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Avoiding the Pitfalls of Bankruptcy for IP Licensees

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When bankruptcy law and intellectual property law converge, the results can be disastrous for those who are ill-prepared. No one knows this better than Jeffrey Thompkins, a rap/hip-hop artist who lost copyrights and royalties when his record label went bankrupt.

A recent decision by the Eleventh Circuit Court of Appeals in Thompkins' case illustrates the importance of planning to protect intellectual property rights before a bankruptcy filing, and of diligently enforcing those rights during the bankruptcy case.

Thompkins entered into a recording contract with Luke Records, Inc., owned by Luther "Luke" Campbell, who was a member of the rap group known as 2 Live Crew. Under the contract, Thompkins was required to record and deliver master recordings for production and release by Luke Records. The record company received worldwide exclusive copyrights on the sound recordings, while Thompkins was to receive royalty payments based on album sales.

As part of the Poison Clan rap group, Thompkins produced three albums for Luke Records. Luke Records, however, became subject to several lawsuits over unpaid royalties and eventually landed in bankruptcy.

As part of the joint plan of reorganization proposed by Luke Records and Luke Campbell, numerous assets — including the copyrights to Thompkins' songs — were sold to Lil' Joe Records (an entity controlled by Luke Records' former CFO, Joe Weinstein) free and clear of liens, claims and encumbrances. The plan also rejected the royalty contract between Thompkins and Luke Records. The bankruptcy court confirmed the reorganization plan. Thompkins did not actively participate in the bankruptcy cases and consequently failed to object to either the asset sale or the rejection of the royalty contract.

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Some years later, Thompkins sued Lil' Joe Records for copyright infringement. The record company moved for summary judgment in district court, arguing that it owned the rights to the music free and clear as a result of the sale in the bankruptcy court. The court agreed, in a ruling the Eleventh Circuit Court of Appeals later upheld.

Thompkins argued that copyright ownership reverted back to him based on Luke Records' rejection of his executory royalty contract in the bankruptcy cases. Although the statutes don't define "executory," courts have typically ruled that executory contracts are those "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance

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would constitute a material breach excusing the performance of the other."

