contract was made.<sup>59</sup>

Relevant factors include the following<sup>60</sup>:

- The duration of the agreement or relationship between the parties. The longer the relationship, the more likely it is that a longer period of notice will be required. The courts also take into account the degree of informality in some longer term relationships;
- The degree of financial dependence between the parties. The greater the dependence, the more likely it is that a longer notice period will be required;
- The time it will take to replace the business lost due to the termination of the contract; and/or
- The higher the capital investment made by the party receiving notice of termination and the higher the extent to which these investments may not be fully amortised at the time of termination, the more likely it is a longer notice period will be required.

The "chief purpose" test has also been applied to determine the reasonableness of notice periods.<sup>61</sup> The test is based on the premise that the "chief purpose" of requiring reasonable notice is to enable the parties to bring the contract to an end in an orderly manner. Therefore, considerations of whether a certain notice

59. *Martin-Baker Aircraft Co. Ltd v Canadian Flight Equipment Ltd*, cited in *Distribution Ltd v Amann & Sohne GmbH & Co KG* [1955] 2 QB 556

60. *Jackson Distribution Limited v Tum Yeto Inc* [2009] EWHC 982

61. *Distribution Ltd v Amann & Sohne GmbH & Co KG* [2009] 4 HKLRD 633

period would give the parties a reasonable opportunity to enter into alternative arrangements and wind-up matters arising out of the relationships become relevant in assessing the reasonableness of notice periods under this test.

If a party fails to give reasonable notice of termination, there still can be a valid termination. In this case, the aggrieved party would be entitled to claim damages, which usually correspond to the loss of profits suffered by the terminated party during the relevant notice period, subject to the usual principles of mitigation.

The Hong Kong approach is flexible and generally the Hong Kong courts do not look at the circumstances and means of termination as relevant when assessing the reasonableness of notice periods. For example, in *Alpha Lettings Limited v Neptune Research and Development Inc*,<sup>62</sup> the Court of Appeal noted that the question of the period of reasonable notice actually is unaffected by whether the parties parted ways in an amicable or vitriolic manner.

### Perpetual agreements

The word "perpetual" is commonly used in commercial contracts. The word was interpreted to mean "never ending" or "of indefinite duration" in *BMS Computer Solutions Limited v AB Agri Limited*,<sup>63</sup> in the context of a software contract. On the facts, the court ruled that the software contract was of indefinite duration, but it nevertheless was subject to terms that governed the termination of the licence. One should exercise care when adopting the wording "perpetual" and should bear in mind the meaning it carries.

### Points to note

- Where a contract is silent as to its term, it may be terminated at any time by either party by giving reasonable notice.
- Where the contract provides for the contract to be for a fixed term, the courts will give effect to this intention. A provision as to reasonable notice is unlikely to be implied into a fixed term contract.
- A number of factors are relevant when considering the reasonableness of a notice period, including the duration of the relationship between the parties, their financial inter-dependence and the time needed for the aggrieved party to restore its market position after termination.

62. [2003] EWCA Civ 704

63. [2010] EWHC 464

- Where the terminating party does not give reasonable notice, the termination will be valid but the aggrieved party will be entitled to damages.

### Practical tips

Parties to a contract are advised to expressly agree contractual terms regarding the contract duration and any termination notice period. Otherwise, the contract may be regarded as terminable on reasonable notice and the length of the notice period would depend on the aforementioned factors and circumstances.

### Termination for material breach

Some contracts contain provisions that entitle the innocent party to terminate the contract if the other party is in material breach. However, the word "material" is not defined in statute, and it is for the courts to decide what amounts to a "material breach" in the circumstances.

### What is a "material" breach?

The meaning of "material" is highly dependent on the specific facts of each case, including the nature of the breach and its consequences (both commercial and monetary). It can therefore be very difficult to reach a conclusion on what would constitute a "material" breach in any given set of circumstances. However, the following factors are likely to be relevant:

- The commercial and monetary consequences. For example, the failure of a party to provide information was not held to be a material breach because the court regarded this as a breach of an ancillary term, and took into account the fact that it only resulted in "relatively small consequences in monetary terms";
- A series of minor breaches can cumulatively constitute a material breach (eg defaulting on three consecutive monthly payment out of 174 monthly instalments can be considered as a material breach, especially if there is nothing to suggest that the defaulting party will be able to meet future payments<sup>64</sup>);
- The impact on the innocent party, and whether the breach was intentional.<sup>65</sup>

64. *NTT Data Hong Kong Ltd v OCTO3 Ltd* [2018] HKEC 1853, applying *Dalkia Utilities Services Plc v Celtech International Ltd* [2006] EWCH 63

65. *NTT Data Hong Kong Ltd v OCTO3 Ltd* [2018] HKEC 1853, applying *Dalkia Utilities Services Plc v Celtech International Ltd* [2006] EWCH 63

## Practical tips

- It may be useful to define “material breach” or expressly state the kinds of breaches that would entitle a party to terminate the contract.
- However, note that it is difficult to draw up an exhaustive list of breaches that will allow termination as it is hard to foresee all possible future outcomes at the time of entering into a contract.
- Even where the contract contains an express clause stating that any breach will entitle the innocent party to terminate, the courts have in some cases refused to interpret these clauses literally on the basis that it would flout business common sense.
- Clearly set out cure periods that are applicable to each type of breach (if applicable).

## Termination by force majeure and frustration

A *force majeure* clause excuses one or both parties from having to perform the contract if it is unable to do so because of reasons that are outside of their control.

Although the term is expressly recognised by the courts, it is yet to be defined. If the parties wish to include a *force majeure* clause into their contract, they must define clearly the circumstances in which this will be triggered. In the absence of an express clause, the common law doctrine of frustration may offer the parties limited relief.

The following principles apply to the interpretation of *force majeure* clauses:

- These clauses usually are construed strictly by reference to the wording used rather than the parties' intention;
- They generally do not cover events caused by negligence or default, unless there is a clear indication to the contrary;
- The *ejusdem generis* rule of interpretation (where a general phrase following a list of items may be interpreted as being limited to the same type of thing as the items in the list), does not automatically apply to these clauses unless

there is clear indication to the contrary. General words usually are given their wide and natural meaning;

- The party relying on the clause must show that no reasonable steps could have been taken to mitigate the *force majeure* event or its consequences;
- The parties' obligations are suspended for the duration of the *force majeure* event. Although the obligations are not discharged, it may not be feasible for the parties to resume their performance of the agreement after a *force majeure* event that has continued for a long time.

Affected parties are required to take reasonable steps to avoid or mitigate the *force majeure* event and its consequences, although there is no requirement for a *force majeure* event to be unforeseeable.

