

New York Law Journal

CORPORATE RESTRUCTURING AND BANKRUPTCY

Monday, March 5, 2007

ALM

Recording Artists, Beware!

A recent ruling permits sale of copyrights free and clear of royalty obligations.

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RECORD COMPANIES have long despised the use of bankruptcy by recording artists seeking to redo their record deals or to sign new ones with competing labels by rejecting their existing deals or threatening to do so. Well, bankruptcy just got more appealing to those same record companies, as a result of the Eleventh Circuit's recent decision in *Thompkins v. Lil' Joe Records, Inc., et al.*¹

In *Thompkins*, the Eleventh Circuit concluded that, through a bankruptcy of an artist's record company, the artist's copyrighted materials that were owned by the record company—e.g., recorded music and related music publishing rights—could be sold by the record company free and clear of any obligation to pay the artist royalties for the buyer's ongoing exploitation of the copyrighted materials.

We suspect it is antithetical to many in the music industry that the right to exploit an artist's copyrighted materials is capable of

being divorced from the obligation to pay the artist royalties. And, it is for that very reason that *Thompkins* is of such interest and potential significance to record labels and their artists.

The Facts in 'Thompkins'

In 1989, Jeffrey J. Thompkins, a rap artist known as "JT Money," signed a five-year exclusive recording agreement with the predecessor to Luke Records, Inc., a rap label founded by a member of the South Florida-based rap group 2 Live Crew.

Pursuant to the recording agreement, Thompkins, among other things, conveyed to Luke Records "exclusive, unlimited and perpetual rights throughout the world" to the copyrights "in sound recordings (as distinguished from the musical compositions embodied thereon) recorded by [Thompkins] during the [t]erm."²

In exchange therefore, Luke Records agreed to pay Thompkins royalties according to certain specified rates. During the five-year term of the contract, Thompkins recorded three albums as part of the group called "Poison Clan."

On March 28, 1995, after the term of the recording agreement expired, an involuntary bankruptcy petition was filed under Chapter 7 of the Bankruptcy Code against Luke Records. The case was subsequently converted to Chapter 11 and procedurally consolidated with the Chapter 11 case of Luke Records' founder, Luther Campbell.

In March 1996, the bankruptcy court approved Luke Records' and Campbell's joint plan of reorganization. Pursuant to this plan, Luke Records sold certain specified assets, including "[a]ll worldwide rights to the masters...owned or controlled by Luther Campbell or Luke Records" and "[a]ll worldwide copyrights and/or publishing interests held by Luther Campbell, Luke Records, Inc., or Pac Jam Publishing" to Lil' Joe Records, Inc. and its owner, Joseph Weinberger.³

Significantly, the assets, which included Luke Records' rights in and to Thompkins' recordings, were sold "free and clear of any and all liens, claims, encumbrances, charges, setoffs, or any recoupments of any kind, and... free and clear of any interest in such property of an entity other than [Luke Records]."⁴

The joint plan further provided that all executory contracts that were not otherwise disposed of prior to confirmation of the joint plan were deemed rejected, pursuant to §365 of the Bankruptcy Code. Luke Records' exclusive recording agreement with Thompkins was among the contracts that were rejected.

Pursuant to the bankruptcy court's order approving the joint plan, counterparties to rejected contracts, including Thompkins, were given 30 days to file a claim for damages in Luke Records' Chapter 11 case. Thompkins never filed such a claim.

Almost six years later, on March 5, 2002, Thompkins sued Lil' Joe Records, Lil' Joe Wein Music, Inc., and Weinberger (collectively, "Lil' Joe") in the U.S. District Court for the Northern District of Georgia for, among

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other things, copyright infringement, or alternatively, breach of contract.⁵

Specifically, *Thompkins* asserted that, as a result of Luke Records' rejection of the exclusive recording agreement almost six years earlier, ownership of the copyrights he transferred to Luke Records under that agreement reverted back to him; consequently, Lil' Joe's exploitation of those copyrights infringed on *Tompkins'* rights therein.

In the alternative, *Thompkins* asserted that Lil' Joe's ownership of the copyrights brought with it an obligation to pay royalties to *Thompkins* for Lil' Joe's ongoing exploitation of those copyrights. By failing to pay such royalties, *Thompkins* asserted that Lil' Joe was in breach of its obligations to *Thompkins*.

Eleventh Circuit Affirmed

The Eleventh Circuit affirmed the district court's summary judgment grant in favor of the defendants.

