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CTRL+ALT+DELETE: DOES THE BANKRUPTCY CODE NEED A REBOOT? THE ELIGIBILITY OF CONSUMER DIGITAL GOODS FOR LIQUIDATION

ABSTRACT

The explosive growth of computers and the Internet at the end of the twentieth century sparked a fundamental change in the form of copyrighted materials. Books, films, music, and entertainment software have more recently been sold and bought as digital goods.

This Comment argues that the first-sale doctrine should apply to digital goods. These digital goods are typically sold in single lump sum payments determined by the quantity of the good, as opposed to a licensing fee determined by usage over time. The result is that these transactions are more similar to purchases rather than licenses. The first-sale doctrine should apply despite the naming conventions utilized in the End-User License Agreements accompanying these digital goods and the form-over-substance analysis favored by courts. Recognizing mass-market digital goods transactions as purchases would grant title of the copy of the digital good to the purchaser. The purchaser with title would be free to exercise the first-sale rights historically enjoyed in the physical world.

Even if courts refuse to recognize these transactions as purchases, § 365(f) of the Bankruptcy Code permits the assignment of these licenses as executory contracts. Through assignment, the trustee could sell off the licenses to third parties during the liquidation of the bankruptcy estate's property in chapter 7. In doing so, the bankruptcy policy of promoting the free assignability of assets and contracts would be respected. Finally, since most chapter 7 cases are no-asset cases, the resale of digital goods through assignment under § 365(f) would provide an additional source of returns to creditors.

INTRODUCTION

The Internet has enabled a nearly infinite amount of content available at the click of a mouse.¹ Increased broadband penetration has brought enhanced connection speeds.² This growth in Internet speed and access has brought digital networks to prominence as the dominant means for distributing copyrighted works.³

Digital distribution is the transmission of computer software, books, music, movies, and photos repackaged as digital media.⁴ Digital distribution has evolved beyond downloads to include apps and digital streaming.⁵ This evolution in delivery has fundamentally uprooted established business models in affected industries.⁶ For example, in 2012, as physical compact disk sales fell over 13% from 2011, digital album sales achieved 14.10% growth.⁷ This

¹ See *The Domain Name Industry Brief*, VERISIGN, INC. (Apr. 1, 2013), <http://www.verisigninc.com/assets/domain-name-brief-april2013.pdf> (stating that, as of 2012, over 250 million domain names were registered).

² See *Leichtman Research Group: Press Release*, LEICHTMAN RESEARCH GROUP (Sept. 4, 2012), <http://www.leichtmanresearch.com/press/090412release.html> (“New consumer research . . . found that nearly 90% of US households . . . currently subscribe to a broadband Internet service.”).

³ See generally Philippe Kern, *The Impact of Digital Distribution—A Contribution*, KEA EUROPEAN AFFAIRS (Apr. 10, 2009), <http://www.keanet.eu/docs/impactondigitaldistribution.pdf>.

⁴ *What is Digital Media?*, MICROSOFT.COM (Mar. 30, 2011), <http://technet.microsoft.com/en-us/library/what-is-digital-media-2.aspx> (“Digital media refers to audio, video, and photo content that has been encoded (digitally compressed).”).

⁵ “App” is the shorthand name for an application program that processes digital data. Software applications include web browsers, word processors, e-mail, presentation programs, and more. *Definition of: Application Program*, PC MAG., <http://www.pcmag.com/encyclopedia/term/37919/application-program> (last visited Feb. 28, 2014). “Streaming” refers to the delivery of multimedia to a user’s computer or mobile device on-demand as opposed to downloading the content to the user’s hard drive for permanent storage. Jan Ozer, *What is Streaming?*, STREAMING MEDIA (Feb. 26, 2011), <http://www.streamingmedia.com/Articles/ReadArticle.aspx?ArticleID=74052>.

⁶ See, e.g., Jessica E. Vascellaro & Sam Schechner, *Slow Fade-Out for Video Stores*, WALL ST. J., Sept. 30, 2010, at A6, available at <http://online.wsj.com/news/articles/SB10001424052748704082104575515933391663168> (suggesting that new digital movie-delivery methods such as Netflix and YouTube contributed to Blockbuster’s bankruptcy); Rosa Golijan, *iTunes Turns 10: How Apple Music Store Killed Old Music Industry*, NBC NEWS (Apr. 28, 2013), <http://www.nbcnews.com/technology/itunes-turns-10-how-apple-music-store-killed-old-music-6C9633923> (claiming that the convenience, portability, and price offered by Apple’s iTunes store “killed the music shop in the last decade”); Todd Leopold, *The Death and Life of a Great American Bookstore*, CNN (Sept. 12, 2011, 12:47 PM EDT), <http://www.cnn.com/2011/US/09/12/first.borders.bookstore.closing/index.html> (providing a thorough history of the rise and fall of Borders bookstores and crediting the demise of Borders, in part, to its late entry into the e-book market long after Amazon’s Kindle and Barnes & Noble’s Nook gained control of the market).

⁷ *The Nielsen Company & Billboard’s 2012 Music Industry Report*, BUS. WIRE (Jan. 4, 2013), <http://www.businesswire.com/news/home/20130104005149/en/Nielsen-Company-Billboard%E2%80%99s-2012-Music-Industry-Report>.

growth continued the shift that was already evident in 2011, when digital music sales exceeded physical sales for the first time, resulting in a 50.3% market share.⁸ In the book industry, Amazon's e-book sales have even cannibalized its own physical book sales.⁹

Digital media is commoditized and sold in the form of digital goods.¹⁰ The digital goods market for e-books, music, and entertainment software is dominated by Amazon,¹¹ Apple,¹² and Valve Corporation,¹³ respectively. These digital retailers exploit the favorable economics of digital catalogs which provide (1) limitless inventory; (2) infinite catalogs for both mass-market hits and niche offerings; and (3) decreased manufacturing and distribution costs.¹⁴

These benefits have been accompanied by an increase in control by rights holders over the ways in which consumers can use their purchases.¹⁵ This increased control limits consumer freedoms by (1) preventing consumers from purchasing or reselling digital goods through second-hand markets; (2)

⁸ Sam Gustin, *Digital Music Sales Finally Surpassed Physical Sales in 2011*, TIME (Jan. 6, 2012), <http://business.time.com/2012/01/06/digital-music-sales-finally-surpassed-physical-sales-in-2011>.

⁹ See Jason Kincaid, *That Was Fast: Amazon's Kindle Ebook Sales Surpass Print (It Only Took Four Years)*, TECHCRUNCH (May 19, 2011), <http://techcrunch.com/2011/05/19/that-was-fast-amazons-kindle-ebook-sales-surpass-print-it-only-took-four-years>.

¹⁰ *Digital Goods*, WEBOPEDIA, http://www.webopedia.com/TERM/D/digital_goods.html (last visited Jan. 25, 2014) (defining digital goods as “any goods that are stored, delivered and used in its [sic] electronic format. . . . Examples of digital goods include e-books, music files, software, digital images, Web site templates, manuals in electronic format, and any item which can be electronically stored in a file or multiple files.”).

¹¹ *Estimating Kindle E-Book Sales for Amazon*, FORBES (Apr. 2, 2014), <http://www.forbes.com/sites/greatspeculations/2014/04/02/estimating-kindle-e-book-sales-for-amazon>.

¹² *Apple's iTunes Accounts for 75% of Global Digital Music Market, Worth \$6.9B a Year*, APPLE INSIDER (June 20, 2013), <http://appleinsider.com/articles/13/06/20/apples-itunes-accounts-for-75-of-global-digital-music-market-worth-69b-a-year>.

