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Distributing a Debtor's Intellectual Property

Does Bankruptcy Code §365(n) apply to agreements to sell recorded music, books, films or videos?

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DESPITE its enactment 16 years ago, there are remarkably few reported decisions on the scope and application of §365(n) of the Bankruptcy Code.[1] Enacted as a "stop-gap" measure ostensibly to ensure a licensee's continued use of licensed technology following a bankrupt licensor's rejection of its license, many bankruptcy practitioners and others in a variety of fields rely, perhaps reflexively, on its protections for a broad array of licensing arrangements.

This article examines §365(n)'s application beyond technology licenses, and specifically to agreements to distribute recorded music, books, films or videos, and the peculiar complications which may arise upon a distributor's election to retain its rights under a rejected distribution agreement.

Distribution Agreements

In the typical distribution agreement, the owner/creator of intellectual property grants to another (whether on an exclusive or non-exclusive basis) one or more of the following rights: the right to manufacture, distribute and/or sell its product in one or more specified territories.

The distributor typically receives a distribution fee measured as a percentage of sales and is also reimbursed for all or a portion of its costs of manufacturing, packaging and selling the product. Often the distributor will advance all or a portion of the cost of making the product, which advance(s) typically is recoupable from amounts otherwise payable to the owner/creator. The licensee's recoupment right is vital because often it represents the licensee's sole means of recovering the advance(s).

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'Lubrizol' Decision

A fundamental right of a debtor in bankruptcy is the right to reject any executory contract or unexpired lease, subject only to the bankruptcy court's typically lenient "business judgment" standard of review.[2] Pursuant to §365(g) of the Bankruptcy Code, rejection constitutes a material breach that relieves the debtor from performing under the contract and typically (though not always) results in termination of the contract.[3] Upon rejection, the nondebtor party to the contract typically has an unsecured damages claim that in most cases is worth no more than cents on the dollar.[4]

The U.S. Court of Appeals for the Fourth Circuit's decision in ***Lubrizol v. Richmond Metal Finishers, Inc.*** (***In re Richmond Metal Finishers, Inc.***), 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986), demonstrated the particularly harsh consequences of rejection on a licensee of intellectual property. Specifically, in that case — an appeal of the debtor's rejection of a nonexclusive license to use the debtor's metal coating process — the Fourth Circuit authorized the debtor to reject the license and, in consequence, prevented Lubrizol from using the metal coating process in its business.

Congress, cognizant of ***Lubrizol's*** potential chilling effect on licensing as a critical means of encouraging innovation, and in response to lobbying efforts mainly from computer industry representatives, effectively overruled ***Lubrizol*** in 1988 through its enactment of the Intellectual Property Licenses in Bankruptcy Act (IPLBA),[5] which included as its core Bankruptcy Code §365(n).

Section 365(n) gives the licensee a choice in the event the debtor rejects its license: it may elect either to treat the license as terminated or, subject to certain limitations and waivers (discussed below), to retain its rights to the intellectual property for the duration of the license (in effect to "reject" the debtor's rejection).[6] This protects to some degree a licensee's investment in reliance upon the availability of the licensed technology.

Though concerns about technology licensing surely motivated §365(n)'s enactment, Congress legislated more broadly and, as a consequence, §365(n) has far broader application. An examination of §365(n)'s application to the distribution agreements described above follows.

Application of §365(n)

Does §365(n) apply to distribution agreements?

At the outset, the authors note that there is no reported decision on point. The authors instead glean the answer from the statute's very words.

Section 365(n) applies only to "an executory contract under which the debtor is a licensor of a right to intellectual property."[7] Though that phrase is nowhere defined in its entirety, its meaning may be derived through an examination of its component parts — i.e. executory contract, intellectual property, and licensor.