## Scope

*Force majeure* clauses can cover itemised events and natural disasters. If parties wish to include economic events (such as economic downturn and economic hardship) within the scope of the clauses, specific and clear drafting will be required to give effect to their intentions.

## Force majeure and frustration

Frustration is a much narrower concept than *force majeure*. An event can only frustrate a contract if it makes performance of the contract impossible, illegal or radically different from what the parties intended at the time of execution of the contract.

## Points to note

- *Force majeure* clauses are construed strictly in Hong Kong, and therefore if the parties wish to cover a wider range of events, they should ensure the clause is carefully drafted to give effect to their intentions and that specific events are clearly spelled out.
- Parties may wish to include additional clauses such as a material adverse change clause (which discharges a party from performance in the event the contract becomes unfavourable because of the occurrence of a defined change) and a hardship clause. The latter type of clause may be useful to get the parties to renegotiate the contract if a significant change of circumstances renders contractual performance radically different from the obligations originally undertaken or illegal. Hardship clauses often provide that the contract will terminate if the parties cannot renegotiate within a specified time.

- To minimise the risk of courts applying the *ejusdem generis* rule when interpreting *force majeure* clauses, the parties may consider adding wording such as "including but not limited to..." when drafting clauses that include general categories, followed by itemisation of specific events.

### Sample clause

Neither party will be deemed to be in breach of this Agreement or otherwise liable to the other party for any failure or delay or for the consequences of any failure or delay in the performance of this Agreement if it is due to [a Force Majeure Event] [any event beyond the reasonable control [and contemplation] of a party to this Agreement] [including, acts of God, war, industrial disputes, protests, fire, flood, storm, tempest, epidemic, explosion [an act of terrorism] and national emergencies] [and the party so delayed will be entitled to a reasonable extension of time for performing such obligations].





Consent



## Consent not to be "unreasonably withheld"

In commercial agreements, it is common to require consent of one party for certain actions and to provide that such consent cannot be unreasonably withheld or refused.

### Has consent been unreasonably withheld?

A small number of cases have addressed this issue. The following factors are relevant:

- the parties' intention behind the inclusion of the consent clause;
- the reason for withholding consent; and
- whether the withholding of consent was objectively reasonable given the circumstances and the facts.

This issue occurs most frequently in cases involving landlords and tenants. The party claiming that consent has been unreasonably withheld bears the burden of proof.

### Examples of withheld consent

In *Olympia & York Canary Wharf Ltd v Oil Property Investments Ltd*,<sup>66</sup> the Court held that a landlord's refusal to give consent to the reassignment of a lease, from the existing tenant to the original tenant, was reasonable on the grounds that the original tenant intended to exercise a personal right to terminate the lease. It was therefore reasonable for the landlord to refuse consent as the reassignment would have a substantial and adverse effect on the landlord's interests.

However, in a later case, the court recognised that it would be unreasonable for a party to withhold approval for the purpose of terminating the contract. In that case, the court was concerned with an agreement that provided that neither party could transfer or assign its rights without the prior approval of the other, such approval not to be unreasonably withheld.<sup>67</sup> The court held that a party's withholding of approval to a proposed transfer based on its intention to terminate the contract under the change of control provisions was not reasonable.

66. *Olympia & York Canary Wharf Ltd v Oil Property Investments Ltd* [1994] 2 EGLR 121 83

67. *British Gas Trading Ltd v Eastern Electricity* [1996] EWCA Civ 1239

## Right of approval/ Right of consent

The grounds on which approval may be withheld are narrower than the grounds on which consent may be withheld. The court recognised that "consent" bears a wider meaning than "approval": consent is often used in the sense of permission, whereas approval connotes the act of approving if satisfactory.<sup>68</sup> It will be easier for parties to argue that consent, as opposed to approval, was reasonably withheld.

## Implied limitation on right to withhold consent and approval

In the absence of express wording in the contract, there is no general rule setting limits to the exercise of a party's discretion to withhold consent or approval. Nevertheless, in various cases, the courts have been willing to imply some restrictions on the exercise of such discretion. It was held that the exercise of discretion to withhold consent must be "genuine and rational",<sup>69</sup> and not "empty and irrational".<sup>70</sup> Additionally, in another case, the court ruled that the discretion to withhold approval has to be exercised in good faith and not arbitrarily.<sup>71</sup>

This principle has been upheld in the Hong Kong courts. In *Best View Medical Co Ltd v Richermen International Investments Ltd*, the court held that the landlord was not acting reasonably by demanding a non-refundable reinstatement charge before it would allow renovations to take place pursuant to a clause in the tenancy agreement.<sup>72</sup>

## Points to note

- The reasonableness of a withholding of consent or approval is highly dependent on the specific facts and circumstances of each case.
- A right of approval is regarded as narrower than a right of consent.
- Even where the right to withhold consent is absolute, courts still may impose limits on the exercise of a party's discretion, such as by requiring the party to exercise its discretion rationally or in good faith.

68. *British Gas Trading Ltd v Eastern Electricity* [1996] EWCA Civ 1239

69. *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287

70. *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287

71. *Lymington Marina Ltd v McNamara and Ors* [2007] EWCA Civ 151

72. [2018] HKCA 288



# Damages



The primary purpose of an award of damages for breach of contract is to compensate the injured party for loss, and not to punish the wrongdoer. Damages should place the injured party in the same position as if the contract had been performed.<sup>73</sup>

## Liquidated damages and the rule against penalties

Liquidated damages are payments of fixed sums (provided for under the contract) in the event of a specific breach of contract. Liquidated damages clauses generally are supported by Hong Kong courts, but parties should ensure that such clauses do not fall foul of the common law rule against penalties.

### Advantages of adopting a liquidated damages clause

Liquidated damages clauses allow for more certainty and can save time and costs when bringing claims for breach of contract. They especially are useful in relation to the more common and predictable breaches of contract.

#### Advantages for the customer

If liquidated damages clauses are in place, court proceedings for breach of contract are likely to be shorter as the court does not need to assess the amount payable. There also is no need to prove loss or that the loss is direct. The clauses would significantly lower the risks for customers in commercial agreements.

#### Advantages for the supplier

Liquidated damages clauses allow suppliers to limit their liability for specific breaches of contract, as they provide for certain fixed sums as the sole and exclusive remedy for the specified breaches.

### What constitutes penalty?

Penalty clauses are unenforceable under Hong Kong law. The person claiming that a clause providing for the payment of a fixed sum upon the occurrence of certain events is a penalty clause bears the burden of proof. The question is one to be considered at the time of making the contract, not at the time of breach.

