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## The Effect of Rejection of a Copyright License on a Non-Debtor Licensee

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### Introduction

In general, a trustee may assume, reject, or assign an executory contract of the debtor under title 11 of the United States Code (the “Bankruptcy Code”).<sup>1</sup> Courts have generally held that intellectual property license agreements are executory contracts.<sup>2</sup> If the license is an exclusive copyright license, it is a transfer of ownership under title 17 of the United States Code (the “Copyright Act”).<sup>3</sup> Thus, some courts treat a copyright license as transfer of ownership, not an executory contract.<sup>4</sup>

This article explores the rights and obligations of a non-debtor licensee when a debtor-licensor rejects a copyright license under the Bankruptcy Code. Part I analyzes the legal standard and differing approaches that courts have adopted to determine whether a copyright license is an executory contract. Part II examines the effect of section 365(n) on a licensee’s rights and obligations after a copyright license is rejected.

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<sup>1</sup> See generally 11 U.S.C. § 365 (2018).

<sup>2</sup> See *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003).

<sup>3</sup> 17 U.S.C § 101 (2018).

<sup>4</sup> See *Minden Pictures, Inc. v. John Wiley & Sons*, 795 F.3d 997, 1003 (9th Cir. 2015) (“[E]ither an assignment...or an exclusive license... qualifies as a “transfer” of a right in a copyright for the purposes of the Act.”). See also *Imperial Residential Design, Inc. v. Palms Dev. Grp.*, 29 F.3d 581, 583 (11th Cir. 1994); *In re AEG Acquisition Corp.*, 161 B.R. 50 (B.A.P. 9th Cir. 1993).

## I. A Copyright License May be an Executory Contract Depending on Whether it is Exclusive or Non-Exclusive.

Section 365 of the Bankruptcy Code governs the treatment of a debtor's executory contracts.<sup>5</sup> Executory contracts are not defined outright in the Bankruptcy Code. Courts generally define executory contracts as, one "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."<sup>6</sup> The status of copyright licenses as executory contracts relies on if the license is exclusive or non-exclusive.<sup>7</sup>

*A. Non-exclusive copyright licenses are always treated as executory contracts and are entitled to the protections of § 365(n).*

A non-exclusive copyright license does not transfer any ownership of property.<sup>8</sup> Thus, ownership of the copyright remains with the licensor.<sup>9</sup> A non-exclusive license prohibits the licensor from suing the licensee for infringement.<sup>10</sup> A licensee's obligations under a non-exclusive license are generally to publish the copyrighted work and pay royalties to the licensor.<sup>11</sup> Courts have recognized the licensor's duty not to sue as an ongoing obligation necessary for an executory contract.<sup>12</sup> The court in *In re Golden Books*, reasoned that the duty of "refraining from suing the other for infringement of any of the [intellectual property] covered by the license" was enough of an obligation for the contract to be executory.<sup>13</sup>

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<sup>5</sup> See *Mission Prod. Holdings, Inc. v. Tempnology*, 139 S.Ct. 1652, 1657 (2019).

<sup>6</sup> See *Lewis Bros. Bakeries v. Interstate Brands Corp.* (*In re Interstate Bakeries Corp.*), 751 F.3d 955, 962 (8th Cir. 2014); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

<sup>7</sup> See *Otto Preminger Films, LTD. v. Quintex Ent. Inc.* (*In re Quintex Ent. Inc.*), 950 F.2d 1492, 1493 (9th Cir. 1991).

<sup>8</sup> See 17 U.S.C. § 101 (2018).

<sup>9</sup> See *In re Patient Educ. Media, Inc.*, 210 B.R. 273, 240 (Bankr. S.D.N.Y. 1997); 17 U.S.C. § 101.

<sup>10</sup> *Id.*

<sup>11</sup> See *Peer Int'l Corp. v. Pausa Records, Inc.*, 909 F.2d 1332, 1337 (9th Cir. 1990).

<sup>12</sup> See *In re Golden Books Family Ent., Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001).