¹³ Oliver Chiang, *The Master of Online Mayhem*, FORBES (Feb. 2, 2011, 6:00 PM), <http://www.forbes.com/forbes/2011/0228/technology-gabe-newell-videogames-valve-online-mayhem.html> (stating that Valve's proprietary platform, Steam, controls 50% to 70% of the PC market for downloaded games).

¹⁴ CHRIS ANDERSON, *THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE* 9–10 (2006). With regards to the entertainment software industry, Gabe Newell, CEO of Valve Corporation and developer of the digital entertainment software distribution service Steam, summarized the advantages of digital distribution over physical retail stating, “[Valve employees] can put something up on Steam, deliver it to people all around the world, [and] make changes. . . . On Steam there's no shelf-space restriction. . . . [E]ventually pretty much every game that's ever been available will be on there 24/7.” John Walker, *RPS Exclusive: Gabe Newell Interview*, ROCK, PAPER, SHOTGUN (Nov. 21, 2007, 3:40 PM), <http://www.rockpapershotgun.com/2007/11/21/rps-exclusive-gabe-newell-interview>.

¹⁵ See generally JONATHAN L. ZITTRAIN, *THE FUTURE OF THE INTERNET—AND HOW TO STOP IT* 102–03 (2008) (discussing the increased regulatory intervention inherent in tethered appliances).

invoking privacy concerns; (3) hindering consumer innovation; and (4) inhibiting market efficiency through increased transaction costs.¹⁶

With technology outpacing legal developments, it is unclear what happens to these digital goods in chapter 7 bankruptcies. If these items were eligible for liquidation, they could generate returns for creditors, thereby promoting the bankruptcy policy of maximizing the value of the bankruptcy estate.¹⁷ This Comment argues that these digital goods should be eligible for (1) resale under the first-sale doctrine or, in the alternative, (2) assumption and assignment to third parties under § 365(f) of the Bankruptcy Code (the “Code”) as property of the bankruptcy estate.

I. BACKGROUND

A. *The First-Sale Doctrine*

Copyright law seeks to balance the exclusive rights of copyright owners with the public interest in access to information and advancement of the arts and sciences.¹⁸ These exclusive rights include the right to reproduce the copyrighted work, prepare derivative works, distribute copies, and perform or display the work publicly.¹⁹ To meet this goal, the legal doctrine of exhaustion limits rights holders’ power over their works when a copyrighted work is transferred from the rights holder to a transferee.²⁰

Section 109 of the Copyright Act is the statutory embodiment of the first-sale doctrine.²¹ The first-sale doctrine allows owners of legally purchased copies of copyrighted works to redistribute those copies, whether through

¹⁶ Aaron Perzanowski & Jason Schultz, *Digital Exhaustion*, 58 UCLA L. REV. 889, 891 (2011).

¹⁷ 4 COLLIER ON BANKRUPTCY ¶ 506.03[6][a][ii] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (“[T]he policy of maximizing the value of the debtor’s bankruptcy estate”).

¹⁸ See *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984).

Because this task involves a difficult balance between the interests of authors and inventors in the control and exploitation of their writings and discoveries on the one hand, and society’s competing interest in the free flow of ideas, information, and commerce on the other hand, our patent and copyright statutes have been amended repeatedly.

Id.

¹⁹ 17 U.S.C. § 106 (2012).

²⁰ See Herbert Hovenkamp, *Post-Sale Restraints and Competitive Harm: The First Sale Doctrine in Perspective*, 66 N.Y.U. ANN. SURV. AM. L. 487, 491 (2011).

²¹ 17 U.S.C. § 109.

resale, gift, donation, etc.²² This limitation on an author's exclusive rights strikes "a balance between the artist's right to control [her] work . . . and the public's need for access."²³ Without the first-sale doctrine, copyright owners could restrict everyday transactions that would not otherwise involve them.²⁴ The first-sale doctrine prevents such interference by severing the copyright owner's exclusive distribution right whenever it transfers title to a particular copy of a work.²⁵

The first-sale doctrine provides four benefits: (1) access, (2) preservation, (3) privacy, and (4) transactional clarity.²⁶ First, the first-sale doctrine promotes access by lowering costs and increasing availability of copyrighted works.²⁷ The copyrighted goods are more affordable and accessible through second-hand markets beyond the copyright owners' control.²⁸ Second-hand markets pressure copyright owners to lower prices for their works.²⁹ The availability of these works is broadened through the geographic dispersion of second-hand markets, as well as the willingness of these markets to serve customers beyond the copyright owners' primary customer bases.³⁰

²² See 2 PAUL GOLDSTEIN, GOLDSTEIN ON COPYRIGHT § 7.6.1 n.4 (3d ed. 2005) ("[A] gift of copies or phonorecords will qualify as a 'first sale' to the same extent as an actual sale for consideration.").

²³ Perzanowski & Schultz, *supra* note 16, at 892 (quoting *Stewart v. Abend*, 495 U.S. 207, 228 (1990)) (explaining that the monopoly privileges under Article I, § 8 of the Constitution are intended to provide an important public benefit); see also *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 158 (1948) ("The copyright law, like the patent statute, makes reward to the owner a secondary consideration."); *Fox Film Corp. v. Doyal*, 286 U.S. 123, 127 (1932) ("The sole interest of the United States and the primary object in conferring the monopoly lie in the general benefits derived by the public from the labors of authors.").

²⁴ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1386 (2013) ("Congress did not intend to permit copyright owners 'to fasten . . . a restriction upon the subsequent alienation of the subject-matter of copyright after the owner had parted with the title to one who had acquired full dominion over it and had given a satisfactory price for it.'" (quoting *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339, 350 (1908))).

²⁵ 17 U.S.C. § 109; e.g., *Columbia Pictures Indus., Inc. v. Redd Home, Inc.*, 749 F.2d 154, 159 (3d Cir. 1984) ("The first sale doctrine prevents the copyright owner from controlling the future transfer of a particular copy once its material ownership has been transferred."); *Am. Int'l Pictures, Inc. v. Foreman*, 576 F.2d 661, 664 (5th Cir. 1978) ("After the first sale of a copy the copyright holder has no control over the occurrence or conditions of further sales of it. . . . The first sale thus extinguishes the copyright holder's ability to control the course of copies placed in the stream of commerce.").

²⁶ Joseph P. Liu, *Owning Digital Copies: Copyright Law and the Incidents of Copy Ownership*, 42 WM. & MARY L. REV. 1245, 1303, 1310–11, 1320–21, 1330–33, 1336 (2001); R. Anthony Reese, *The First Sale Doctrine in the Era of Digital Networks*, 44 B.C. L. REV. 577, 584 (2003) (addressing access, preservation, privacy); see also Perzanowski & Schultz, *supra* note 16, at 894 (listing two additional benefits: increased innovation and platform competition).

²⁷ Reese, *supra* note 26, at 578.

²⁸ *Id.*

²⁹ *Id.* at 585.

³⁰ *Id.* at 604 (citing the works of Homer and Virgil as historical proof that distribution of a work in multiple copies to various owners increases the likelihood that at least one copy will survive the test of time).

Additionally, the reduced costs of purchasing previously-owned works allow second-hand markets to experiment with alternative access models, such as rentals or product sampling.³¹

Price competition facilitates access to copyrighted works by compelling copyright owners and second-hand markets to lower their prices. Since the copyright owner can only set the price for the initial sale of a copy of the work, second-hand markets have discretionary authority to set prices.³² The price competition within these markets drives prices down, which ultimately benefits the consumer.