The 2015 Supreme Court decision in *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* revised the test in England & Wales for which sums may be considered a "penalty". The test under England law

73. *Robinson v Harman* (1848) 1 Ex 850, applied in Hong Kong in *Hong Jing Co Ltd v Zhuhai Kwok Yuen Investment Co Ltd* [2013] 1 HKLRD 441

had previously been whether the sum represents a "genuine pre-estimate of loss" but the court said consideration should be given as to whether the sum "is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."<sup>74</sup> The new test was seen as representing a shift towards rewarding a party's "legitimate interest" and commercial purpose in imposing the clause, rather than simply compensating their loss.

In Hong Kong, however, the "genuine pre-estimate of loss" test continues to apply, having been recently applied in cases such as *Brio Electronic Commerce Ltd v Tradelink Electronic Commerce Limited*.<sup>75</sup> This will remain the case until such time as the courts in Hong Kong revisit the topic. As such, the established principles taken from *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*<sup>76</sup> continue to be relevant in Hong Kong:

- Liquidated damages are based on a genuine pre-estimate of loss, whereas a penalty aims to intimidate the other party not to breach the contract in the first place.
- The labels of "liquidated damages" and "penalty" are not conclusive, and the court will examine all relevant circumstances.
- If the stipulated sum is extravagant and unconscionable compared to the expected loss that would result from the breach, it probably will be held to be a penalty.
- If the breach is a mere non-payment of a sum, and the stipulated amount of liquidated damages is greater than the sum that is owed, then it is likely that such amount will be held to be a penalty.
- Market practice is a relevant factor when assessing whether a stipulated sum is a penalty.
- The courts recognise that the formula for calculating liquidated damages is unlikely to be oppressive when two parties are of equal bargaining powers.<sup>77</sup>
- Primary obligations to pay a sum under a contract, such as exit fees and non-refundable deposits, are not generally subject to the rule against penalties. Nevertheless, default interest rate clauses are subject to the rule against penalties.

74. [2015] HKSC 67

75. [2016] 2 HKLRD 1449

76. [1915] AC 79

77. *Ip Ming Kin v Wong Siu Lan* [2013] HKEC 816 (applying *Philips Hong Kong Ltd v Attorney General of Hong Kong* [1993] 61 BLR 41)



### Practical tips

- Parties should include a statement to acknowledge that the fixed sum payable in the event of a breach is a genuine pre-estimate of loss and not a penalty, although this labelling is not conclusive.
- When drafting “minimum commitment” or “take to pay” clauses, the clauses ideally should be drafted as primary obligations to pay money rather than as consequences for breaches, so as to avoid the application of rule against penalties.
- It is advised that sums payable as service credits be varied in accordance with the severity of the breach. There is a greater risk of the service credits being considered as a penalty if the same sum is applied regardless of the severity of the breach.
- Evidence of how the fixed sum was calculated at the time of drafting of the contract can be useful to prove that such a sum is a genuine pre-estimate of loss.

	Unliquidated damages	Liquidated damages	Indemnity
What is it?	No fixed amount	Amount fixed by agreement Pre-agreed sums that become payable upon a party's breach of some other duty in a contract  Imposes a duty on the party in breach to pay the agreed sum, without inquiries into the plaintiff's loss	Obligation to compensate for defined loss or damage by making a money payment

	Unliquidated damages	Liquidated damages	Indemnity
Rules of assessment	<p>Generally assessed at the time of the breach</p>	<p>Questions of causation, remoteness, mitigation and proof of loss are irrelevant in determining whether there is a liability to pay liquidated damages</p> <p>Must be a genuine pre-estimate of the loss,<sup>78</sup> or else the clause will be regarded as a penalty clause and will be unenforceable</p>	<p>Might be subject to the rules on assessment of loss depending on how the clause is drafted and the aims to be achieved</p> <p>If the indemnity clause requires the payment of a fixed sum of money or contains a set formula such that the plaintiff does not need to prove any losses, it may be argued that this falls under the case of liquidated damages, so that the rules on assessment of loss would not apply</p> <p>If the clause requires the paying party to pay to prevent the loss, and specifically in cases where the triggering event is not a breach of contract by the paying party, it is in practice necessary to apply the rules on assessment of loss</p> <p>However, even if the duty to pay under an indemnity is construed as being in substance similar to an obligation to pay “damages”, the usual rules on assessment of damages may not apply (ie the paying party may not need to pay for all foreseeable losses that are caused by the triggering event, and the amount depends on the payment obligation under the contract terms<sup>79</sup>)</p> <p>There are cases where it is possible to indemnify against losses that are only connected with the triggering event<sup>80</sup></p> <p>The application of the remoteness test also depends on the interpretation of the indemnity clause,<sup>81</sup> and it can be excluded by express terms in the contract<sup>82</sup></p> <p>On the other hand, if the triggering event for the payment obligation under the indemnity is a breach of contract by the paying party, the court may interpret the clause as being, in substance, a duty to pay damages. Therefore, the court may require the payment to be assessed based on the usual rules of damages for breach of contract<sup>83</sup></p>

78. *Phillips (Hong Kong) Ltd v The Attorney General of Hong Kong* [1993] UKPC 3

79. *Maurice v Goldsborough, Mort & Co* [1939] AC 452

80. *Campbell v Conoco UK Ltd* [2002] EWCA Civ 704

81. *Total Transport Corp v Arcadia Petroleum Ltd (The Eurys)* [1996] 2 Lloyd's Rep 408

82. *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428

83. *Total Transport Corp v Arcadia Petroleum Ltd (The Eurys)* [1996] 2 Lloyd's Rep 408

## Practical tips

- When drafting an indemnity clause, either expressly apply or exclude the rules on mitigation, remoteness and causation.
- In the absence of express wording on these points, the courts are likely to interpret an indemnity as giving rise to a claim for damages, but they will assess the payment due according to the contract wording.

## Rescission

If an innocent party has been induced to enter into a contract by misrepresentation, mistake, fraud, undue influence or duress, the party may be able to set aside the contract through the remedy of rescission. Rescission restores the innocent party's position as if the contract was never entered into.

There are certain situations in which the remedy of rescission may be lost:

- The party who was entitled to rescind elects to affirm the contract after discovering the true state of affairs;
- There is a lapse of time;
- It is not possible to restore the parties to their positions before the contract was made; and
- When third-party interests are involved.

