

INTELLECTUAL PROPERTY ADVISOR

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CAN AN INDIVIDUAL NOW USE A CHAPTER 7 BANKRUPTCY TO WIPE OUT AN INTELLECTUAL PROPERTY JUDGMENT?

by David Sar

In this uncertain economic environment, companies are increasingly concerned about bankruptcy filings. Let's say that a company is owed money from an individual due to a hard-won intellectual property judgment or a painstakingly negotiated settlement. Will the debt be legally owed *in full* if the person files a Chapter 7 liquidating bankruptcy? Or, will it be "discharged" and treated like any other debt in a bankruptcy, such that the company would be legally entitled to receive only cents on the dollar, if anything? As discussed below, a recent bankruptcy case has cast doubt upon the traditional legal analysis.

The question of Chapter 7 dischargeability is particularly important in intellectual property matters because of the relative ease with which a company owner can be found liable for the infringing acts of his company. In contrast to other types of cases in which liability usually stops at the corporation or limited liability company, a company owner participating in an intellectual property infringement can often be found to be personally liable. Therefore, it can matter greatly whether the owner will be able to escape an intellectual

property money judgment or settlement by filing an individual Chapter 7 liquidating bankruptcy and folding his company.

In traditional cases of clear and indefensible infringement, courts have usually found the debt to be "non-dischargeable." That means that the Chapter 7 debtor owes the full amount of the debt even after the bankruptcy. That outcome occurs, however, only so long as certain facts are found, or conceded, during the course of the intellectual property judgment or settlement, and only so long as appropriate action is taken during the bankruptcy to preserve the debt.

A case decided by the Sixth Circuit Court of Appeals in 2004 demonstrates the usual situation. See *In re Trantham*, 304 B.R. 298 (6th Cir. 2004). The case arose when a defendant farmer used patented seed technology without authorization from the agri-business which owned the technology. The farmer, Mr. Trantham, used technologically superior seed but failed to pay for a license and then tried to conceal what he had done. The patent holder sued, asserting claims for patent infringement.

A jury from the western portion of Tennessee found the farmer liable for patent infringement. The jury further found that the defendant farmer had acted willfully. The total judgment was nearly \$600,000. The jury's award was comprised of \$106,132.50 in compensatory damages, trebled to \$318,397.50, plus prejudgment interest of \$9,005.27 and attorneys fees of \$265,275.12.

After the jury verdict but days before the final judgment was entered, Mr. Trantham filed a Chapter 7 bankruptcy petition. He sought to have his assets distributed to his creditors on a pro rata basis according to the amounts owed and the level of bankruptcy priority given to the debts. The farmer hoped that once his assets were distributed, his debts would be discharged and the discharged creditors would not be able to recover anything else. If all of his debts, including the patent judgment,

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were discharged, the debtor farmer would have the proverbial “fresh start” coming out of bankruptcy.

The Bankruptcy Act, however, contains certain exceptions in a Chapter 7 case to the general rule of dischargeability. The discharge exceptions are narrowly construed in favor of the debtor. See *Meyers v. I.R.S.*, 196 F.3d 622 (6th Cir. 1999). The party seeking the exception bears the burden of proof of showing by a preponderance of the evidence that the debt should not be discharged. See *Grogan v. Garner*, 498 U.S. 279, 286 (1991).

The relevant exception provides that an individual debtor is not discharged from any debt “for willful and malicious injury by the debtor to another entity or to the property of another entity.” 11 U.S.C. § 523(a)(6). “From the plain language of the statute, the judgment must be for an injury that is both willful and malicious. The absence of one creates a dischargeable debt.” See *Markowitz v. Campbell*, 190 F.3d 455, 463 (6th Cir. 1999).

The Sixth Circuit found that the judgment against Mr. Trantham fell within the Bankruptcy Act’s exception for willful and malicious injuries and therefore was nondischargeable. *In re Trantham*, 304 B.R. at 308. The Court first noted that the jury had found that Mr. Trantham had infringed willfully. This finding satisfied the first requirement of the exception.

The Court then stated that the “maliciousness” requirement would be satisfied if the debtor had acted with a conscious disregard of his duty or if he had acted without just cause or excuse. The Court noted that the district court found that Mr. Trantham “deliberately” infringed the patent for the sole purpose of avoiding payment of the license fee and then attempted to conceal his actions. Those actions, the Court concluded, were tantamount to a finding that Mr. Trantham acted in conscious disregard of his known duty with respect to the patent. *Id.* The entire judgment for willful patent infringement in the amount of \$592,677.89 was therefore nondischargeable. *Id.* at 309.