First, the term "executory contract," used throughout §365, has a settled meaning in bankruptcy as a contract under which the obligations of each party remain substantially unperformed such that one party's failure to perform would constitute a material breach.[8]

Second, "intellectual property" is defined in §101(35A) of the Bankruptcy Code (enacted as part of the IPLBA) to include a "work of authorship protected under [the Copyright Act]."[9] Section 102 of the Copyright Act,[10] in turn, defines "works of authorship" to include "literary works," "musical works, including any accompanying words," "dramatic works, including any accompanying music," "motion pictures and other audiovisual works," and "sound recordings."[11]

Third, a "licensor" is one who grants another the right to do a thing which, absent the grant (i.e. license), the licensor could prevent.[12] Under the Copyright Act, the right to reproduce (i.e. manufacture) and distribute "works of authorship," belong exclusively to the copyright owner.[13] A distributor typically acquires those rights through the owner's grant of a license (either exclusive or nonexclusive). The owner in that circumstance clearly is a "licensor."

In view of the foregoing, it seems clear that §365(n) applies to an executory contract to manufacture, distribute and sell "works of authorship," including recorded music, books, films and videos.

A potential complication arises if the distributor requires use of the debtor's trademark(s). The reason is because §365(n) does not apply to trademark licenses.[14] Thus, unlike the outcome with a copyright license, the debtor's rejection of a trademark license relieves it from performing under the license and, as in ***Lubrizol***, is tantamount to termination.

This inconsistency should not, however, preclude §365(n)'s application to the copyright license. That is to say that, at least on the face of the statute, the result occasioned by §365(n)'s inconsistent treatment of copyright and trademark licenses should be that the licensee may still elect to retain its copyright right, notwithstanding that §365(n) does not preserve its continued use of the debtor's trademark(s).[15]

> *It would seem from the statute's plain language that, with the exception of specific performance, §365(n) preserves a distributor's rights to manufacture, distribute and sell the debtor's intellectual property and to continue recouping unpaid advances.*

In the case of an exclusive license, such a result would leave the parties at a standstill — i.e., neither party could exploit the product without the other because the licensee would control the manufacturing, distribution and sale rights while the debtor would control the trademark rights — and, as a practical consequence, is likely to encourage compromise.[16] In the case of a nonexclusive license, such a result likely would leave the licensee with only an unsecured damages claim.

The licensee could, however, find itself much better off than either of those two possible outcomes suggest. At least one court seemingly indicated in dicta a willingness to continue trademark rights in place post-rejection where such rights are incidental to protected §365(n) rights.[17] Such a result certainly is plausible in view of the statute's legislative history (noting that Congress left it to the courts to fashion equitable relief concerning a licensee's ongoing trademark use)[18] and the statute's prohibition against the debtor's interference with the licensee's protected copyright rights.[19]

More significantly, though, it is quite possible that, as a matter of trademark law, the debtor's consent, or license, to use its trademark in the manufacture, distribution and sale of its product is not required.[20] In that event, §365(n)'s lack of application to trademarks would be of no consequence to the licensee's right to continue to exploit the debtor's products post-rejection.[21]

The bottom line is that the trademark issue should not trump §365(n)'s application to the distributor's licensed copyright rights.

Scope of Licensee's Rights

As noted above, rejection constitutes a breach only.[22] In the face of the debtor's breach, §365(n) gives the licensee the ability to treat the agreement as terminated (assuming the agreement permits termination)[23] or to retain rights (including any exclusive right) under the agreement or any agreement supplementary thereto for "the duration of such contract" and any period for which such contract may be extended by the licensee.[24] Pending the licensee's election, it has been decided that the "rights and obligations of the parties remain intact … '[r]ejection does not change the substantive rights.' "[25]

Which contract rights survive upon the licensee's retention election? On that question the statute is not completely clear. What is clear is that the licensee can continue to enforce the contract's exclusivity provision(s), but no longer can compel the debtor's specific performance.[26] A consequence of the licensee's inability to compel the debtor's specific performance is that the licensee will be unable to compel delivery of products completed after the debtor's bankruptcy filing notwithstanding any minimum delivery commitments in the contract.[27] Instead, the licensee will only retain rights in the debtor's completed products on the date of its bankruptcy filing, i.e. catalogue as opposed to new products.[28]

What is less than clear are the licensee's other remaining contract rights. The other rights the statute identifies specifically are rights "under such contract … to such intellectual property … as such rights existed immediately before the case commenced."[29] One interpretation of the phrase rights "to such intellectual property," albeit quite a narrow one, is that the additional remaining rights are intellectual property rights only, and do not include other rights, such as recoupment, that arguably are not intellectual property rights.

