

IP Licensing in the United Kingdom: Beware of Third Party Rights

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Under U.K. law, the doctrine of privity of contract means that, as a general rule, a contract only can confer rights or impose obligations on the parties to that contract. Even where a contract is made with the express purpose of conferring a benefit on someone who is not a party, that person (the third party) has no right to sue on the contract. The Contracts (Rights of Third Parties) Act 1999 ("the Act"), however, which came into force on November 11, 1999, has created a significant exception to the doctrine of privity of contract by providing that, in certain circumstances, a third party is now able to enforce the terms of an agreement in its own right. As such, it may have a dramatic effect on all types of contracts, including licences of intellectual property, entered into under English law. The implications for the licensing of intellectual property rights could be far-reaching.

THE NEW REGIME

Essentially, the Act gives a third party the right to enforce a term of a contract if:

- the contract expressly provides that he may [section 1(1)(a)]; or
 - the term purports to confer a benefit on him [section 1(1)(b)].
- This sub-section will not confer a right on a third party where it is clear from the contract that the parties did not intend the third party

to be able to enforce rights under the contract [section 1(2)].

In either case, the third party must be expressly identified in the contract — whether by name, as a member of a class or as answering a particular description — although it need not be in existence when the contract is made [section 1(3)]. Taking a very basic example of how this will work: a common provision in an intellectual property license is an indemnity given by the licensor against any losses, liabilities, claims or other costs incurred by the licensee as a result of the use of the intellectual property in accordance with the terms of the license. Sometimes, this indemnity is given in favor not only of the licensee but also its sub-licensees, sub-contractors, affiliates and so on. Following the implementation of the Act, any member of that class of persons would be able to rely on the protection of the indemnity, were he to suffer loss.

The Act clearly states that where a third party has the right to enforce a contractual term, he will enjoy the same remedies as he would have had in an action for breach of contract if he had been a party to the contract [section 1(5)]. This is an entirely new legal right in the hands of the third party. Previously, only the licensee would have been in a position to enforce the indemnity, and, had it not done so (for whatever reason), the sub-licensee, sub-contractor or other named party would have been left without a remedy. Now, they will be entitled to obtain damages, an injunction or an order for specific performance as if they had been parties to the contract.

The situation will be different where the contractual term in question is not specific as to the identity of the beneficiaries. For example, a

payment clause in a license may provide that payment of royalties should be made to the licensor or "as it directs." Such a provision presumably would not be precise enough to enable a claim to be made by the licensor's parent company, or subsidiary, even if they were accustomed to receiving the payments. Consider also a third party who, in reliance on a representation made by one of the parties to a contract (but not on a term of the contract), alters his position and suffers loss as a result. In those circumstances, the third party again could not sue the contracting party as there would be no contractual term that purported to confer a benefit on him, and mere reliance on contractual arrangements will not give rise to a liability. The essential requirements are that (a) the third party is at least a member of an identifiable group and that (b) the contract expressly confers a benefit on that group.

Clearly, in the majority of cases, it will be undesirable (or simply inappropriate) to give rights to third parties, but under the Act there is a danger that such rights may be conferred unintentionally. This is because where a term "purports to confer a benefit" on a third party, it will be presumed that the term is enforceable by him, and the intention of the parties will be irrelevant.

How can parties avoid unintentionally assuming this sort of liability? The Act provides that if the parties to a contract do not wish to give a third party the right to enforce a term of that contract (even though the term purports to confer a benefit on that third party), an express statement to that effect in the contract will prevent

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any rights being conferred [sections 1(2), 1(4)]. Such a statement can be framed in a number of different ways. For example, the parties can exclude the Act from the agreement as a whole. Alternatively, they can provide that the Act is to be disapplied from certain clauses of the agreement only. A third option is to exclude not only third party rights arising from the Act, but all third party rights (however arising). It is therefore possible to avoid the undesirable consequences of the Act, but careful drafting will be needed to ensure that contracts properly reflect the intention of the parties.

IMPLEMENTATION

The new legislation only applies to its full extent to contracts signed more than six months after the Act came into force, that is to contracts signed after May 11, 2000. The Act applies, however, to contracts signed within the six-month transitional period that “expressly provide” for it to do so (section 8). In other words, during the transitional period, it is not possible to “accidentally” trigger the operation of the Act, but it can be invoked by express agreement of the parties.

VARIATION

One important issue for the parties to a contract will be the ability to terminate or vary the terms of the contract in circumstances where this might affect a right conferred on a third party. The Act provides that if a third party has a right to enforce a term of a contract then, in certain circumstances, the parties will not be able to vary or rescind the contract so as to affect the third party’s entitlement without his consent [section 2(1)]. These circumstances include:

- when the third party has relied on the term [to the knowledge of the contractual party against whom the term is enforceable [(the “promisor”)];
- when the third party has communicated his assent to the term;

- where the promisor reasonably can have been expected to have foreseen that the third party would rely on the term, and the third party has in fact done so.