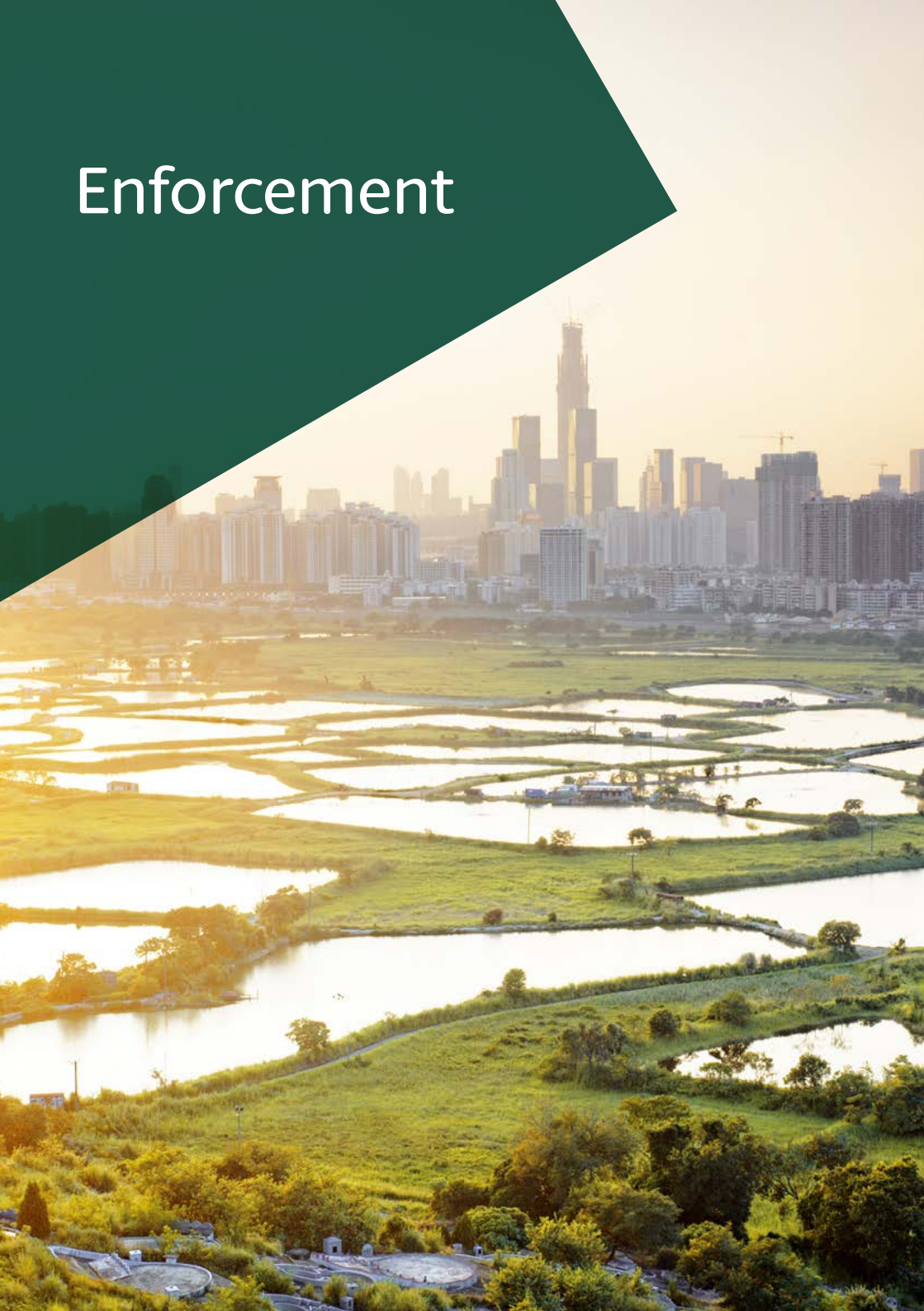
The Misrepresentation Ordinance (Cap. 284, Laws of Hong Kong) includes relevant provisions on the available remedies if a party was induced to enter into a contract by misrepresentation.

## Restitution

The remedy of restitution is available if a contract is too uncertain to be enforced. However, restitution is not available for expenses that were incurred during the pre-contractual negotiation process.<sup>84</sup>

84. *Regalian Properties plc v London Dockland Development Corp* [1995] 1 All ER 1005.

# Enforcement



## Vitiating Factors

Various factors might interfere with the enforcement of a contract, including unconscionability, duress and undue influence. While each represents a separate legal doctrine, they have the same impact of rendering a contract or part of a contract unenforceable.

### Unconscionability

Unconscionability involves a court's refusal to enforce a contract or part of a contract that is unfair and unreasonable, or where a court changes such a contract. Case law tends to deem contracts unconscionable where there is manifest inequality between the parties and where one side is taking advantage of the other on account of this inequality. The Unconscionable Contracts Ordinance (Cap 458, Laws of Hong Kong) essentially provides the same, although only in contracts where a consumer is one of the parties. Both the legislation and the case law provide a limited role for unconscionability in order to minimise interference with the commercial certainty that should naturally flow from contracts.

### Duress

Duress involves illegitimate pressure on a person to enter into a contract. This pressure might take on some form of violence or threat of violence, either towards the person entering into the contract and their family members or towards the person's property. Economic duress also is a possibility, where a party threatens to unlawfully break the contract if the terms are not changed, although causation is more difficult to satisfy with this form of duress. The key element for both is that the other party has no practical alternative to agreeing to the contract or the updated terms, although it is somewhat unpredictable how a court will see this. Moreover, it is possible that the party who acted under duress nevertheless affirms the contract following removal of the duress, which typically would frustrate recovery of damages.

### Undue Influence

Under this principle of equity, the level of influence falls short of duress, often because the threat or action in question is lawful. Nevertheless, such influence has been deemed to warrant unenforceability of the contract due to the lack of free will exhibited by the person who entered into the contract, usually as a result of a relationship of trust between the parties and a transaction that cannot be adequately explained. The party who wants to enforce the contract must show that the contract was entered into according to the other party's free

will. The undue influence need only be a factor in inducing the person to enter into the contract for it to be deemed unenforceable. Again, problems arise if the party who wants to avoid enforcement affirmed the contract after the undue influence had stopped.

## Recognising foreign judgments

In order to enforce a foreign judgment, the judgment must either be registered under the relevant statute or be recognised under the common law rules, depending on the jurisdiction from which the judgment originated. A distinction needs to be drawn between Mainland judgments, judgments from designated jurisdictions, and judgments from jurisdictions other than those that are designated under statute.

### Enforcement of foreign judgments – under statute

For foreign judgments to be enforced, they must first be registered according to the requirements under the Foreign Judgments (Reciprocal Enforcement) Ordinance (Cap 319, Laws of Hong Kong) ("**FJREO**"). The purpose of registration is to facilitate reciprocal recognition and enforcement of judgments. Proceedings brought to enforce foreign judgments that fall within the ambit of the FJREO through the common law rules may be struck out (section 8 of FJREO).

### Registration procedures

A judgment creditor who obtained judgment from a jurisdiction designated under the FJREO may apply to the Court of First Instance (the "**CFI**") on ex parte basis (meaning that only one party's interests are represented in court) for the registration of that judgment. Provided the requirements in FJREO are met, the foreign judgment will be registered. The judgment debtor (meaning, the party who is liable to pay the winning party a sum of money pursuant to a court judgment) will then be served with a notice of registration (rather than a court order) and he may apply to the court to set aside the registration. If the registration is not set aside, the judgment will then be executed.