The court easily dismissed *Thompkins'* first point—that copyright ownership reverted to him upon Luke Records' rejection of the recording agreement—because it is well established that rejection, while a material breach, is not the functional equivalent of a rescission. Where property—here, copyrighted material—is acquired by a bankrupt debtor pursuant to a pre-bankruptcy executory contract, rejection “does not obligate the debtor to return the property.”⁶

What is more significant, though, is the Eleventh Circuit's ruling on *Thompkins'* second point—that is, that a buyer cannot purchase a copyright without assuming the concomitant obligation to pay royalties for its use of the copyright. Here, the Eleventh Circuit held that in bankruptcy it is possible to sever the obligation to pay royalties from the ownership of the copyright.

This latter holding in this case stands in stark contrast to the Second Circuit's much earlier decision in *Fain v. Irving Trust Co.* (*In re Waterson, Berlin & Snyder Co.*).⁷ *Waterson* involved the bankruptcy of a music publisher that, prior to its bankruptcy, had purchased from the plaintiffs musical compositions, including words and music, all of which were identical except as to royalty and advance rates.

The receiver for the bankrupt music publisher sought to sell all of the music publisher's right, title and interest in the copyrights for the songs free from royalty claims. The plaintiffs objected to any sale free and clear of their royalty rights and sought an

order directing the receiver to reassign the copyrights to them, or, in the alternative, to sell the copyrights subject to the plaintiffs' continued right to receive royalties.

On appeal from the district court's decision to rescind the publishing contracts and reassign the copyrights to the plaintiffs, the Second Circuit ruled that a rescission was inappropriate. The court further concluded that the receiver or trustee in bankruptcy was authorized to sell the copyrights for the benefit of the bankrupt's creditors.

Importantly, though, the Second Circuit held that “while the copyrights may be sold by the trustee, they should be sold *subject to* the right of the composers to have them worked in their behalf and to be paid royalties according to the terms of the contracts.”⁸ In other words, the buyer of the copyrights would have to work them and pay over to the composers any royalties accruing after the sale.

Why the divergence between the Eleventh and Second Circuits? Because, according to the Eleventh Circuit, the court in *Waterson* was concerned that, unless the artist's royalty rights travelled with the copyrights, the artist would be deprived of the only means of compensation he had been promised.

In the Eleventh Circuit's view, what differs in *Thompkins* is that the Bankruptcy Code, which did not exist in its present form until 1978, well after *Waterson* was decided, expressly provides the artist with the right to assert a pre-petition damage claim against the bankrupt recording company for unpaid future royalties. Thus, according to the Eleventh Circuit, “the author-assignor is not left completely without recourse in the event that his original copyrights, transferred in consideration of future royalties, are later sold to a third party out of the debtor-assignee's estate, free and clear of royalty obligations due to the rejection of the original copyright transfer/royalty agreement.”⁹

Unfortunately for *Thompkins*, he did not avail himself of the right to file a damage claim.

Implications of Ruling

At least one implication of *Thompkins* is obvious, and that is that recording artists must be vigilant in protecting their rights in the event their record label files for bankruptcy.

It is unclear from the Eleventh Circuit's decision whether such vigilance on the part of *Thompkins* would have altered the outcome; however, at the very least, artists should follow carefully the treatment of their recording contract and, if it is rejected, file a claim for damages.

The implications of the *Thompkins* decision from the record label's perspective can be summed up as follows:

(1) A record label that suffers from financial distress and its creditors should carefully consider bankruptcy as a means of maximizing value through a sale of the label's music catalogue free and clear of claims for ongoing artist royalties; and

(2) An acquisitive music label may use bankruptcy opportunistically to acquire and subsequently exploit copyrighted music free and clear of the obligation to pay royalties.

Of course, many record labels may be reluctant not to pay royalties out of concern for artists or for reputational or other practical business reasons. Nevertheless, one can imagine a situation in which the acquiring label is interested solely in an artist's prior recordings or circumstances involving so-called “one-hit wonders,” where the benefits of acquiring the artist's existing repertoire free of any obligation to pay royalties outweighs the reputational or other costs of doing so.

Additionally, a record label could use the specter of a “free and clear” transaction to renegotiate the terms of the artist's existing recording contract.

By providing record labels with this flexibility and leverage, *Thompkins* represents a clear bankruptcy win for the labels.



1. 2007 WL 316302 (11th Cir. Feb. 5, 2007).

2. 2007 WL 316302 at *1.

3. 2007 WL 316302 at *3.

4. *Id.* at *4, n.18.

5. The case was subsequently transferred to the U.S. District Court for the Southern District of Florida.

6. 2007 WL 316302 at *8.

7. 48 F.2d 704 (2d Cir. 1931).

8. 48 F.2d at 710 (emphasis added).

9. 2007 WL 316302 at *12. Of course, in the many cases where unsecured creditors receive only cents on the dollar for their claims, the damage claim is worth far less than the ongoing right to receive royalties from a third-party buyer of the debtor's assets.