Second, the first-sale doctrine preserves and maintains the circulation of publicly accessible works.³³ The preservation of these copyrighted works occurs by ensuring their availability. Copyright owners may cease production of a work, thereby terminating the public's ability to obtain new copies. This decision may be cost-related. For example, a publisher may determine that the demand for a work is insufficient as compared to the costs involved in creating, storing, distributing, and marketing copies to consumers.³⁴ In this scenario, the first-sale doctrine allows for continued access to these works by sale, rental, or borrowing, even though production of new copies may no longer be economically viable for the copyright owner.³⁵

Besides economic reasons, new copies may no longer be available because the copyright owner refuses to supply the work or decides to recall distributed copies. The copyright owner's refusal may be due to dissatisfaction with some aspect of the work, such as quality or an outdated authorial message.³⁶ Additionally, if the creator has transferred copyright ownership to a corporate author or publisher, the copyright owner may recall the work if it is antithetical

³¹ *Id.* at 586–88. Libraries, used bookstores, Amazon's physical book offerings, video rental stores, and online auction sites, such as eBay, are just some examples of the myriad commercial access models made possible through the first-sale doctrine.

³² *Id.* at 585.

³³ *Id.* at 594–95, 599.

³⁴ *Id.* at 593.

³⁵ *Id.* at 593–94.

³⁶ *E.g., id.* at 595 (citing the example of silent-film actress Mary Pickford's attempts to withhold her films from television and cinema for fear that future audiences would ridicule her); *see also* *Worldwide Church of God v. Phila. Church of God, Inc.*, 227 F.3d 1110, 1122 (9th Cir. 2000) (Brunetti, J., dissenting). In that case, the plaintiff, Worldwide Church of God, destroyed copies of a book written by its founder and ceased circulation of the book. Its decision was "based on a 'Christian duty' to keep doctrinal errors out of circulation." *Id.*

to the current moral or political climate.³⁷ When the copyright owner takes such measures, the first-sale doctrine provides an alternate way for the public to maintain access to previously distributed copies of the work.

Third, the first-sale doctrine protects consumer privacy by permitting owners of lawfully purchased copies to transfer their copies without requiring the copyright owner's permission.³⁸ If consent were required, the copyright owner could monitor, record, and possibly restrict the transfer of copies.³⁹ This privacy protection takes on greater importance when considering works that may be controversial or unpopular.⁴⁰

Fourth, the first-sale doctrine provides transactional clarity by removing restrictions on the transfer of copyrighted goods.⁴¹ This transactional clarity simplifies information costs and improves market efficiency by removing idiosyncratic restrictions, which restrain each second-hand seller.⁴² Complying with such restrictions imposes additional costs on the initial purchaser as well as any downstream transferees. These additional costs may discourage consumers from lawfully acquiring a copy or choosing to ignore the restrictive terms entirely.⁴³

B. Software End-User License Agreements

While the first-sale doctrine governs the secondary distribution of copyrighted works, it is generally not applicable to transactions involving digital goods. This is because digital retailers typically structure the transaction as a license, not a sale. Industry practice requires consumers to agree to the terms of the digital retailer's End-User License Agreement ("EULA"), which dictates the terms of the transaction.⁴⁴ These EULAs generally prohibit

³⁷ *E.g.*, Reese, *supra* note 26, at 597 n.69 (relating book publisher Harper Collins's decision to not publish Leon Trotsky's book because the United States might have allied with Josef Stalin's Soviet Union for the remainder of World War II as an example of a politically-motivated decision to not release a copyrighted work into circulation).

³⁸ 17 U.S.C. § 109 (2012).

³⁹ Perzanowski & Schultz, *supra* note 16, at 896.

⁴⁰ *See generally* Julie E. Cohen, *A Right to Read Anonymously: A Closer Look at "Copyright Management" in Cyberspace*, 28 CONN. L. REV. 981 (1996).

⁴¹ Perzanowski & Schultz, *supra* note 16, at 896.

⁴² *Id.* at 896–97.

⁴³ *See id.* (citing *Straus v. Victor Talking Mach. Co.*, 243 U.S. 490, 501 (1917) (“[N]ot one purchaser in many would read such a notice, and that not one in a much greater number, if he did read it, could understand its involved and intricate phraseology . . .”).

⁴⁴ *E.g.*, *iTunes Store: Terms and Conditions*, APPLE, <http://www.apple.com/legal/internet-services/itunes/us/terms.html#GIFTS> (last updated Sept. 17, 2014); *Kindle Store Terms of Use*, AMAZON, <http://www.amazon>.

copying, reverse engineering, renting, and transferring the software.⁴⁵ Typically, EULAs refer to the transaction as a license rather than a sale, and courts have interpreted these contracts in the retailers' favor.⁴⁶ By qualifying the transaction as a license, retailers are able to limit the software's dissemination in compliance with the EULAs' terms and restrictions.⁴⁷

This conflict between the competing interests of the retailer and the consumer is referred to as the "software licensing dilemma."⁴⁸ If software is sold, rather than licensed, the retailer's ability to restrict unauthorized use of its product is severely limited.⁴⁹ In contrast, if the software is licensed, the consumer's right to use the software is greatly limited because the first-sale doctrine does not extend to licenses.⁵⁰ For example, most EULAs restrict any transfer of software, including noncommercial transfers, to prevent the possibility of buyers renting the software to third parties.⁵¹

*Vernor v. Autodesk*⁵² and *Krause v. Titleserv, Inc.*⁵³ exemplify the software licensing dilemma. In *Vernor*, the Ninth Circuit Court of Appeals favored the terms of the software license and held that the transferee had violated the terms of the license by reselling the software.⁵⁴ Despite the fact that the transferee had purchased the physical disks on which the software was written, the court held the transferee was bound by the original license agreement which restricted resale of the software.⁵⁵

In *Krause*, the Second Circuit Court of Appeals held that the right to continuous and indefinite possession was a critical factor in assigning

com/gp/help/customer/display.html/ref=help_search_1-4?ie=UTF8&nodeId=201014950 (last updated Sept. 6, 2012); *Steam Subscriber Agreement*, STEAM POWERED, http://store.steampowered.com/subscriber_agreement (last visited Oct. 20, 2013).

⁴⁵ E.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

⁴⁶ See *Vernor v. Autodesk*, 621 F.3d 1102 (9th Cir. 2010); *ProCD v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996).

⁴⁷ See *Vernor*, 621 F.3d at 1104, 1116.

⁴⁸ Nancy S. Kim, *The Software Licensing Dilemma*, 2008 BYU L. REV. 1103, 1103.

⁴⁹ *Id.*

⁵⁰ *Id.* at 1145 (noting that if the parties were to enter into a "pure licensing transaction," then the transfer restriction terms would be enforceable as a contractual obligation).

⁵¹ See, e.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

⁵² 621 F.3d 1102.

⁵³ 402 F.3d 119 (2d Cir. 2005).

⁵⁴ 621 F.3d at 1112.

⁵⁵ *Id.* at 1103–04, 1116.

ownership.⁵⁶ Here, the plaintiff had developed software solely for use by the defendant, who then altered the software without the plaintiff's consent.⁵⁷ Despite the licensing agreement's contrary language, the court held the defendant to be an owner of the software because the plaintiff never reserved the right to repossess the software copies and the defendant had the right to continue to use and possess the program indefinitely.⁵⁸

C. *The Chapter 7 Bankruptcy Process and Executory Contracts*

When a debtor files his or her chapter 7 bankruptcy petition, a bankruptcy estate is simultaneously formed.⁵⁹ The bankruptcy estate is comprised of “all legal or equitable interests of the debtor as of the commencement of the case” and extends to any proceeds derived from such property.⁶⁰ The bankruptcy trustee serves as a fiduciary for the creditors of the bankruptcy estate.⁶¹ The trustee administers the estate, which, in a chapter 7 bankruptcy, primarily involves the liquidation of estate property and the pro rata distribution of liquidation returns to unsecured creditors.⁶²

Upon filing, the trustee must assume, reject, or assign the debtor's prepetition contracts.⁶³ These prepetition contracts may include executory contracts. An executory contract is a contract in which “the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”⁶⁴ A common example of an executory contract is a lease. A lease is executory because there are outstanding obligations by both the lessor and the lessee—the lessor agrees to continued leasing of the property and the lessee agrees to pay rent and maintain

⁵⁶ 402 F.3d at 124–25.