### Meaning of "designated jurisdictions"

A reference to "a jurisdiction designated under the FJREO" refers to one of the jurisdictions listed in Schedules 1 and 2 of FJREO. They include Australia, Austria, Belgium, Bermuda, Brunei, France, Germany, India, Israel, Italy, Malaysia, New Zealand, Netherlands, Singapore and Sri Lanka. Judgments of a "superior court" – a court having unlimited jurisdiction in civil and

criminal matters – in civil and commercial matters originating from the above jurisdictions can be enforced through the statutory regime under the FJREO.

### Additional requirements for registration of foreign judgments

Other requirements need to be met before a foreign judgment can be registered in Hong Kong. First, section 3(2) of FJREO requires that the judgment to be enforced must be final and conclusive between the parties. A judgment will be deemed final and conclusive notwithstanding any pending appeal or the fact that it still may be subject to appeal in the courts of the country from which the judgment originated (section 3(3) FJREO). Second, the judgment must provide for payment of a sum of money (excluding sums payable in respect of taxes or other similar charges or in respect of a fine or other penalty). Third, the foreign judgment must have been handed down after the FJREO became applicable to the country from which the judgment originated.

### Setting aside a registration

Registration must, or may, be set aside if the court is satisfied that one of the grounds listed in sections 6 and 7 of FJREO applies. An application to set aside a registration is made by way of summons supported by an affidavit and is generally determined summarily, although the court may order a trial of an issue where necessary. This may be the case where, for example, the judgment debtor is seeking to have the registration set aside on the grounds that the judgment was obtained by fraud.

If the court sets aside the registration, no further application for registration can be made, unless the registration is set aside on the ground that an appeal is pending against the judgment in the country from which that judgment originated.

### Execution

If the registration cannot be set aside, the judgment creditor can then seek execution of the registered foreign judgment. The procedure for enforcement will vary based upon the type of enforcement sought.

### Enforcement of Mainland judgments – under statute

Mainland judgments are registrable under the Mainland Judgments (Reciprocal Enforcement) Ordinance (Cap 597, Laws of Hong Kong) (“**MJREO**”). In order to be registered, the judgment must fulfil the requirements set out in section 5(2) MRJEO, namely (i) it must have been handed down on or after 1 August 2008 by a designated court that was the chosen court under a valid choice of Mainland court agreement between the parties to the judgment, (ii) it must

be final and conclusive; (iii) it must be enforceable in the Mainland; and (iv) it must order payment of a sum of money.

### Procedure

As the MJREO is modelled on FJREO, the application procedures are very similar. The judgment creditor (the Plaintiff) must apply to the Court of First Instance to register the judgment by ex-parte originating summons within two years after the Mainland judgment takes effect or, where the judgment has a period for performance, by the day after the last day of such period.

The judgment creditor must file an affidavit and draft order. The draft order must specify the period within which an application may be made to set aside the registration and must state that execution will not be granted until after the expiry of this period. If the judgment creditor is resident out of the jurisdiction, they may be required to provide security for costs of the application.

### Setting aside the registration

An application to set aside the registration will succeed if any of the grounds specified under section 18 of MJREO are satisfied. Likewise, registration may be set aside, or an application for registration may be adjourned, if the case falls under any of the grounds specified in section 19 of MJREO.

Where the registration is set aside, no further application can be made unless the registration was set aside based on one of the following grounds:

- An appeal is pending against the judgment in the Mainland;
- The case in which the judgment was given is ordered to be retried by a competent designated court;
- At the date of the application for registration the judgment was not enforceable under the law of the Mainland; or
- The judgment was registered for the whole sum but, as at the date of the application for registration, part of it had already been satisfied.

### Execution

After the period for making an application to set aside registration has expired, the judgment creditor may request execution of the registered judgment. The procedure for enforcement will vary based upon the type of enforcement sought.



## Enforcement of foreign judgments – under common law

Foreign judgments that are not registrable under the FJREO can nonetheless be enforced under the common law rules. The judgment creditor needs to issue a writ endorsed with a short statement of claim, which sets out the details of the foreign judgment and the sum awarded.

### Procedures

To enforce a foreign judgment under the common law, the writ must be issued within 12 years of the date on which the foreign judgment became enforceable. Once the judgment debtor has given notice of intention to defend, the judgment creditor may then issue a summons for summary judgment supported by an affidavit. The foreign judgment should be exhibited to the affidavit.

### Points to note

- Parties seeking to enforce foreign judgments can initiate proceedings under either the statutory or common law regimes.
- Note, however, that only the foreign judgments that are not registrable under the FJREO and MJREO can be enforced via the common law route. Any attempt to enforce a foreign judgment that falls within the scope of the FJREO or MJREO by bringing common law proceedings will result in those proceedings being struck out.

## Severability of unenforceable clauses

### Doctrine of severance

The doctrine of severance becomes relevant when certain contractual terms are held to be unenforceable or illegal. Under the doctrine, the invalid and illegal provision can be struck out without affecting the validity of the rest of the contract.

### Severance of an entire clause

The courts will not sever a clause if 1) the clause is the whole or substantially the whole of the consideration for a promise that a party is seeking to enforce; or 2) severing the clause would leave the contract as a whole without a subject matter.

## Severance of part of a clause

The "blue pencil" test applies when a court has to decide whether to sever part of a clause. Where the offending wording can be deleted without thereby affecting the meaning of the remaining part, severance is possible. The court will not, however, redraft or rewrite the clause or contract.

In addition, courts will not strike out part of a clause if doing so would affect the scope and intention of the clause. If the enforceable and unenforceable parts of the clause are held to be interdependent, the court will not sever the offending part of the clause.

## Overriding public policy

Courts will only sever the unenforceable parts of a contract if there is public policy interest in doing so.

## Points to note

- Although severance is available even without an express severance provision, it is helpful to include a severance clause in order to demonstrate that the parties intended that, should any part of the contract be considered unenforceable, that part should be severed and the rest of the contract should stand.
- Even in the absence of an express severance clause, parties still may be able to persuade the court to sever the offending part of a clause, provided this can be done merely by deleting text.

## Sample clause

If a provision of this Agreement is found to be illegal, invalid or unenforceable, then to the extent it is illegal, invalid or unenforceable, that provision will be given no effect and will be treated as though it were not included in this Agreement. However, the validity or enforceability of the remaining provisions of this Agreement will not be affected.