This means that third parties are given considerable scope to protect their rights, although the Court can dispense with the need to obtain their consent in certain circumstances. In particular, the Court may dispense with this requirement where the third party’s consent cannot be obtained because his whereabouts cannot be ascertained, or where it cannot be determined whether or not the third party has in fact relied on the term [sections 2(4), 2(5)]. The Court may, however, impose conditions for dispensing with this consent, such as ordering the payment of compensation to the third party [section 2(6)]. Once again the parties are free to agree expressly in the contract that it can be varied or terminated without the consent of the third party, or to specify different circumstances in which the third party’s consent will be needed [section 2(3)].

RIGHTS, NOT OBLIGATIONS

It is important to note that, under the Act, it is only possible to confer benefits on third parties; it is not possible to pass on burdens or obligations. For example, an intellectual property license often will contain a confidentiality provision that will seek to place obligations of confidentiality not only on a licensee but also on its employees, agents, consultants, sub-contractors or sub-licensees. However, these third parties will not, as a result of the Act, be liable in their own right for breaches of confidentiality (although in practice they may well have been required to enter into separate written agreements with the licensor). While the contractual parties can make the enforcement of the third party’s right conditional on it doing some act or taking some other step, they cannot take action against the third party if it fails to fulfill such a condition.

EXEMPTIONS

Several minor categories of contract are exempt from the provisions of the Act, but these are not relevant to intellectual property licensing. One important exception which may be relevant, however, is that section 2(2) of the Unfair Contract Terms Act 1977 (UCTA), which limits a party’s ability to restrict its liability for negligence, will not apply to third parties [section 7(2)]. In other words, if a third party is entitled to enforce a term of a contract pursuant to the Act, an exclusion clause that restricts the benefit of that term and which would be invalid as against the other contractual party under section 2(2) of UCTA, will be valid as against that third party.

The rationale behind this is that the parties to a contract can, even under the terms of the Act, decide whether or not to grant rights to third parties. Accordingly, they should be free to exclude all contractual liability to third parties if they wish. The position will be somewhat different where the third party is itself seeking to rely on the exclusion clause (which might arise, for example, where a contractual party has excluded liability for the negligence of its agents or employees as well as itself). In those circumstances, section 2(2) of UCTA will apply, and the third party only will be entitled to rely on the exclusion clause if it is reasonable to do so. This is because a third party only can rely on such a clause if it could have done so if it had been a party to the contract and, if it had been, then it would have been subject to UCTA.

DOUBLE LIABILITY

There was some concern that under the Act a contractual party might be placed in a position whereby it was liable not only to the other party to the contract but also to a third party, in respect of the same breach of contract. To avoid such a party being sued twice for the same loss, the Act provides that where a contractual party has

recovered a sum in respect of the third party's loss, or expenses in making good such a loss to the third party, the Court will take this into account and reduce any award to the third party (section 5).

DEFENSES

The Act provides that, as against a third party, a promisor will have available to him:

- the defenses arising from the contract and relevant to the term in question if they would have been available if the proceedings had been brought by the contractual party entitled to enforce the term (the "promisee"); and

- the defenses and counterclaims that would have been available if the third party had been a party to the contract.

At the same time, the contractual parties can expressly provide that the promisor may have the benefit of any other defenses that would have been available if the promisee had brought the proceedings.

ASSIGNMENT

One interesting question is whether a third party, which has a right to enforce a term of a contract, can assign that right. The Act itself provides no express guidance on this, but the Law Commission's 1996 report entitled "Privity of Contract: Contracts for the Benefit

of Third Parties," which is the impetus for this legislation, says:

2. Assignment of the Third Party's Right

14.6 Although we do not regard a third party under our proposed Act as having a "full" contractual right, his right under our proposals is clearly closely analogous to a contractual right, and standard common law contractual principles should in general apply to it. We therefore see no good reason, and none was suggested to us, why the third party's right should not be assignable in the same way as a contracting party's rights under the contract.

14.7 We therefore recommend that:

...although no legislative provision on this is necessary, a third party should be able to assign its rights under our proposed Act in an analogous way to that in which a contracting party can assign its rights.

The Courts may take a different approach, but this seems to reflect current thinking. Thus, contracts should include express provisions to permit or prohibit assignment as appropriate.

PRACTICAL IMPLICATIONS OF THE ACT

The implications of the Act need to be considered by anyone

involved in the negotiation or drafting of contracts under U.K. law. In many cases, this may mean simply inserting a clause into the agreement stating that the Act does not apply. However, where it is desirable to confer the right to enforce a contractual term on a third party, it will be important to consider the following:

- whether the right should be subject to conditions;

- whether the third party is to take the benefit of other contractual provisions besides the principal clause. If, for instance, the third party is to have the benefit of a payment clause, it might also be appropriate to grant the third party the benefit of a no set-off clause, a default interest clause and a currency of payment clause;

- whether the third party should be entitled to assign that right;

- whether the third party's consent to variation or termination is required, or only required in certain circumstances; and

- whether it would be appropriate to extend or limit the defenses available to the promisor against a claim made by the third party.

Finally, if the parties do wish to confer a right on a third party, this should always be expressly stated, rather than left to section 1(1)(b) of the Act. This way, the parties to a contract hopefully will be able to protect themselves from unintentionally assuming liability for third party claims.