Similar outcomes of non-dischargeability have been reached in a variety of other types of intellectual property cases. For example, non-dischargeability has been found in cases involving judgments of

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cybersquatting, *In re Wright*, 355 B.R. 192 (Bankr. C.D. Cal. 2006), trademark infringement, *In re Klayminc*, 37 B.R. 728 (Bankr. S.D. Fla. 1984) (violation of a consent judgment), misappropriation of customer lists, *In re Springer*, 85 B.R. 634 (Bankr. S.D. Fla. 1988), violation of a state trade secrets law, *In re Allison*, 176 B.R. 60 (Bankr. S.D. Fla. 1994), and other patent infringement cases, *In re Magnavox Co.*, 627 F.2d 803, 806 (7th Cir. 1980); *Monsanto Co. v. Thomason*, Ch. 11 Case No. 00-31755, Adv. No. 01-3012, slip op. (Bankr. W.D. La. Apr. 4, 2003); *Goldsmith v. Overseas Scientific Corp.*, 188 F. Supp. 530 (S.D.N.Y. 1960). The requisite finding of intent to injure was not found in a trademark counterfeiting case because of its particular facts. *In re Meece*, 261 B.R. 403 (Bankr. N.D. Tex. 2001).

The legal analysis stated in Mr. Trantham’s case may, however, be evolving. Earlier this year, a Bankruptcy Court for the District Court of New Jersey faced a situation that it found distinguishable from the “garden-variety” infringement of *In re Trantham*, 304 B.R. 298 (6th Cir. 2004), and *In re Wood*, 309 B.R. 745 (Bankr. W.D. Tenn. 2004). See *In re Benun*, 386 B.R. 59, 78 (Bankr. D.N.J. 2008). In *Benun*, the underlying patent case addressed whether Mr. Benun had infringed Fuji Photo Film’s rights when, through his business, he refurbished Fuji-patented disposable camera shells. Mr. Benun and his company were found liable for willful patent infringement and owed a judgment of roughly \$23 million. The New Jersey Bankruptcy Judge,

however, “split the baby” and decided that a portion of a patent infringement judgment was discharged by Mr. Benun’s bankruptcy and a portion would still be owed after bankruptcy.

In a long and complicated decision, the Bankruptcy Court in New Jersey reasoned that that the Bankruptcy Act’s requirement of willfulness required intentional consequences, not merely intentional acts. *Id.* It determined that such a finding had not been automatically made when the jury in the patent case found willful patent infringement. The Court indicated that the jury could have found willfulness under the Patent Act based merely upon recklessness (with unintended consequences) rather than deliberately intended consequences, as required by the Bankruptcy Act. The Court therefore decided that willfulness proven under the Patent Act was not necessarily the same as willfulness under the Bankruptcy Act.

Thusly freed from jury’s underlying determination of willful patent infringement, the Bankruptcy Judge re-assessed the particular facts of infringement that the jury had already evaluated. The Judge determined that a portion of the infringing activity was willful and malicious and that other infringing activity was not. *Id.* at 106-07.

The Bankruptcy Judge’s decision was very recently affirmed in relevant part by the District Court. *See In re Benun*, Case No. 08-1927 (D.N.J. December 1, 2008) (stating that the parties challenged certain findings but not the appropriateness of the test applied by the Bankruptcy Court).

The lessons from these cases? First and foremost, the question of dischargeability in a Chapter 7 bankruptcy often matters because it asks whether a judgment or settlement for money should be wiped out for the infringer or the infringing company’s owner and primary decision-maker. Second, the particular facts proven about the infringement, or agreed to in a settlement, will decide the question. Third, a bankruptcy judge may revisit a jury’s decision (or the parties’ settlement) if the decision (or settlement) is not sufficiently clear. Fourth, now that bankruptcy activity has increased in recent months, these legal issues are again likely to surface. ■

FIRM CORNER

The 2008 edition of *Chambers USA: America’s Leading Lawyers for Business* ranked Brooks Pierce among the best firms in North Carolina. The firm was ranked in the number one category for Antitrust, Environmental, and Litigation. *Chambers USA* did not rank Intellectual Property practices at North Carolina firms.

Three attorneys were recently selected to become the newest partners of the firm:

- **Julia Ambrose** has significant appellate and trial court experience in antitrust, First Amendment and products liability litigation. She previously practiced with Jones Day and with Williams & Connolly in Washington, D.C., after having clerked for U.S. Supreme Court Justice Sandra Day O’Connor.
- **Darrell Fruth** maintains a complex litigation and counseling practice with a focus on intellectual property and environmental law. He is registered to practice before the United States Patent and Trademark Office and has experience litigating patent, copyright, and trademark matters. He is also a registered professional engineer with experience representing clients on environmental and land use issues that include CERCLA, the Clean Water Act and Climate Change regulation. Prior to joining Brooks Pierce, Mr. Fruth clerked for a federal district court judge and practiced in San Francisco.
- **Iain MacSween** practices in the areas of banking and financial services and corporate law. Iain, who is also qualified in Scotland and the State of New York, previously practiced with a premier Scottish law firm, where he worked with several multi-national banks and oil and gas companies, and served as inhouse counsel for a Fortune 500 multi-national utility company.