<sup>13</sup> *Id.*

Courts generally agree that non-exclusive copyright licenses are executory contracts when there is underperformance of an obligation.<sup>14</sup> Non-exclusive licenses prohibit the licensor from suing for infringement while requiring the licensee to distribute the copyrighted material and pay the licensor royalties. These ongoing obligations for both licensors and licensees generally render a non-exclusive license executory. As such, when a debtor-licensor rejects a non-exclusive license, which is an executory contract under the Bankruptcy Code, the non-debtor licensee is entitled to the protections of section 365(n) discussed below.

*B. Exclusive copyright licenses are usually viewed as executory contracts except when analyzed as a transfer of property under the Copyright Act.*

Under the Copyright Act, exclusive licenses are “a transfer of copyright ownership.”<sup>15</sup> Bankruptcy courts have generally considered performance under the terms of the contract rather than the transfer of ownership under the Copyright Act. Courts have not directly addressed whether exclusive licenses should be treated as transfer of *property* under the Copyright act, or a contractual right under the Bankruptcy Code. Courts consider that exclusive licenses are a transfer of property rights, but ultimately look to performance. For example, in *In re Learning Publications, Inc.*, and *In re Stein & Day*, the courts reasoned that exclusive copyrights to distribute books were not executory contracts because the authors had finished writing the books pre-bankruptcy. While the courts considered the exclusive licenses as a transfer of copyright ownership, the holding was based on performance.<sup>16</sup>

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<sup>14</sup> See *In re Patient Educ. Media, Inc.*, 210 B.R. at 240. See also *In re EI Int'l*, 123 Bankr. 64 (Bankr. D. Idaho 1991); *Delightful Music Ltd. v. Taylor* (*In re Taylor*), 913 F.2d 102 (3d Cir. 1990) (debtor, music artist James Taylor was permitted to reject an executory contract in which he had agreed to write and perform seven albums worth of music).

<sup>15</sup> See 17 U.S.C. § 101.

<sup>16</sup> See generally *In re Learning Publications, Inc.*, 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988); *In re Stein & Day*, 81 B.R. 263, 266 (Bankr. S.D.N.Y. 1988) (while these two cases were decided before section 365(n) was implemented, their treatment of copyright licenses as contractual rights, not property rights is instructive).

The United States Court of Appeals for the Ninth Circuit in *In re Qintex Entertainment, Inc* held that exclusive licenses were executory based on performance after the adoption of section 365(n). There, the debtor-licensor was party to five exclusive licenses to distribute colorized versions of films.<sup>17</sup> The Ninth Circuit held that four of the contracts were not executory because performance was complete, while the fifth was executory because of underperformance by the licensee, not because of a transfer of exclusive rights.<sup>18</sup>

Two years after *In re Qintex*, the Ninth Circuit again addressed the issue of whether exclusive copyright licenses are property or contractual rights in *In re AEG Acquisitions Corp.* The court reasoned that, “If a debtor has granted an assignment or exclusive license of its copyright rights prior to filing bankruptcy, the assignment or exclusive license should be treated as a completed prebankruptcy transfer of property by the debtor, not as an executory contract.”<sup>19</sup> The holding suggests that ongoing contractual obligations notwithstanding the transfer of property still control if the contract is executory.<sup>20</sup>

Outside of bankruptcy, the Ninth Circuit addressed the transfer of rights under an exclusive license in *Gardner v. Nike*. The Ninth Circuit held that an exclusive license does not permit the licensee to transfer their ownership of the copyrighted material to a third party without the consent of the licensor.<sup>21</sup> This implies that even under an exclusive copyright license, the transfer of property rights is not absolute because the licensor retains some property rights.<sup>22</sup> The court’s analysis, rejecting licenses as a complete transfer of property in *Gardner*, returns to the reasoning from *In re Qintex* that exclusive licenses should be viewed based on performance

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<sup>17</sup> See *In re Qintex Ent. Inc.*, 950 F.2d 1492, 1493 (9th Cir. 1991).

<sup>18</sup> *Id.* at 1496.

<sup>19</sup> *In re AEG Acquisition Corp.*, 161 B.R. 50, 59 (B.A.P 9th Cir. 1993).

<sup>20</sup> *Id.*

<sup>21</sup> *Gardner v. Nike, Inc.*, 279 F.3d 774, 780 (9th Cir. 2002).