That interpretation, however, fails to give effect to the predicate rule of law that rejection does not alter the parties' substantive rights. That is to say, that if, as the law requires, the parties' rights survive rejection intact, then — other than the rights specifically identified as unenforceable or deemed waived under §365(n) — all other rights must survive, whether or not they can be characterized as intellectual property rights.

Indeed, the better view, and the one that squares with the law of rejection generally, is that §365(n)(1)(B)'s reference to intellectual property rights, far from circumscribing the licensee's rights, reflects an additional post-rejection right — that is, the right to demand the debtor's ongoing, albeit passive, performance under the contract. In that sense, it simply gives express recognition to the licensee's right, unlike in ***Lubrizol***, to continue to exploit the debtor's intellectual property post-rejection, and is not intended, by negative inference or otherwise, to eliminate the licensee's other rights.

Now, the licensee's retention of rights carries a price. That price is exacted through the statute's adjustment of the parties' past, present and future royalty arrangements.

As to the parties' future royalty arrangement, §365(n)(2)(B) obligates the distributor to "make all royalty payments due under [the agreement]."[30] That section makes clear what has to be paid to the debtor, i.e. "all royalty payments due," and that the contract is the source for quantifying the amount due. Because recoupment reduces the amount "due" from one party to another, §365(n)(2)(B) seemingly respects a distributor's recoupment rights —whether they are contractual or equitable. Certainly, one would expect that to be true where the amounts to be recouped are advances of future royalties that, in the absence of recoupment, would fall due twice, once when the advance is paid to the debtor and again when earned from product sales — an absurd and inequitable result. Nevertheless, to further insulate its recoupment rights, the distributor should clearly specify in its contract with the debtor that recoupment of advances and other amounts are deductions in calculating the "royalty payments due" under the contract.[31]

If §365(n)(2)(B) defines the parties' future royalty arrangement, then §365(n)(2)(C)(i) and (ii)'s waiver provisions define the parties' past and present arrangements, respectively. Specifically, §365(n)(2)(C)(i) requires that the distributor waive "any right of setoff [the distributor] may have with respect to such contract under [title 11] or applicable nonbankruptcy law."[32] Section 365(n)(2)(C)(ii) requires that the distributor waive "any claim allowable under section 503(b) of [title 11] arising from the performance of such contract."[33]

Turning first to the statute's required "setoff" waiver, a question arises as to whether it is so broad as to encompass recoupment rights as well. No reported decision has decided the issue, and the commentators who have considered it have reached inconsistent conclusions.[34] The authors conclude that the far better view is that recoupment rights are not included within the "setoff" waiver.

The idea that "setoff" includes recoupment derives mainly from cases that loosely describe recoupment as a form of setoff.[35] True enough, but such loose characterizations, taken out of context, overlook the vast body of case law distinguishing setoff, which involves a claim by a creditor against the debtor arising from a separate transaction than the transaction giving rise to the debtor's claim against the creditor — from recoupment, which is a defense to the debtor's claim against the creditor that arises from the same transaction giving rise to the debtor's claim.[36] It is difficult to imagine that in enacting §365(n), Congress overlooked this well-established distinction.