## Practical tips

- Note that the court will not redraft or rewrite an unenforceable clause.
- Parties are advised to separate out liability clauses into different paragraphs or sub-clauses, as this would make it easier to sever an unenforceable provision from the remaining provisions.



# Assignment, novation, variation



## Assignment

The benefit of a contract is assigned when the contractual rights are assigned. An assignment can be done in writing or orally. A written assignment is recognised as a legal assignment, whereas an oral assignment is recognised as an equitable assignment. The nature of the assignment affects the assignee's ability to enforce the rights assigned to it.

### Legal assignment

An assignee can only enforce a legal assignment if the requirements under section 9 of the Law Amendment and Reform (Consolidation) Ordinance (Cap. 23, Laws of Hong Kong) are complied with:

- The assignment must be absolute;
- The assignment must be in writing and signed under hand by the assignor;
- The assignment must not purport to be by way of a charge only; and
- Express notice in writing of the assignment has been given to the other party to the contract that is being assigned.

With a legal assignment, an assignee can enforce the assigned rights in his/her own name.

### Equitable assignment

With an equitable assignment, an assignee cannot enforce the assigned rights unless the assignor is made party to the action. If an assignee wishes to enforce the assignment in his/her own name, the assignment must be perfected as a legal assignment by satisfying the aforementioned requirements.

### Automatic assignment

In situations such as death, bankruptcy and/or foreclosure, there will be an automatic assignment effected by operation of law.

### Non-assignable contracts

If the parties wish to make a contract non-assignable, they should insert a non-assignment clause into the contract. Without a non-assignment clause, and in the absence of specific statutory restrictions or restrictions derived from public policy, a contract generally is freely assignable.

## Novation

With a novation, both the contractual obligations and the contractual rights of the original party to the contract are transferred to the new party. This is different from the position following an assignment, as only contractual rights may be assigned. Novation consequently discharges the original contractual party from the contract.

## Variation

Contractual terms can be varied by agreement between the parties. An agreement to vary a contract is similar to the formation of a contract, and requires offer, acceptance of the particular offer by the other party and intention for the parties to be legally bound. In addition, there must be sufficient consideration to support the variation of the contract.

When issues arise as to whether the parties have agreed to vary the contract terms, the courts examine all relevant circumstances to ascertain the parties' intention. These include, but are not limited to, the character of the proposed varied terms and the nature of the document containing the proposed varied terms.<sup>85</sup>

### Sample clause

The following is a sample clause on assignment, which requires consent not to be unreasonably withheld:

Either party may at any time assign, transfer, charge or deal in any other manner with all (but not some only) of its rights and obligations under this Agreement to a Group Company of that party subject to the consent (not to be unreasonably withheld) of the other party to this Agreement.

85. Chong Cheng Lin Courtney v Cathay Pacific Airways Ltd [2011] 1 HKLRD 10



# Doctrine of privity





The doctrine of privity of contract states that a contract cannot confer rights or impose obligations on any person other than the parties to the contract (*Tweddle v Atkinson*<sup>86</sup>). It follows that a person cannot acquire or enforce rights under a contract to which they are not a party, nor can a person who is not party to a contract be made liable under that contract. The doctrine of privity historically has been accepted and regarded as intimately connected with the doctrine of consideration and the rule that consideration must move from the promisee.

General exceptions to privity of contract include:

- Agency;
- Trust;
- Assignment; and
- Covenants concerning land.

## Contracts (Rights of Third Parties) Ordinance

The Contracts (Right of Third Parties) Ordinance (Cap. 623) (“**CRTPO**”) came into effect on 1 January 2016. The Ordinance’s purpose is to modify the doctrine of “privity of contract” in order to allow third parties, in certain circumstances, to enforce contractual terms that concern them.

The Ordinance applies to all contracts entered into on or after 1 January 2016 (section 3(1) of CRTPO), and it does not affect any other right or remedy of a third party that exists or is available apart from the Ordinance (section 5(4) of CRTPO), such as common law rights and remedies in tort, agency and trust, or other rights conferred by legislation (for example, the Third Parties (Rights Against Insurers) Ordinance (Cap. 273, Laws of Hong Kong)).

A summary of the key provisions of the CRTPO is set out below:

### Application

The CRTPO does not apply to the following (section 3 of CRTPO):

- A bill of exchange, a promissory note or any other negotiable instrument;
- A deed of mutual covenant (as defined by section 2 of the Building Management Ordinance (Cap. 344, Laws of Hong Kong));

86. [1861] EWHC J57

- A land covenant;
- A contract of carriage within the meaning of the Bills of Lading and Analogous Shipping Documents Ordinance (Cap. 440, Laws of Hong Kong), provided this does not include any clause excluding or limiting liability;
- A contract for the carriage of goods by air governed by the Carriage by Air Ordinance (Cap. 500, Laws of Hong Kong);
- A letter of credit; and
- A company's articles having effect as a contract under seal under section 86 of the Companies Ordinance (Cap. 622, Laws of Hong Kong).

### Third parties' rights to enforce contractual terms

A third party may enforce a term of a contract provided that (section 4 of CRTPO):

- The third party is expressly identified in the contract by name, as a member of a class or as answering a particular description; and
- Either of the following circumstances applies:
  - By express provision: the contract expressly provides that the third party may do so; or
  - By a rebuttable presumption: the term purports to confer a benefit on the third party (unless it is established that, on a proper construction of the contract, this was not the parties' intention).

The above is applicable regardless of whether the third party has given consideration for the term and whether the third party was in existence when the contract was entered into. Thus, a third party company may enforce a contractual term even if it had not yet been incorporated at the time the contract was made.

If a third party seeks to enforce a term of the contract, they are subject to any other terms of the contract that are relevant to the term in question. For instance, if a term is subject to a limitation clause, a third party seeking to enforce the term will need to contend with the limitation.

### Remedies available to third parties (section 5 of CRTPO)

A third party enforcing a term of the contract has the same remedies available to it in an action for breach of contract as would be available to the parties to

the contract. Such remedies include damages, injunctions, specific performance and other remedies under the rules of equity. Similarly, any procedural requirements, defences or equitable bars that would apply to a contracting party seeking to enforce a contractual term equally apply to a third party enforcing a contractual term pursuant to the CRTPO.

### Rescission and variation (sections 6 and 7 of CRTPO)

Once a third party's rights are crystallised, the contracting parties cannot rescind the contract or vary such rights without the third party's consent. Crystallisation occurs upon "acceptance", when a third party gives notice to the promisor that it has assented to the term. Another situation in which crystallisation can occur is where the third party has relied on the contractual term and the promisor is aware of (or reasonably be expected to have foreseen) such reliance.