⁵⁷ *Id.* at 120–21.

⁵⁸ *Id.* at 124.

⁵⁹ 11 U.S.C. § 541(a) (2012) (“The commencement of a case under . . . this title creates an estate.”).

⁶⁰ *Id.* § 541(a)(1), (6).

⁶¹ *E.g.*, Phx. Elec. Contracting Corp. v. N.Y. Tel. Co., 587 N.Y.S.2d 485, 486 (Sup. Ct. 1992) (“A Trustee in bankruptcy representing all creditors of the estate has a duty to examine all proofs of claim, and must object to allowance of claims found to be improper. Thus, the Trustee stands in a fiduciary relationship to all creditors . . .” (citation omitted)).

⁶² 11 U.S.C. § 704(a) enumerates the various duties of the trustee, listing foremost among them the duty to “collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest.” 11 U.S.C. § 704(a)(1). 11 U.S.C. § 726(b) provides for the pro rata distribution of payments to unsecured creditors in accordance with the priority order enumerated in § 507 and to non-priority unsecured creditors under § 726(a)(2). *Id.* § 726(b).

⁶³ *Id.* § 365(a), (f).

⁶⁴ Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

the leased property throughout the term of the lease. To assign an executory contract, the trustee must first assume the contract under § 365(a) of the Code, subject to court approval.⁶⁵ Generally, courts defer to the trustee's judgment in determining the treatment of the executory contract.⁶⁶

Outside of bankruptcy, a debtor may be prevented from assigning an executory contract because the contract prohibits, restricts, or conditions assignment.⁶⁷ Within bankruptcy, § 365(f) permits the trustee to assign the executory contract to a third-party, even if the contract or applicable nonbankruptcy law would otherwise prohibit such assignment.⁶⁸ In this way, the Code permits the trustee to effectively exchange contracts for value for the benefit of the estate.

In order to assign an executory contract under § 365(f), the trustee must first assume the contract.⁶⁹ Section 365(f) permits assignment, except as provided in subsection (c), despite anti-assignment provisions or applicable law.⁷⁰ Section 365(c) prohibits assumption or assignment of an executory contract if applicable law excuses the non-debtor party from accepting or rendering performance to a party other than the debtor.⁷¹

The references to applicable law in § 365(c) and (f) have differing scopes.⁷² Section 365(f)(1) provides an exception to laws that prohibit, restrict, or condition the assignment of executory contracts. In contrast, § 365(c)(1) applies where applicable nonbankruptcy law specifically excuses a non-debtor

⁶⁵ 11 U.S.C. § 365(f)(2)(A) (“The trustee may assign an executory contract or unexpired lease of the debtor only if . . . the trustee assumes such contract or lease in accordance with the provisions of this section . . .”).

⁶⁶ 3 COLLIER ON BANKRUPTCY, *supra* note 17, at ¶ 365.03[2] (citing *Cor 5 Route Co. v. Penn Traffic Co.* (*In re Penn Traffic Co.*), 524 F.3d 373, 383 (2d Cir. 2008); *Orion Pictures Corp. Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095 (2d Cir. 1993); *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir. 1985); *In re Old Carco LLC*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009); *In re Pilgrim's Pride Corp.*, 403 B.R. 413 (Bankr. N.D. Tex. 2009)).

⁶⁷ Michelle Morgan Harner et al., *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 195 (2005).

⁶⁸ 11 U.S.C. § 365(f) (“[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease . . .”).

⁶⁹ *Id.*

⁷⁰ *Id.* § 365(f)(1).

⁷¹ *Id.* § 365(c)(1)(A).

⁷² Madlyn Gleich Primoff & Erica G. Weinberger, *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment and Rejection of Executory Contracts, Including Intellectual Property Agreements, and Related Issues Under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code*, 8 AM. BANKR. INST. L. REV. 307, 333 (2000) (quoting *In re Catapult Entm't, Inc.*, 165 F.3d 747, 754 (9th Cir. 1999)).

party from accepting performance or rendering performance because the identity of the assignor is material to the agreement.⁷³

III. THE ECONOMIC REALITIES OF DIGITAL GOODS TRANSACTIONS FAVOR PERMITTING LEGAL RESALE UNDER BOTH THE FIRST-SALE DOCTRINE AND § 365(F)

A. *Digital Goods Should Be Eligible for Resale Under the First-Sale Doctrine*

1. *Copy Ownership Is a Prerequisite to Exercising First-Sale Rights*

Before being able to take advantage of the first-sale doctrine, an individual must own a legally acquired copy of the copyrighted work.⁷⁴ A sale involves transfer of title from seller to buyer, whereas a license is only a temporary transfer with expectation that the transferred good must be returned.⁷⁵

Under federal copyright law, licenses are either exclusive or non-exclusive. An exclusive license entitles the licensee to all the rights of the copyright owner contemplated in the license.⁷⁶ Conversely, a non-exclusive license does not transfer ownership rights, which, instead, remain vested in the copyright owner.⁷⁷ Courts have used various approaches to determine when title to a copyrighted work has transferred from copyright owner to transferee.⁷⁸ Historically, courts have almost exclusively looked to the language of the contract in determining whether a sale or granting of a license has occurred.⁷⁹ For example, in *MAI Systems Corp. v. Peak Computer, Inc.*, the software contract between MAI Systems (“MAI”) and Peak Computer (“Peak”)

⁷³ *Id.* at 333–34.

⁷⁴ 17 U.S.C. § 109(a) (2012) (extending § 109 rights only to “the owner of a particular copy . . . lawfully made”).

⁷⁵ Brian W. Carver, *Why License Agreements Do Not Control Copy Ownership: First Sales and Essential Copies*, 25 BERKELEY TECH. L.J. 1887, 1896, 1934 (2010) (defining a sale as a transaction in which “a copy is transferred, the recipient owns the copy, and the recipient is therefore entitled to the benefits of § 109 and § 117”; whereas a license is a “permanent transfer of a copy of a copyrighted work in which the transferor purportedly retains full title to and ownership of the transferred copy”).

⁷⁶ 17 U.S.C. § 201(d)(2) (“Any of the exclusive rights compromised in a copyright . . . may be transferred . . . and owned separately.”).

⁷⁷ See *In re Patient Edu. Media, Inc.* 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (stating that a non-exclusive license does not transfer any ownership rights from owner to licensee).

⁷⁸ Carver, *supra* note 75, at 1898–99 (categorizing the five investigative approaches as follows: the “reservation of title” approach; the “agreement controls” approach; the “UCC controls” approach; the “economic realities” approach; and the “perpetual possession” approach).