Moreover, to conclude that setoff encompasses recoupment is to adopt the peculiar interpretive notion that the term "setoff," as used throughout other sections of the Bankruptcy Code (e.g., 11 U.S.C. §§362(a)(7), (b)(6), (b)(17), 506(a) and 553) — indeed, repeatedly distinguished from recoupment in court decisions interpreting §362(a)(7)[37] — means something else in §365(n). To take that approach would be inconsistent with the fundamental tenet of statutory construction that the same word should have the same meaning throughout a statute.[38]

Now, it is true, that portions of §365(n)'s legislative history state that the purpose of the setoff waiver is to ensure the debtor's continued receipt of an undiminished royalty stream and the "preservation of royalty payments called for under the contract, free of offset or administrative claim…,"[39] which, again, broadly viewed, seemingly supports the notion that the waiver encompasses recoupment rights. But, the Supreme Court instructs that resort to legislative history is permissible only where the statute is not otherwise clear on its face or application of the statute as written yields absurd results.[40]

Here, the statute is clear: it says "setoff," not setoff and recoupment. And, excluding recoupment from the "setoff" waiver ensures the availability to the debtor of royalties in an easily imagined "setoff" situation and in no way renders the provision absurd. For example, assume that a distributor collected substantial prepetition earned royalties that did not fall due until after the commencement of the debtor's bankruptcy case. Assume further that after the filing of the case, but before the date on which the royalty payments are due, the debtor rejects the distribution agreement, and the distributor elects to retain its rights under §365(n)(1)(B).

By operation of §365(n)(2)(C)(i)'s setoff waiver, the distributor could not assert a right to offset its rejection damages claim against the prepetition royalties earned by the debtor. Rather, the distributor would pay the prepetition royalties earned to the debtor, and assert its unsecured damages claim against the debtor's estate — an outcome entirely consistent with the "setoff-only" waiver.

One final point on the "setoff" waiver. If resort to legislative history proves necessary, the most specific articulation of the scope of the waiver is contained in the Judiciary Committee Report, which provides that "the licensee waives any right to set off damages which it incurred as a result of the trustee's rejection…."[41] This language suggests that the "setoff" waiver, far from encompassing recoupment rights, is limited to rejection damages of the kind described in the example above.

The final element of the price a distributor must pay to retain its rights is the distributor's deemed waiver under the statute of an administrative expense claim under §503(b) of the Bankruptcy Code. Similar to the setoff waiver, which addresses prepetition claims capable of setoff, the administrative expense claim waiver addresses postpetition claims arising from the distributor's postpetition performance under the agreement.

Conclusion

Though the result is not entirely free from doubt, particularly in the absence of on point authority, it would seem from the statute's plain language that, with the exception of specific performance, §365(n) preserves a distributor's rights to manufacture, distribute and sell the debtor's intellectual property and to continue recouping unpaid advances.