However, if the contract contains an express term stating that 1) one or more parties to the contract may rescind or vary the contract without the third party's consent; or 2) the third party's consent is only required in specified circumstances, this express term shall prevail, provided that – before the third party's rights crystallised (see above) – the third party was aware of the express term, or the contracting parties had taken reasonable steps to make the third party aware of this term.

Notwithstanding the above, the court has the power to make an order to rescind or vary the contract without the consent of the third party if all the contracting parties agree to do so or the court thinks it just and practicable. Such an order may be made subject to any condition the court thinks fit, including payment of compensation to the third party.

### Arbitration provisions (section 12 of CRTPO)

A third party may enforce an arbitration agreement if:

- The third party has a right to enforce a term under section 4 and that term is subject to an arbitration agreement; or
- The arbitration agreement provides that a third party may enforce its rights by submitting its dispute with the promisor to arbitration.

### Assignment (section 14 of CRTPO)

A third party may assign his third party rights unless:

- The contract expressly provides otherwise; or
- The right is personal to the third party and is not assignable.

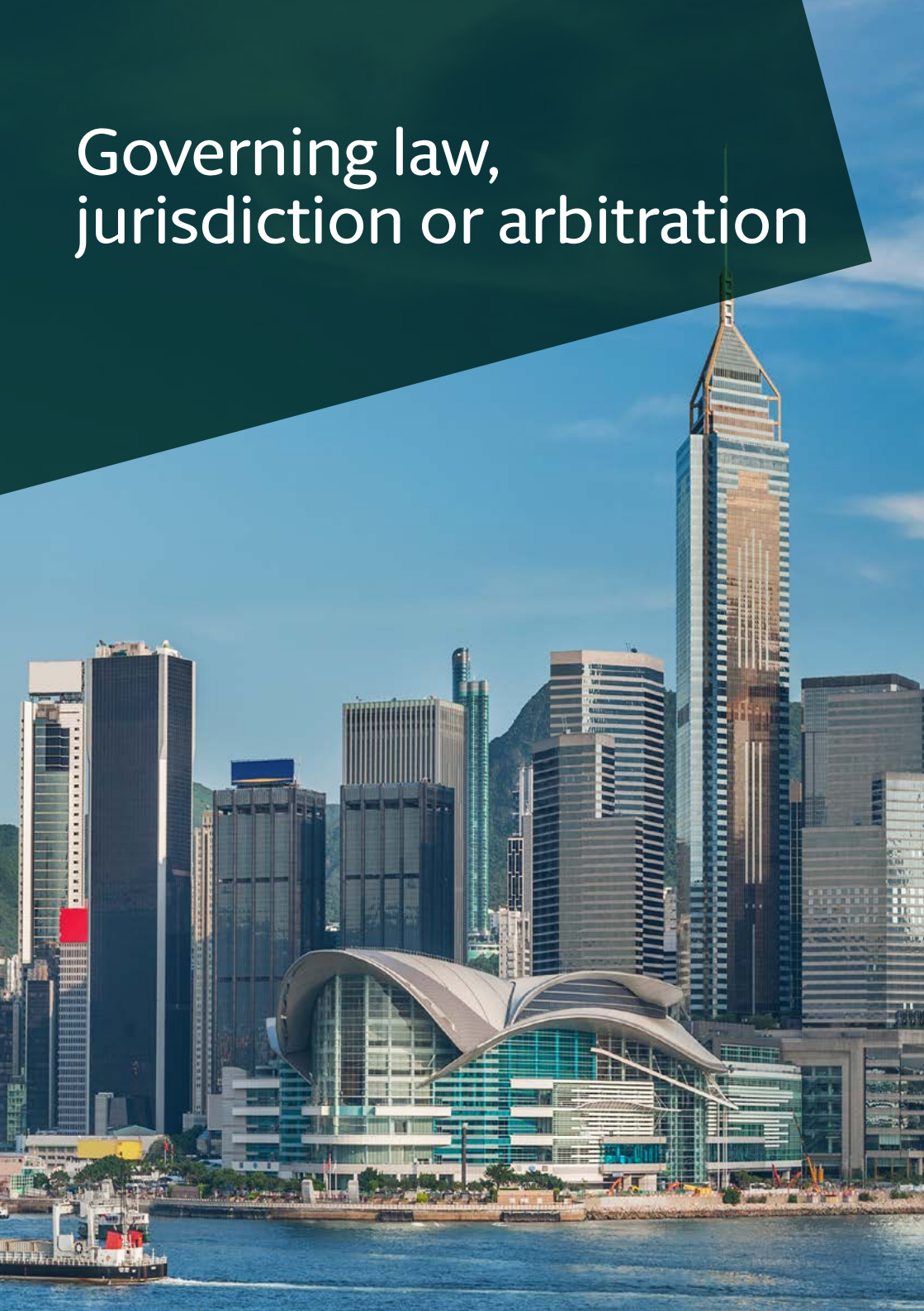
### Points to note

- The third parties should be identified in the agreement by their names, class membership or description.
- A third party enforcing a term of the contract has the same remedies available to it in an action for breach of contract as would be available to the contracting parties themselves. Such remedies include those available under the rules of equity.
- Once third party rights are crystallised, which occurs upon the third party's "acceptance" of, or "reliance" on, the relevant contract terms, the contracting parties cannot rescind or vary such rights without the third party's consent.





# Governing law, jurisdiction or arbitration



Any commercial contract should contain a governing law or applicable law clause, which expressly states the substantive law chosen by the parties as the law applicable to the contractual provisions. In the absence of such a clause, especially in an international contract, the parties will be forced to rely on conflict of law rules to resolve the issue of the contract governing law. This might put the parties in a difficult position as they could find themselves subject to laws they are not familiar with, and which may even be in a foreign language.

Parties also should choose the appropriate forum to resolve their disputes. Generally, the contract should nominate the courts of a particular jurisdiction or opt for arbitration as the dispute resolution mechanism.

## Scope of governing law

The governing law will be applied to the interpretation of the contract and the merits of the disputes. Only lawyers qualified in the governing law jurisdiction should advise on the substance of the contract. Generally, parties will include a governing law clause that covers both contractual and non-contractual disputes.

## Mandatory laws

Mandatory laws (or overriding provisions) apply to the contract even though they are not part of the applicable law. Parties cannot attempt to avoid the application of mandatory rules under their own law by relying on a choice of foreign law.

An example of this is section 17 of the CECO, which implies that the CECO provisions are to be treated as mandatory. Generally, employment and consumer protection related laws are also mandatory.

## Choice of jurisdiction

The choice of jurisdiction ideally will coincide with the governing law. The jurisdiction clause determines the courts that will have jurisdiction over any dispute arising in connection with the contract and the applicable procedure. Examples of procedural issues include remedies, enforcement of judgements, capacity to sue and admissibility of evidence.