⁷⁹ See, e.g., *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 518 n.5, 518–19 (9th Cir. 1993); see also *Microsoft Corp. v. Harmony Computers & Elecs., Inc.*, 846 F. Supp. 208 (E.D.N.Y. 1994).

restricted use of MAI's software solely for Peak's own internal use.⁸⁰ In violation of the contract, Peak used MAI's software to maintain its customers' computers.⁸¹ The court determined copyright ownership from the language of MAI's contract. The contract defined itself as a license, effectively disqualifying Peak's customers as MAI software owners.⁸² The court held that Peak's additional usage had violated MAI's exclusive reproduction right since only MAI, as the owner of the computer program, was permitted to legally make another copy.⁸³

2. *Commercial Digital Goods Transactions Are Sales*

The intangibility of digital goods has created newfound considerations regarding ownership.⁸⁴ The analysis is complex because software licensing involves elements of contract law, intellectual property, and commercial law.⁸⁵ The current standard in software licensing is for distributors to qualify the transaction as the granting of a license rather than a sale.⁸⁶ Tactically, software distributors include this limitation in order to limit the ownership rights of consumers, particularly their rights under the first-sale doctrine.⁸⁷

In analyzing the transaction between the copyright owner and the consumer, courts should extend their analysis beyond the four corners of the contract. Instead, courts should look to the underlying economic realities of the transactions.⁸⁸

⁸⁰ 991 F.2d at 511.

⁸¹ *Id.* at 517–18.

⁸² *Id.* at 518 n.5.

⁸³ *Id.* at 518–19 (quoting 17 U.S.C. § 117 (2012)).

⁸⁴ Kim, *supra* note 48, at 1113 (“Software does not fit neatly into preexisting legal categories because it is both tangible and intangible, and both privately owned and publicly distributable.”).

⁸⁵ *Id.* at 1106–07.

⁸⁶ See, e.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

⁸⁷ DOUGLAS E. PHILLIPS, *THE SOFTWARE LICENSE UNVEILED: HOW LEGISLATION BY LICENSE CONTROLS SOFTWARE ACCESS* 23 (2009) (refuting the argument that EULAs grant rights to users that would otherwise not be present under the first-sale doctrine in stating, “On the contrary, most licenses state that even lending the software is prohibited, and they also impose conditions and limitations on the transfer of a license to third parties.”); John A. Rothchild, *The Incredible Shrinking First-Sale Rule: Are Software Resale Limits Lawful?*, 57 RUTGERS L. REV. 1, 25–26 (2004).

⁸⁸ RAYMOND NIMMER, *THE LAW OF COMPUTER TECHNOLOGY* § 1.18[1], at 1-103 (2d ed. 1992) (“Ownership of a copy should be determined based on the actual character, rather than the label, of the transaction by which the user obtained possession. Merely labeling a transaction as a lease or license does not control.”).

Software distributors use “license” as a term of art to refer to what is in fact “a *permanent* transfer of a copy of a copyrighted work” to the licensee while the transferor retains full title and ownership of the transferred copy.⁸⁹ Despite the naming convention, the “license” referred to in the software distributor’s EULA contemplates no expected return of the digital good.⁹⁰

The Ninth Circuit Court of Appeals followed this “economic realities” approach in *Microsoft Corp. v. DAK Industries, Inc. (In re DAK Industries, Inc.)*.⁹¹ Before DAK Industries (“DAK”) filed its chapter 11 bankruptcy petition, DAK and Microsoft agreed to a license agreement. This agreement granted DAK non-exclusive, worldwide licensing rights for one year to Microsoft’s Word software.⁹² Under the terms of the agreement, Microsoft agreed to supply DAK with a master disk for Word, and DAK would use that disk to install Word on computers it would then sell to consumers.⁹³ DAK was also entitled to updates and new versions of Word.⁹⁴ In exchange, DAK agreed to pay a \$45 royalty rate per copy of Word it installed.⁹⁵ DAK was obligated to pay Microsoft a minimum commitment of \$2,750,000 in five installments.⁹⁶ The royalty rate would apply only after DAK sold more than 61,000 units.⁹⁷

After paying the first three installments, DAK filed for bankruptcy with two outstanding payment obligations totaling \$1,395,833.⁹⁸ DAK sold approximately 7,600 Word copies postpetition.⁹⁹ DAK sold these copies without paying any royalties to Microsoft.¹⁰⁰ Microsoft filed a motion for an administrative expense payment for DAK’s postpetition use and sale of its software.¹⁰¹

⁸⁹ Carver, *supra* note 75, at 1896 (emphasis added); *see, e.g., iTunes Store: Terms and Conditions, supra* note 44; *Kindle Store Terms of Use, supra* note 44; *Steam Subscriber Agreement, supra* note 44.

⁹⁰ *See* Carver, *supra* note 75, at 1896–97 (providing an analysis of the confusion this classification has caused amongst the courts).

⁹¹ 66 F.3d 1091 (9th Cir. 1995).

⁹² *Id.* at 1092.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at 1092–93.

⁹⁶ *Id.*

⁹⁷ *Id.* at 1093.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

The Ninth Circuit Court of Appeals confirmed the lower courts' denial of Microsoft's claim.¹⁰² Under its holding, DAK was not obligated to pay any administrative expenses to Microsoft, even though DAK profited from Microsoft's software postpetition.¹⁰³

The Ninth Circuit based its holding on the "economic realities of the particular arrangement."¹⁰⁴ In doing so, the court concluded the agreement was more akin to a lump sum sale of software rather than a license.¹⁰⁵ In recognizing the transaction as a sale despite Microsoft's intent to license, the court analyzed the pricing structure of the agreement. First, the pricing structure was unlike a license because the payments were not based on the duration of the software's use.¹⁰⁶ Rather, the payments were based upon the quantity of units purchased by DAK.¹⁰⁷ Second, the agreement resembled a sale because DAK received all of its rights under the agreement at the agreement's commencement without regard to the amount of software sold.¹⁰⁸ Third, Microsoft did not provide DAK with anything following DAK's bankruptcy filing.¹⁰⁹ Most significantly, DAK's postpetition software sales were similar to inventory sales because "DAK did not employ Word over a period of time in order to run its operation. Rather, it sold the program to consumers."¹¹⁰

These same factors are present in a typical digital good transaction. Most importantly, in such a transaction, a consumer pays a one-time fee in exchange for the digital good, and this fee is based on the quantity purchased as opposed to the duration of use.¹¹¹ Second, when the licensor has few ongoing obligations or none at all, the agreement is not an executory contract and is not governed by § 365.¹¹²

¹⁰² *Id.* at 1092.

¹⁰³ *Id.* at 1095.

¹⁰⁴ *Id.* (citing *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1182 (9th Cir. 1988)).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 1096.

¹¹⁰ *Id.*

¹¹¹ See, e.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

¹¹² Jennifer S. Bisk, *Software Licenses Through the Bankruptcy Looking Glass: Drafting Individually Negotiated Software Licenses that Protect the Client's Interests in Bankruptcy*, 17 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 611, 623 (2007) (citing *In re Stein*, 81 B.R. 263, 266–67 (Bankr. S.D.N.Y. 1988); *In re Monument Record Corp.*, 61 B.R. 866, 868–69 (Bankr. M.D. Tenn. 1986)).

Software distributors may object to recognizing these transactions as sales; however, market efficiency should trump such protectionist motivations.¹¹³ Courts should apply the first-sale doctrine to digital goods to permit consumers to transfer their digital purchases. With the freedom to take advantage of the first-sale doctrine, consumers would enjoy the same rights traditionally enjoyed with respect to their physical purchases. As a result, the benefits of the first-sale doctrine—access, preservation, privacy, and transactional clarity—would be extended into the digital realm. In doing so, the balance between the exclusive rights of copyright holders with the public interest in the free flow of information would be respected.¹¹⁴ Further, by extending the first-sale doctrine to digital goods, these digital assets would be eligible for liquidation in a chapter 7 bankruptcy as property of the bankruptcy estate.