<sup>22</sup> *Id.*

rather than as a transfer of property. Courts generally treat exclusive licenses as executory notwithstanding the transfer of property interests, instead they analyze performance of obligations under the terms of the contract.<sup>23</sup>

## **II. Non-Debtor Licensees Rights and Obligations Under Section 365(n).**

Under the Bankruptcy Code, intellectual property is defined to include copyright.<sup>24</sup> Section 365(n)(1) provides that upon rejection of an executory contract where the debtor is a licensor of an intellectual property right, the non-debtor licensee may elect to either treat the contract as terminated and assert a claim for rejection damages, or retain their rights for the duration of the licensing agreement.<sup>25</sup> The licensee will have to make royalty payments due and will have waived any right to setoff with respect to applicable non-bankruptcy law.<sup>26</sup>

Under section 365(n)(1)(a) a non-debtor licensee may treat the contract as terminated and assert a claim for rejection under section 502(g).<sup>27</sup> If a licensee elects to assert their claim as rejection under section 502(g), then they become an unsecured creditor and will get whatever is left over after secured creditors are paid out.

Section 365(n)(1)(A) permits a non-debtor licensor to retain their rights under the license agreement. Section 365(n)(2) defines the obligations of the licensee. The licensee can elect to retain their rights under the agreement for the duration of the agreement provided that they make all royalty payments due to the licensor's estate.<sup>28</sup> These royalty payments are due regardless of

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<sup>23</sup> See generally *In re Qintex Ent. Inc.*, 950 F.2d 1492, 1493 (9th Cir. 1991).

<sup>24</sup> See 11 U.S.C. §101(35a)(e).

<sup>25</sup> See 11 U.S.C. § 365(n)(1).

<sup>26</sup> See 11 U.S.C. § 365(n)(2). See also *Encino Bus. Mgmt. v. Prize Fize, Inc. (In re Prize Frize, Inc.)*, 32 F.3d 426, 428 (9th Cir. 1994) (“Section 365(n) has struck a fair balance between the interests of the bankrupt and the interests of a licensee of the bankrupt's intellectual property. The bankrupt cannot terminate and strip the licensee of rights the licensee had bargained for. The licensee cannot retain the use of those rights without paying for them.”).

<sup>27</sup> 11 U.S.C. § 365(n)(1)(a).

<sup>28</sup> 11 U.S.C. § 356(n)(2)(B).

what the “royalties” are called in the agreement.<sup>29</sup> Additionally, if the licensee elects to retain their rights, they waive off any set off or claims against the bankruptcy estate stemming from the license.<sup>30</sup> If the licensee wants to retain their rights, they must act quickly and make an affirmative election to accept the rejection or assert their right to retain the intellectual property under 365(n).<sup>31</sup> If the licensee does not make an election to retain their rights, courts will treat the silence as rejection and the license as terminated.<sup>32</sup>

## **Conclusion**

When a trustee rejects an executory contract of a license of intellectual property, that rejection is a breach of contract. Bankruptcy courts have generally analyzed the obligations under the contract, rather than the transfer of property rights when determining if a copyright license is executory.<sup>33</sup> Thus, non-exclusive licenses are generally executory and exclusive licenses are usually executory provided the court does not reason the exclusive license to be a transfer of property. If the contract is executory, the non-debtor licensee can retain their rights under section 365(n). The non-debtor licensee can either treat the contract as terminated or continue to assert their rights through the terms of the contract, provided they continue to make royalty payments to the licensor.<sup>34</sup>

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<sup>29</sup> See *Encino Bus. Mgmt. v. Prize Fize, Inc. (In re Prize Frize, Inc.)*, 32 F.3d 426, 428 (9th Cir. 1994).

<sup>30</sup> 11 U.S.C. 365(n)(2)(C). See also *In re Spansion, Inc.*, 507 Fed. Appx. 125 (3d Cir. 2012).

<sup>31</sup> *In re EI Int'l*, 123 B.R. 64, 67 (Bankr. D. Idaho 1991).

<sup>32</sup> *Id.*

<sup>33</sup> See *In re Quintex Ent.*, 950 F.2d 1492, 1493 (9th Cir. 1991).

<sup>34</sup> See 11 U.S.C. § 365(n)(2).