If the choice of jurisdiction is different from the governing law, potential issues may arise as different rules would be applied to determine matters of substance and matters of procedure. Usually, expert evidence will be needed to prove substantive issues of foreign law to the satisfaction of the court chosen by the jurisdiction clause, thus resulting in increased costs and complexity when dealing with disputes.

If the contract does not contain a jurisdiction clause, the correct forum for resolving any disputes will be determined in accordance with the rules of private international law. Again, this may lead to uncertainty and, in turn, to increased costs and complexity when dealing with disputes.

An exclusive jurisdiction clause is intended to prevent a party from bringing proceedings in a foreign court that was not the one chosen by the parties at the time of entering into the contract. On the other hand, parties may choose to have a non-exclusive jurisdiction clause in order to allow for flexibility to bring actions in different countries. This could be useful if, for example, the assets of either party are located in a foreign country.

### Points to note

- Think carefully about the choice of governing law and jurisdiction clauses
- Be wary of potential complications if the governing law is different from the chosen jurisdiction.
- Some mandatory provisions will apply regardless of the choice of governing law clause.
- Decide whether "exclusive" or "non-exclusive" jurisdiction clauses should apply.
- Is arbitration an option?

### Sample governing law and jurisdiction clause

This Agreement and all non-contractual obligations arising out of, or in connection with, this Agreement are governed by, and shall be construed and take effect in accordance with, the law of [ ]. Each party irrevocably agrees that the courts of [ ] shall have [exclusive OR non-exclusive] jurisdiction to settle any dispute (including non-contractual disputes) arising out of or in connection with this Agreement or its subject matter or formation.



## Arbitration clause

If the parties to a contract decide that disputes are to be determined by arbitration, a well drafted arbitration clause will ensure that the parties' needs are met, and it will minimise the chances of litigation and potential issues in enforcing arbitral awards.

When drafting an arbitration clause, the parties should consider whether they want an institutional arbitration or ad hoc arbitration, and they should reflect the same in the clause.

### Validity

Pursuant to section 19 of the Arbitration Ordinance (Cap. 609, Laws of Hong Kong) ("**AO**"), which adopts the definition in Option I of article 7(1) of the UNCITRAL Model Law, "arbitration agreement" is defined as "an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not". Pursuant to the same section, an arbitration agreement may take the form of an arbitration clause in a contract or of a separate agreement.

In addition, section 19(1) of the AO provides that an arbitration agreement shall be in writing. An arbitration agreement is regarded as being in writing as long as it has been recorded in any form, regardless of whether the agreement was concluded orally, by conduct or by other means.

### Separability

Pursuant to section 34 of the AO, which adopts the definition in Article 16 of the UNICITRAL Model Law, an arbitration clause is independent of the other terms of a contract. This means that a decision by the arbitral tribunal that a contract is null and void would not thereby render the arbitration clause invalid. This is usually referred to as the separability of an arbitration clause.

### Elements of a good arbitration clause

- The clause should clearly stipulate that arbitration is the chosen form of dispute resolution
- The seat of arbitration should be specified
- The governing law for the arbitration clause should be specified
- The qualifications of the arbitrators and the procedure for their appointment should be specified

- The language of the arbitration proceedings and the applicable law should be specified
- The clause should state whether certain institutional rules apply (ie whether the parties are going to adopt an institutional arbitration or ad hoc arbitration)
- The clause should include provisions relating to confidentiality

### Practical tips

For institutional arbitration, it may be more advantageous to adopt model clauses produced by the relevant institution. However, the following should be noted when adopting model clauses:

- Adopt the most recent version of the clause.
- Read the clause in the context of the contract to ensure consistency, and include provisions to indicate which provisions will prevail in case of inconsistency.
- Consider any additional provisions or amendments that may be beneficial given the context.
- Consider any inconsistency with mandatory provisions of the applicable law.



The below is a sample governing law and arbitration clause for arbitration under the HKIAC administered arbitration rules:

### Sample governing law and arbitration clause

1. This Agreement is governed by, and shall be construed in accordance with, the laws of Hong Kong, without regard to the conflicts of laws provisions thereof.
2. (a) Any dispute, controversy, difference or claim arising out of or relating to this Agreement, including the existence, validity, interpretation, performance, breach or termination thereof or any dispute regarding non-contractual obligations arising out of or relating to it shall be referred to and finally resolved by arbitration administered by the Hong Kong International Arbitration Centre (HKIAC) under the HKIAC Administered Arbitration Rules in force when the Notice of Arbitration is submitted.  
  
(b) The law of this arbitration agreement shall be Hong Kong law.  
  
(c) The seat of arbitration shall be Hong Kong.  
  
(d) The number of arbitrators shall be three. The arbitration proceedings shall be conducted in English.  
  
(e) The IBA Rules on the Taking of Evidence in International Arbitration (in force when the Notice of Arbitration is submitted) shall apply to the arbitration.

### Points to note

- As the arbitration clause is separable from the underlying agreement, the law of the arbitration agreement should be clearly stated.
- The 'seat' is where the arbitration is conducted for legal purposes.
- The number of arbitrators should be one or three depending upon factors such as the value and complexity of the dispute and the need for technical expertise.
- Draft the arbitration clause widely to cover all disputes under the contract, unless there are particular disputes that will be carved out separately for determination.

# Interpretation



The main task associated with interpreting terms of a contract is identifying the parties' intentions in an objective manner. The interpreter is to look at the four corners of the contract, not at the negotiations leading up to the contract or the subjective views of the parties concerning the contract. Therefore, careful drafters will want to be sure that the contract fully captures the understanding between the parties and that nothing has been left to be implied from the negotiations.

Contract drafters may hope that a court faced with interpreting a contract's terms will focus on the abstract meaning of those terms. However, courts consistently have looked at the context within the contract when interpreting specific terms. Moreover, when the context leads to an interpretation of a term that contradicts business common sense, that common sense will govern over the abstract meaning. Therefore, drafters would be wise to either ensure that terms in a contract reflect business common sense or take extra steps to clarify the terms in order to discourage litigation over their meaning.

In addition to the terms of the contract, their context and business common sense, courts will select from various possible canons of interpretation when attempting to resolve a dispute over them, including but not limited to:

- *Contra proferentem*, where the court interprets a term against the party that introduced the term to the contract;
- *Ut res magis valeat quam pereat*, where the court tries to interpret the terms in a way that maintains the validity of the contract; and
- *Expressio unius*, where the court excludes items not listed in the contract where a general description of the items is absent from the contract.

In light of these factors, drafters will want to be as specific and detailed as possible without leaving any key terms to be implied. They also will want to ensure that nothing in the context of the contract as a whole will undermine the court's adoption of the abstract meaning of key terms, assuming that parties want to be bound by the abstract meaning of those terms.

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