B. Technology Licenses Are Executory Contracts

If courts continue not to recognize mass-market, digital goods transactions as sales, § 365(f) provides an alternative means by which a bankruptcy trustee may assign these digital goods to maximize the value of the estate. Section 365(f) permits assumption and assignment of certain executory contracts without the consent of the non-debtor party, even if the contract explicitly prohibits assignment.¹¹⁵

A prebankruptcy contract is executory if there are material obligations owed by each party to the other and such obligations remain incomplete.¹¹⁶ Some courts utilize a functional analysis in determining whether a contract is executory by looking to the nature of the parties, the intended outcome of reorganization, and whether acceptance or rejection will benefit the bankruptcy estate.¹¹⁷ A trustee must determine whether an intellectual property license is

¹¹³ See Kim, *supra* note 48, at 1162–63 (noting the greater significance of this policy concern beyond the software industry in light of the possibility that other commercial goods may follow similarly restrictive practices).

¹¹⁴ Sony Corp. of Am. v. Universal City Studios, Inc., 464 U.S. 417, 429 (1984).

¹¹⁵ 11 U.S.C. § 365(f)(1) (2012) (“[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.”).

¹¹⁶ Countryman, *supra* note 64, at 460 (defining executory contracts as existing when “obligation[s] of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other”).

¹¹⁷ Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 280 (1989).

an executory contract before the trustee may assume and assign it.¹¹⁸ Intellectual property licenses that contain continuing obligations are generally considered to be executory contracts.¹¹⁹

Generally, licensing agreements are executory because each party owes an outstanding obligation to the other party. Most commonly, the licensor agrees not to sue the licensee for infringement and the licensee reciprocates by limiting its use of the licensed intellectual property to those uses stipulated by the licensor's terms.¹²⁰ Other contract provisions such as royalty payments, revocation, and the length of the agreement are also indicative of an executory license.¹²¹ In the context of software licensing, there may be additional ongoing performance obligations such as reporting, servicing, providing maintenance, and providing technological upgrades.¹²²

Whether the court holds the contract to be executory depends, in part, on whether the license is exclusive or non-exclusive.¹²³ An exclusive license to use intellectual property transfers title and ownership of the contracted intellectual property to the licensee.¹²⁴ In contrast, a non-exclusive license

¹¹⁸ Peter M. Gilhuly et al., *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 3 (2013).

¹¹⁹ See, e.g., *In re Buildnet, Inc.*, No. 01-82293, 2002 WL 31103235, at *8 (Bankr. M.D.N.C. Sept. 20, 2002) (“[M]ost patent, trademark, technology and other intellectual property licenses are executory contracts.” (citing *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1045 (4th Cir. 1985) (*Richmond III*)).

¹²⁰ See, e.g., *Jacob Maxwell, Inc. v. Veeck*, 110 F.3d 749, 753 (11th Cir. 1997) (concluding implied non-exclusive license to use copyrighted material prevented infringement suit); *In re Access Beyond Techs., Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999) (citing *DeForest Radio Tel. & Tel. Co. v. United States*, 273 U.S. 236, 242 (1927)) (stating that refraining from suing the other party for patent infringement was a material obligation and the *raison d’etre* for a patent license).

¹²¹ Gleich Primoff & Weinberger, *supra* note 72, at 317 (citing *Andrews v. Riggs Nat’l Bank of Wash., D.C. (In re Andrews)*, 80 F.3d 906, 914 (4th Cir. 1996); *Encino Bus. Mgmt., Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.)*, 32 F.3d 426, 428 (9th Cir. 1994); *In re Constant Care Cmty. Health Ctr., Inc.*, 99 B.R. 697, 702 (Bankr. D. Md. 1989)).

¹²² Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 756–57 (2007); see, e.g., *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 264 (4th Cir. 2004) (holding that each party owed the continuing material duty to maintain the confidentiality of the source code developed by the other party under the license agreement).

¹²³ See, e.g., *In re Richmond Metal Finishers, Inc.*, 38 B.R. 341, 344 (E.D. Va. 1984) (*Richmond II*), *rev’d sub nom.*, *Richmond III*, 756 F.2d at 1045–47; *PlayMedia Sys. v. Am. Online, Inc.*, 171 F. Supp. 2d 1094, 1099 (C.D. Cal. 2001); *In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002); *In re Golden Books Family Entm’t, Inc.*, 269 B.R. 300, 311 (Bankr. D. Del. 2001); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997).

¹²⁴ See *Fawick v. Comm’r*, 436 F.2d 655, 662 (6th Cir. 1971) (citing S. REP. NO. 83-1622 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 5082–5883) (stating exclusive license agreements may be recognized as sales for tax purposes); *Golden Books Family Entm’t, Inc.*, 269 B.R. at 310.

typically only grants the licensee the permission to use the licensed intellectual property. The licensor usually retains the rights and remedies associated with ownership in the underlying intellectual property.¹²⁵ This grant of permission is considered personal to the individual licensee, and can be freely alienated without the licensor's consent.¹²⁶ The personal aspect stems from the licensor's reliance on the named licensee in negotiating the license terms such that substitution of the licensee would affect the substance of the agreement.¹²⁷

In *In re Richmond Metal Finishers*, the Bankruptcy Court for the Eastern District of Virginia held a technology license, which permitted the non-debtor licensee to use the debtor's metal-coating technology, to be an executory contract eligible for rejection by the licensor-debtor under § 365.¹²⁸ The debtor argued that interested potential licensees would be more eager to purchase its technology if the debtor was not obligated to permit the existing licensee to use the technology.¹²⁹ The debtor also argued that the non-exclusive license was an executory contract eligible for rejection because its efforts to license the technology were restrained by the existing license.¹³⁰

The licensee countered that the technology license was not executory because the debtor executed the agreement prepetition.¹³¹ However, the

¹²⁵ See *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996) (concluding non-exclusive patent is personal and, so, non-assignable without licensor's consent); *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986) (asserting non-exclusive licensee of patent does not possess property interest).

¹²⁶ Federal common law holds patent license agreements personal to the licensee and consequently non-assignable without the consent of the licensor. See *CFLC, Inc.*, 89 F.3d at 679; *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1093 (6th Cir. 1979) ("It has long been held by federal courts that agreements granting patent licenses are personal and not assignable unless expressly made so." (citing *Unarco Indus., Inc. v. Kelley Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972))). This same reasoning has been extended to prevent the assignment of non-exclusive copyright licenses absent the licensor's consent. See *PlayMedia Sys.*, 171 F. Supp. 2d at 1099 ("A non-exclusive licensee . . . has 'no right to re-sell or sublicense the rights acquired unless he has been expressly authorized to do so.'" (quoting *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333 (9th Cir. 1984))); *Valley Media, Inc.*, 279 B.R. at 135 ("A non-exclusive license of rights by a copyright owner to another party is not assignable by that party without the permission of the copyright holder under federal copyright law since the license represents only a personal and not a property interest in the copyright." (citing *Golden Books Family Entm't Inc.*, 269 B.R. at 309)); *Patient Educ. Media, Inc.*, 210 B.R. at 240-41 ("[T]he nonexclusive license is personal to the transferee, and the licensee cannot assign it to a third-party without the consent of the copyright owner." (citing *CFLC, Inc.*, 89 F.3d at 679)).

¹²⁷ *Bisk*, *supra* note 112, at 618-19.

¹²⁸ 34 B.R. 521, 526 (Bankr. E.D. Va. 1983) (*Richmond I*), *rev'd*, *Richmond II*, 38 B.R. 341 (E.D. Va. 1984), *rev'd sub nom.*, *Richmond III*, 756 F.2d 1043, 1045-47 (4th Cir. 1985).