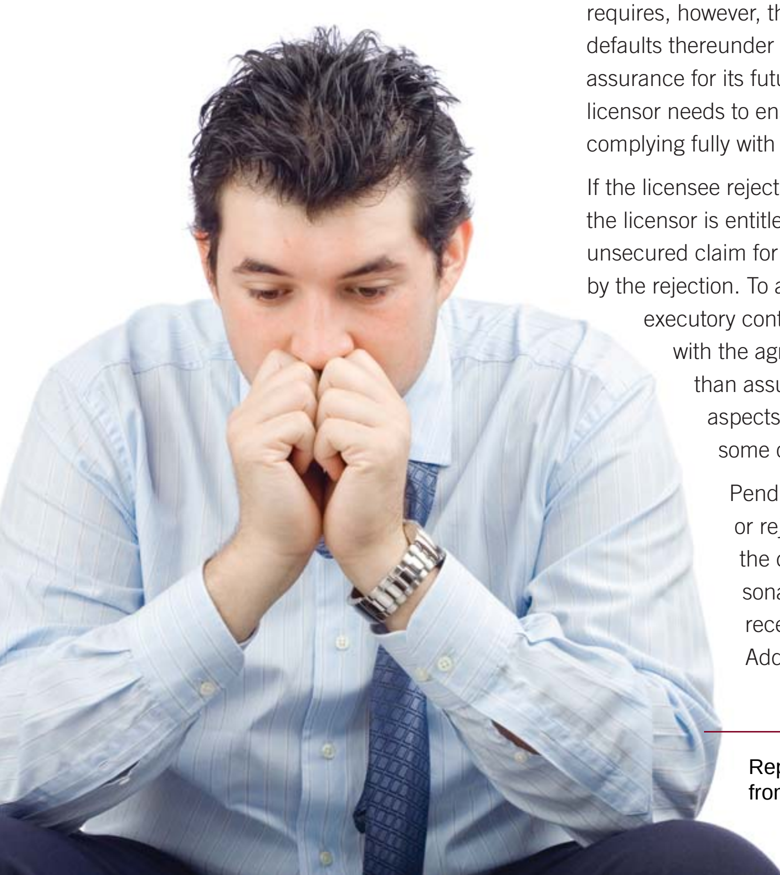
Facts Unchanged

The Eleventh Circuit found that the rejection in Thompkins' case did not change the fact that Luke Records owned the copyrights outright and was able to sell them free and clear in the bankruptcy case. Therefore, Thompkins could not maintain his copyright infringement claim.

Additionally, since Thompkins failed to timely file a proof of claim for damages based on the contract rejection, his claim for damages was waived. Consequently, Lil' Joe Records maintained the rights to the music without having to pay any royalties to Thompkins.

Proper Planning

Thompkins could have obtained significantly better results if he'd planned properly when he signed the recording contract with Luke Records. Rather than selling the copyrights, Thompkins could have licensed them to Luke Records and retained ownership himself. Alternatively, he could have required Luke Records to create a bankruptcy remote entity or a trust and licensed the copyrights to this newly created entity or trust. Either structure would have helped insulate him from Luke Records' financial problems.



If he had licensed the copyrights, Thompkins also could have actively monitored compliance with the license agreement. When a default occurred, he could have terminated the license.

Monitoring is essential for a licensor to enforce its rights on a timely basis. Once a bankruptcy case has started, the licensor and other creditors are enjoined from virtually all collection efforts, including post-bankruptcy attempts to terminate license agreements or otherwise curtail licensees' use of intellectual property.

However, by actively monitoring a licensee's pre-bankruptcy compliance, a licensor may be able to terminate a license agreement before a bankruptcy proceeding begins, if the licensee/debtor has no post-bankruptcy cure rights.

Monitoring Your Rights

At the same time, it is critical for an owner of intellectual property to actively monitor its rights during the course of a bankruptcy proceeding. Under bankruptcy laws, a debtor may either assume or reject license agreements that constitute executory contracts.

In assuming such an agreement, the debtor generally may assign it to a third party. That requires, however, that the licensee cure all defaults thereunder and provide adequate assurance for its future performance. The licensor needs to ensure that the debtor is complying fully with these requirements.

If the licensee rejects the license agreement, the licensor is entitled to a pre-bankruptcy unsecured claim for the damages caused by the rejection. To assume or reject an executory contract, the debtor must deal with the agreement as a whole, rather than assuming only the beneficial aspects and rejecting the burdensome ones.

Pending a decision to assume or reject the executory contract, the debtor must pay for the reasonable value of the benefits received under the contract. Additionally, the licensor may seek to compel the debtor to assume or reject the contract to address any doubt concerning the status of the contract or any prejudice the licensor may suffer by continuing to perform under the contract.

There are some exceptions to these general principles. For example, the licensor may be able to obtain relief from the automatic stay if the debtor/licensee's continued use of the intellectual property is damaging the licensor's reputation or infringing the goodwill associated with the licensor's property rights.

In addition, in many jurisdictions, the debtor/licensee cannot assign a non-exclusive license agreement without the licensor's consent. Finally, trademarks are excluded from the definition of "intellectual property" under the Bankruptcy Code, and a recent decision has concluded that trademark licenses are non-assignable unless the license agreement expressly allows it.

Thompkins is an important reminder that owners of intellectual property need to understand both how a licensee's bankruptcy can affect their rights and how proper planning and active participation in a bankruptcy case can minimize the effects. The case highlights that an astute owner of intellectual property can protect its rights with proper planning prior to a licensee's bankruptcy filing, and with diligent enforcement of its rights during the bankruptcy case.

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