1. 11 U.S.C. §§101 et seq. (2004)
2. See, e.g., *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993) cert. dismissed 511 U.S. 1026 (1994).
3. 11 U.S.C. §365(g).
4. 11 U.S.C §502(g).
5. Intellectual Property Licenses in Bankruptcy Act, Pub. L. No. 100-506, 102 Stat. 2538 (codified at 11 U.S.C. §365(n) (2004)).
6. 11 U.S.C. §365(n)(1).
7. Id.
8. See, e.g., *Argonaut Ins. Co. v. Ames Dept. Stores, Inc.* (*In re Ames Dept. Stores, Inc.*), Civ. No. 93-4014, 1995 WL 311764, at *3, (S.D.N.Y. May 18, 1995).
9. 11 U.S.C. §101(35A).
10. 17 U.S.C. §§101 et seq.
11. 17 U.S.C. §102(a)(1), (2), (3), (6) and (7).
12. See *W. Elec. Co. v. Pacent Reproducer Corp.*, 42 F.2d 116, 118 (2d Cir. 1930), cert. denied, 282 U.S. 873 (1930).
13. 17 U.S.C. §106.
14. 11 U.S.C. §101(35A) (excluding trademarks from definition of "intellectual property"); S. Rep. No. 100-505, at 5 (1988), reprinted in 1988 U.S.C.C.A.N. 3200, 3204.
15. See *Raima UK Ltd. v. Centura Software Corp.* (*In re Centura Software Corp.*), 281 B.R. 660 (Bankr. N.D. Cal. 2002).
16. Alternatively, the debtor's rejection may not be approved on the ground that a standstill result reveals an imprudent exercise of business judgment. Id., at 672, n.19.
17. *In re Matusalem*, 158 B.R. 514, 522 (Bankr. S.D. Fla. 1993).
18. S. Rep. No. 100-505 at 5, reprinted in 1988 U.S.C.C.A.N. at 3204.
19. 11 U.S.C. §365(n)(2)(B).
20. See, e.g., *Champion Spark Plug Co. v. Sanders*, 331 U.S. 125, 129 (1947); *Bliss Salon Day Spa v. Bliss World, LLC*, 268 F.3d 494, 496 (7th Cir. 2001); see also Trademark Act of 1946 (Lanham Act), 15 U.S.C. §1125(a)(1)(A) (1997).
21. Obviously, whether a trademark license is required as a matter of law will depend upon the specific circumstances and trademark use(s) in question.
22. 11 U.S.C. §365(g). Though some courts equate rejection with termination — mainly in the real property lease context — that result is inapposite here given that, under §365(n), termination is at the option of the licensee.
23. 11 U.S.C. §365(n)(1)(A).
24. 11 U.S.C. §365(n)(1)(B).
25. *In re Alongi*, 272 B.R. 148, 153 (Bankr. Md. 2001) (internal citation omitted).
26. 11 U.S.C. §365(n)(1)(B).
27. S. Rep. No. 100-505 at 10, reprinted in 1988 U.S.C.C.A.N. at 3207.
28. The licensee can assert an unsecured claim for any damages resulting from its loss of rights to the debtor's future products. 11 U.S.C. §365(g); S. Rep. No. 100-505 at 10, reprinted in 1988 U.S.C.C.A.N. at 3207.
29. 11 U.S.C. §365(n)(1)(B).
30. 11 U.S.C. §365(n)(2)(B).
31. This, of course, says nothing of the distributor's equitable recoupment rights which exist irrespective of the distributor's contractual recoupment rights.
32. 11 U.S.C. §365(n)(2)(C)(i).
33. 11 U.S.C. §365(n)(2)(C)(ii).
34. Compare Kenneth N. Klee et al., "Recent Developments Concerning Intellectual Property & Bankruptcy," SH054 ALI-ABA 243, 249 (2003), with Mark Gunderson, "Licensing from a Financially Insecure Company," The Legal Intelligencer, June 16, 2003 at S11.
35. See, e.g., *In re Stoecker*, 131 B.R. 979, 983 (Bankr. N.D. Ill 1991).
36. See, e.g., *Davidovich v. Welton* (*In re Davidovich*), 901 F.2d 1533, 1537 (10th Cir. 1990); *Marathon Ashland Petroleum LLC v. Clark Retail Enters. Inc.* (*In re Clark Retail Enters. Inc.*), No. 02 B 40045, 2003 WL 21991624, at *10 (Bankr. N.D. Ill. Aug. 18, 2003).
37. See, e.g., *In re McMahon*, 129 F.3d 93, 96 (2d Cir. 1997); *In re Clark Retail Enters.*, 2003 WL 21991624, at * 10.
38. See *Cohen v. de la Cruz*, 523 U.S. 213, 220 (1998).
39. S. Rep. No. 100-505, at 10, reprinted in 1988 U.S.C.C.A.N. at 3207.
40. See *Lamie v. U.S. Trustee*, 124 S.Ct. 1023, 1031 (2004) citing *Hartford Underwriters Ins. Co. v. Union Planters Bank*, N.A. (*In re Hen House Interstate Inc.*), 530 U.S. 1, 6 (2000).
41. S. Rep. No. 100-505, at 10, reprinted in 1988 U.S.C.C.A.N. at 3207.