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* at 523.

licensee had an ongoing obligation to account for and pay royalties to the debtor-licensor.¹³² The bankruptcy court held that these obligations were sufficient to make the contract executory.¹³³ Under the business judgment rule, the court was satisfied that the contract was executory and permitted the rejection.¹³⁴ The bankruptcy court was subsequently reversed by the district court.¹³⁵

On further appeal, the Fourth Circuit Court of Appeals reversed the district court and agreed with the bankruptcy court holding that the license was executory due to the debtor's continuing obligations to the licensee.¹³⁶ The licensee's ongoing duty was to account for and pay royalties.¹³⁷ The debtor's continuing obligations included (1) notifying the licensee of any infringement claims arising from the licensed technology; (2) defending the licensee in any such infringement suit; and (3) notifying the licensee of any additional licenses to third parties.¹³⁸

D. Software Licenses Are Executory Contracts

Most cases have determined software licenses to be executory contracts.¹³⁹ In *Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.)*, the Ninth Circuit Court of Appeals held that an exclusive software distribution and use license was an executory contract eligible for rejection.¹⁴⁰ The court reached this conclusion because the licensee was obligated to pay the debtor an annual fee for use of the software.¹⁴¹ Failure to make the annual payment would have

¹³² *Id.* at 524.

¹³³ *Id.*

¹³⁴ *Id.* at 525–26. The business judgment rule, which originated in *Otis & Co. v. Pa. R.R. Co.*, 61 F. Supp. 905 (E.D. Pa. 1945), holds directors, managers, and officers of a corporation free from liability for unprofitable business decisions so long as they exercised due diligence and the decision was entered into in good faith.

¹³⁵ *See id.* at 521, *rev'd*, *Richmond II*, 38 B.R. 341 (E.D. Va. 1984), *rev'd sub nom.*, *Richmond III*, 756 F.2d 1043, 1045–47 (4th Cir. 1985).

¹³⁶ *See Richmond III*, 756 F.2d at 1048.

¹³⁷ *Id.* at 1045–47.

¹³⁸ *Richmond I*, 34 B.R. at 522.

¹³⁹ *See Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.)*, 625 F.2d 290 (9th Cir. 1980); *In re Buildnet, Inc.*, No. 01-82293, 2002 Bankr. LEXIS 1851, at *99 (Bankr. M.D.N.C. Sept. 20, 2002); *Rudaw/Empirical Software Prods. Ltd. v. Elgar Electronics Corp. (In re Rudaw/Empirical Software Prods. Ltd.)*, 83 B.R. 241 (Bankr. S.D.N.Y. 1988); *In re Logical Software, Inc.*, 66 B.R. 683, 684 (Bankr. D. Mass. 1986). *But see* *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.)*, 66 F.3d 1091, 1095 (9th Cir. 1995) (holding the software “license” was a sale in substance and could not be found to be executory so as to bar assignment).

¹⁴⁰ 625 F.2d 290.

¹⁴¹ *Id.* at 292.

resulted in a breach of the contract. Additionally, the debtor was restricted from selling its software packages to other parties.¹⁴²

Similarly, in *In re Buildnet*, the court prohibited assignment of a non-exclusive software license without the licensor's consent because of the contract's personal nature.¹⁴³ Here, the customized development of the software for the customer supported the claim that the identity of the licensee was material.¹⁴⁴

I. EULAs Are Executory Contracts

EULAs contain continuing obligations for both the digital retailer and the consumer.¹⁴⁵ Consequently, these EULAs may be characterized as executory contracts.¹⁴⁶ EULAs are also non-exclusive licenses because they grant the same contractual permissions to several licensees through mass-market sales. Software is protected by copyright law.¹⁴⁷ As a result, within every software license, there is an underlying copyright license which is transferred to the licensee.¹⁴⁸

Typically, EULAs grant the licensee uninterrupted permission to access the content, subject to use and transfer restrictions.¹⁴⁹ Because EULA obligations govern for the life of the agreement, it is impossible for either party to fully perform at the outset. The mutual outstanding performance implicit in EULAs matches the elements of an executory contract.¹⁵⁰ Following this analysis, the license, as an executory contract, may be assigned under § 365(f) of the Code,

¹⁴² *Id.*

¹⁴³ 2002 Bankr. LEXIS 1851, at *13.

¹⁴⁴ *Id.* at *16–17.

¹⁴⁵ See, e.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

¹⁴⁶ See, e.g., *RCI Tech. Corp. v. Sunterra Corp (In re Sunterra Corp.)*, 361 F.3d 257, 264 (4th Cir. 2004) (the license was executory due to the continuing obligation of each party to keep the software source code confidential). *But see Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.)*, 66 F.3d 1091, 1095 (9th Cir. 1995).

¹⁴⁷ See *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240, 1249 (3d Cir. 1983) (“[A] computer program, whether in object code or source code, is a ‘literary work’ and is protected from unauthorized copying, whether from its object or source code version.”).

¹⁴⁸ See *Sunterra Corp.*, 361 F.3d at 262 & n.7 (stating that because the software at issue was registered with the United States Copyright Office, copyright law was the applicable nonbankruptcy law that would excuse acceptance of the assignment of the non-exclusive license in the case).

¹⁴⁹ See, e.g., *iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

¹⁵⁰ Countryman, *supra* note 64, at 460.

which permits assignment notwithstanding contractual restrictions on assignment.

E. Assignment of Intellectual Property Licenses

A trustee seeking to assign licensed digital goods must maneuver between the conflicting values of intellectual property and bankruptcy law. Intellectual property law holds that copyright licenses cannot be assigned without the copyright owner's consent.¹⁵¹ This policy is incorporated into § 365(c)(1) of the Code.¹⁵² This restriction is based on intellectual property law's fundamental policy to "encourag[e] the creation and disclosure of new, useful, and non-obvious advances in technology and design."¹⁵³ On the contrary, bankruptcy policy seeks to promote the free assignability of assets and contracts to maximize the value of the bankruptcy estate.¹⁵⁴

Intellectual property licenses, whether exclusive or non-exclusive, are analyzed in the same manner as any other executory contract in a bankruptcy case. If there are continuing material obligations owed by both parties, the license will be recognized as an executory contract.¹⁵⁵ Conversely, if the licensor has fulfilled its obligations under the license and there are no longer any material mutual obligations, the license is not executory.¹⁵⁶ If the license is not executory, then it is not governed under § 365.

Whether the debtor possesses title or a license is essential for determining if a contract is executory. If title has been transferred and there are no other obligations under the contract, then the contract is not executory.¹⁵⁷ As a result, § 365 is inapplicable.¹⁵⁸ Instead, the digital good is owned by the debtor and is

¹⁵¹ David R. Kunej, *Intellectual Property Law in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 AM. BANKR. INST. L. REV. 593, 594 (2001).

¹⁵² See 11 U.S.C. § 365(c) (2012).

¹⁵³ *Everex Sys., Inc. v. Cadtrak Corp (In re CFLC Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996) (quoting *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 150–51 (1989)).

¹⁵⁴ 4 COLLIER ON BANKRUPTCY, *supra* note 17, at ¶ 506.03[6][a][ii] ("[T]he policy of maximizing the value of the debtor's bankruptcy estate").

¹⁵⁵ See, e.g., *Otto Preminger Films, Ltd. v. Quintex Entm't, Inc. (In re Quintex Entm't, Inc.)*, 950 F.2d 1492, 1495 (9th Cir. 1991) ("[W]e will only consider a contract executory if material unperformed obligations remain for *both* parties."); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 242–43 (Bankr. S.D.N.Y. 1997).

¹⁵⁶ *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.)*, 66 F.3d 1091, 1093 (9th Cir. 1995).

¹⁵⁷ *Id.* at 1095–96.