FEDERAL CIRCUIT SAYS “OPEN SOURCE” LICENSES ARE ENFORCEABLE UNDER COPYRIGHT LAW

by Darrell Fruth

The Federal Circuit recently decided for the first time in *Jacobsen v. Katzer* that a copyright holder may distribute work for free public use under an “open source” license and still enforce controls on future distribution and modification of the work. 535 F.3d 1373 (Fed. Cir. 2008). The appeals court vacated the controversial decision of the district court, which found that violating the terms of an “intentionally broad,” non-exclusive open source license could not constitute copyright infringement.

Background

The Plaintiff in the case, Robert Jacobsen, managed an open source software group called the Java Model Railroad Interface (“JMRI”). JMRI’s copyrighted programs for controlling model trains were available for public download from the open source incubator website Source Forge. The code was distributed without a financial fee and pursuant to an open source Artistic License. Defendant Mathew Katzer and a related company offered competing model train software. Their proprietary software incorporated JMRI code, which was obtained pursuant to the Artistic License.

Jacobsen alleged that Katzer’s software violated several conditions in the Artistic License, including requirements for identifying the source of the code and any modifications made to it. Jacobsen sued for copyright infringement in the Northern District of California and moved for a preliminary injunction. The district court denied equitable relief, characterizing the alleged violations as mere breaches of contract, which unlike copyright infringement do not create a presumption of irreparable injury under Ninth Circuit law. Because Jacobsen’s lawsuit also sought a declaration that his software did not infringe a patent held by the defendants, the appeal went to the Federal Circuit.

Legal Issues

The big legal issue on appeal was whether Jacobsen could sue for copyright infringement or was limited to an action for breach of contract. In additional

to making it easier to obtain an injunction, a copyright infringement claim was attractive to Jacobsen because it would come with the potential for attorneys’ fees and statutory damages. These important remedy questions turned on whether the terms violated in the Artistic License were conditions of, or merely covenants to, the copyright license. In other words, if Katzer breached a fundamental condition for obtaining material under the Artistic License, he had no legal right to use the JMRI code, and was therefore subject to a claim for copyright infringement. On the other hand, if Katzer simply breached a promise or covenant in the Artistic License under which he received the code, he was only on the hook for contract damages, which might have been hard to prove in a case like this, where the software and source code were distributed without charge.

Prior case law had held that terms simply requiring payment of royalties and author attribution were mere covenants. *See, e.g., Graham v. James*, 144 F.3d 229, 237 (2d Cir. 1998) (noting that New York law presumes that contract terms are covenants, not conditions). The Federal Circuit, however, noted that the Artistic License at issue in *Jacobsen* was designed to make the relevant terms “conditions” rather than mere covenants. Indeed, the license contained “conditions” under which the material could be used, “provided that” such conditions were met. The court rejected the argument that such conditions were not enforceable under copyright law just because the copyrighted work was made available to the public at no charge. The attribution and modification requirements served to drive traffic to the incubator site and inform downstream users of the project, the kind of economic goals that copyright law was designed to protect. By ignoring these conditions, Katzer’s actions were outside the scope of the Artistic License.

Perhaps as important as the above analysis, the court also noted that as many as 100,000,000 works have already been licensed under open source arrangements, which the court described as a “widely used method of creative collaboration that

serves to advance the arts and sciences in a manner and at a pace that few could have imagined just a few decades ago.” The court cited the Apache web server, the Firefox web browser, and the Linux operating system as important examples.

The Court concluded that copyright holders who engage in open source licensing “have the right to control the modification and distribution of copyrighted material. . . . The choice to exact consideration in the form of compliance with open source requirements of disclosure and explanation of changes, rather than as a dollar-denominated fee, is entitled to no less legal recognition.” 535 F.3d at 1381-82.

Implications

Because the Federal Circuit was created as a specialist court to decide patent appeals, the court is often considered a bellweather on intellectual property matters. So while the *Jacobsen* decision is technically only binding on the small subset of copyright cases subject to Federal Circuit review, the court’s sweeping language will probably make it easier for open source vendors to enforce their rights in other circuits.

The main take away message for business owners is to remain vigilant about the source of any code incorporated in their products. The growing availability of “free” software and source code increases the chance that someone on your product development team will “borrow” a useful piece of code without complying with the terms of an open source license. The implications of such unauthorized use are now clear: your entire distribution network could be halted by a preliminary injunction. With so many products containing software these days, it is only fitting that a case involving toys trains would convey such an important message. ■

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