¹⁵⁸ Kunej, *supra* note 151, at 604.

property of the bankruptcy estate. As such, it is eligible for liquidation by the trustee.

Within the Code, the default rule is that prepetition contracts are assets of the bankruptcy estate and may be assigned subject to limitation.¹⁵⁹ In § 365(c), one such limitation prevents a contract from being assigned if applicable law excuses a non-debtor party from accepting or rendering performance to anyone other than the debtor when the debtor's performance is material.¹⁶⁰ This limitation is referred to as the "materiality" test.¹⁶¹ The materiality test is most applicable to personal services contracts.¹⁶² As an example, imagine a concert agency that contracts with a famous pop singer to perform on stage. The singer could not assign her contractual obligation to perform to another individual because the services are personal in nature.¹⁶³

In *In re Patient Education Media, Inc.*, the Bankruptcy Court for the Southern District of New York held that the federal common law of non-assignability prevented the transfer of a copyright license in bankruptcy.¹⁶⁴ The debtor's assets included photographic images that had been included in an educational film it acquired through a non-exclusive copyright license with a photographer.¹⁶⁵ Upon filing, the debtor attempted to sell its rights to the videotapes. The photographer objected and argued that, under copyright theory, the license was "personal" and not freely assignable.¹⁶⁶

The court ruled for the photographer.¹⁶⁷ First, the court distinguished between exclusive and non-exclusive licenses, stating that under a non-

¹⁵⁹ See 11 U.S.C. § 365(f)(1) (2012) ("Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease . . .").

¹⁶⁰ *Id.* § 365(c)(1)(A).

¹⁶¹ Kuney, *supra* note 151, at 606–07.

¹⁶² Kuney, *supra* note 151, at 630 (noting that some courts have viewed § 365(c) as intending to "protect the non-debtor party from an assignment where the identity of the party providing performance is material").

¹⁶³ This example is borrowed from Kuney, *supra* note 151, at 630 ("It seems almost beyond debate that rock stars cannot assign their contracts, inside or outside of bankruptcy because the identity of the performer is material.").

¹⁶⁴ 210 B.R. 237, 242–43 (Bankr. S.D.N.Y. 1997).

¹⁶⁵ *Id.* at 239.

¹⁶⁶ *Id.* at 240.

¹⁶⁷ *Id.* at 243.

exclusive license, ownership remains with the licensor.¹⁶⁸ Second, the court concluded that a non-exclusive copyright license is generally an executory contract governed by § 365.¹⁶⁹ Lastly, the court looked to analogous patent cases and held that the debtor could not sell the videotapes because the sale would be an assignment of the copyright license without the requisite consent of the licensor.¹⁷⁰

In its conclusion, the court recognized the conflicting interests of bankruptcy law and intellectual property law in stating, “Although the assignment of the . . . license will maximize the assets available to creditors, this goal must give way to the countervailing considerations expressed in § 365(c).”¹⁷¹

The court should not have looked to federal common law in determining the assignability of the executory contract.¹⁷² The court was dealing with a copyright license, not a patent governed by federal law. Instead, state law should have been the applicable law under § 365(c) as state law typically determines contract rights.¹⁷³

1. Section 365(f) Permits Assignment of Software Licenses

EULAs classify their underlying licenses as non-exclusive.¹⁷⁴ Courts have consistently held non-exclusive copyright licenses like EULAs non-assignable without the consent of the licensor if the license explicitly restricts assignment.¹⁷⁵ Courts look to the personal nature of non-exclusive copyright

¹⁶⁸ *Id.* at 240–41 (contrasting between an exclusive license under which a licensee “may freely transfer his rights” with a non-exclusive license in which “the licensee cannot assign it to a third-party without the consent of the copyright owner”).

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 242–43 (“Because federal law governs the assignability of nonexclusive patent licenses, and because federal law makes such licenses personal and assignable only with the consent of the licensor, the . . . license is not assumable and assignable in bankruptcy under 11 U.S.C. § 365(c).” (quoting *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986))).

¹⁷¹ *Id.* at 243.

¹⁷² *Contra id.* at 242.

¹⁷³ *Cf. Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 739 (Cal. 1957) (“We can find no policy underlying the federal patent statutes that requires a uniform federal rule of construction of license contracts to determine their assignability.”) *But see id.* at 242 (“Ordinarily, a court will apply state contractual law to disputes concerning the scope of a copyright license. State contractual law will yield, however, to an overriding federal law or policy.” (citations omitted)).

¹⁷⁴ *See, e.g., iTunes Store: Terms and Conditions*, *supra* note 44; *Kindle Store Terms of Use*, *supra* note 44; *Steam Subscriber Agreement*, *supra* note 44.

¹⁷⁵ *See SQL Solutions, Inc. v. Oracle Corp.*, No. C-91-1079, 1991 WL 626458, at *5–6 (N.D. Cal. Dec. 18, 1991).

licenses as the basis for holding them non-assignable under § 365(c).¹⁷⁶ However, the personal nature of a contract is not “self-evident” but should be determined by the purposes and provisions of each particular contract.¹⁷⁷ Section 365(f) of the Code provides an exception to § 365(c) by permitting assignment of executory contracts notwithstanding an anti-assignment provision in the contract.¹⁷⁸

The key issue in assigning digital goods is whether the assignment involves the transfer of personal, non-assignable rights or the assignment is more akin to a commodity in which the personal nature of the transferee is immaterial. In these mass-market commodity transactions, the personal nature of the performance aspect is absent. The EULAs are not negotiated between the parties and the licensee’s identity is not material to the license’s terms. Consequently, assumption and assignment of digital goods and their governing EULAs are not barred by § 365(c). As a result, § 365(f) allows a trustee to assign digital goods to a third-party even if the contract expressly restricts assignment.¹⁷⁹

CONCLUSION

For over a hundred years, books, films, and records have been freely gifted, loaned, rented, and sold by their purchasers under the first-sale doctrine. This freedom has resulted in the uninhibited flow of information and the creation of innovative business models to the benefit of society. As the world converts to a digital landscape, these personal effects—our favorite books, music, movies, and videogames—will vanish into bits and bytes.

Currently, these digital forms are not eligible for resale under the first-sale doctrine. This restraint inhibits alienability of goods, consumer freedom, and innovation potential. This transfer restriction is the result of the digital retailers’ classification of the underlying transactions as licenses rather than sales. Courts have traditionally supported software distributors by applying a form-over-substance analysis, in which the words of the agreement trump the economic realities of the transaction. Instead, courts should strongly consider recognizing the transaction as a sale, in which title of the copy is transferred

¹⁷⁶ Neil S. Hirshman et al., *Is Silence Really Golden? Assumption and Assignment of Intellectual Property Licenses in Bankruptcy*, 3 HASTINGS BUS. L.J. 197, 202 (2007).

¹⁷⁷ *Farmland Irrigation Co.*, 308 P.2d at 740.

¹⁷⁸ 11 U.S.C. § 365(f) (2012).

¹⁷⁹ *Id.*

from the distributor to the consumer. In doing so, the consumer would be vested with the requisite ownership rights to legally resell the copy under the first-sale doctrine.

Should courts not recognize digital goods transactions as sales, § 365(f) of the Code, which permits assumption and assignment of executory contracts notwithstanding anti-assignment provisions, provides an alternative method for reselling digital copies in chapter 7. Further, § 365(c)'s assignment limitation should be limited to personal contracts and not digital goods.

As digital goods comprise an ever-growing proportion of debtors' assets, permitting trustees to assign access and use of digital goods is essential to maximizing the value of the estate. The benefits of this solution extend beyond the bankruptcy context. Freeing these digital goods from the grasp of licensors will maximize their value to society and promote the free flow of information.

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