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Intellectual Property

A Question of Jurisdiction

Should copyright contract breaches be filed in federal or state courts?

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Consider the following scenario: Your client created a design two years ago that she believed had great commercial potential. She registered the work with the U.S. Copyright Office and started to look for commercial outlets for the print.

Licensee Co. of Paramus visited the client's home/studio in Piscataway, saw the design and agreed with the client's assessment of its commercial potential. After negotiations with Licensee Co. and other interested companies, your client granted Licensee Co. a three-year exclusive license to reproduce the design on boxes and wrapping paper. Licensee Co. agreed to pay the client an initial upfront fee and royalties based on sales revenues throughout the three-year term of the license. The client received her initial fee and all royalties due in the 20 months of the license term.

Two months ago, however, Licensee Co. missed a royalty payment.

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Last month's check also failed to arrive. The client is in your office demanding fast action. She says Licensee Co.'s license is terminated because of its failure to pay and that the company is infringing copyrighted work. Client wants Licensee Co. to stop selling the products with the design. In fact, she wants Licensee Co. to pull all such products from distribution, including those already on retail store shelves, and to destroy all products it has in inventory with the design.

Do you file *Client v. Licensee Co.* in federal court with an order to show cause seeking injunctive relief or do you file a contract action in state court?

The threshold issue in this fact pattern — whether federal jurisdiction exists when a party with contractual rights to another's copyrighted material breaches the agreement — has given the courts a surprising level of difficulty. Some cases grant plaintiffs under these circumstances access to federal court and the full panoply of rights and remedies under the federal Copyright Act, 17 U.S.C. § 101 et seq. These include injunctive relief, impoundment and destruction of infringing articles, actual or statutory damages and attorneys' fees. Other cases, however, have rejected federal jurisdiction in this circumstances. They treat these cases as “gar-

den variety” contract claims arising under state law.

This article will examine these lines of cases and the circumstances that may influence courts in reaching a conclusion favoring or rejecting jurisdiction.

The Copyright Act and Federal Jurisdiction

The U.S. Constitution expressly grants Congress the power to grant copyright and patent protection “by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” U.S. Const. Art. 1, § 8, cl. 8. Congress first granted protection to copyrights as early as 1819.

In its current configuration, the Copyright Act grants protection to “original works of authorship fixed in any tangible medium of expression,” including literary works, musical works, pictorial, graphic and sculptural works, motion pictures and sound recordings. 17 U.S.C. § 102. The act grants authors of copyright protected works the exclusive rights to reproduce the works, to make derivative works from the work and to distribute copies of the work to the public, among other rights. 17 U.S.C. § 106 et seq. Congress has provided that the Copyright Act pre-

empties "all legal or equitable rights that are equivalent to any of the exclusive rights" of the act. 17 U.S.C. § 301.

Federal courts have jurisdiction over infringement claims arising under the Copyright Act as a result of the general grant of jurisdiction over federal questions. 28 U.S.C. § 1331. Congress' view that protection of copyrights deserves special federal attention is reflected in its enactment of 28 U.S.C. § 1338(a), which grants *exclusive* jurisdiction "of any civil action arising under any Act of Congress relating to ... copyrights" to the federal courts. In fact, federal court jurisdiction over copyright claims predates the general grant of federal question jurisdiction to the federal courts.

Copyright vs. Contract: Federal vs. State Jurisdiction

The prototypical copyright claim arises when an author or artist creates a work and a stranger sells "knockoffs" to the public. Our hypothetical, however, posits another common circumstance. Authors and artists often commercialize their copyrighted works by assigning or licensing their rights to others for a fee. These agreements authorize by contract what would otherwise constitute an infringement of the copyright.

The decision whether a breach of this contract gives rise to a copyright or merely a state contract claim determines (unless diversity jurisdiction exists) whether the author/artist can pursue the claim in federal court. It also determines whether the formidable arsenal of federal copyright remedies will be available or whether the author/artist will be relegated to state law contract claim remedies.

The U.S. Supreme Court has yet to establish a framework for this issue in the copyright field. The leading case is from the Second U.S. Circuit Court of Appeals. *T.B. Harms Co. v. Eliscu*, 339 F.2d 823 (1964), cert. denied, 381 U.S. 915 (1965). *T.B. Harms* involved a dispute over title to the copyrights in four songs. Eliscu claimed the right to receive royalties from exploitation of the songs, and T.B. Harms Co. sued for a declaration that Eliscu had no such rights.

The Second Circuit held that no

federal jurisdiction existed. Not all claims that refer to the Copyright Act or that affect title to or the value of a copyright arise under the Copyright Act, according to the decision.

The court said that a contract-related claim relating to copyright arises under the Copyright Act if the complaint seeks "a remedy expressly granted by the Act, e.g., a suit for infringement ... or asserts a claim requiring construction of the Act ... or, at the very least and perhaps more doubtfully, presents a case where a distinctive policy of the Act requires that federal principles control the disposition of the claim." *Id.* at 828. The court continued: "The general interest that copyrights, like all other forms of property, should be enjoyed by their true owner is not enough to meet this last test." *Id.* ...

The opinion relied on a series of venerable Supreme Court cases limiting federal jurisdiction in patent-related cases arising from a contract breach. That was an apt close analogy, since federal jurisdiction over patent cases springs from the same statute as copyright cases, 28 U.S.C. § 1338(a).

Although widely cited, *T.B. Harms* did not put an end to the jurisdictional uncertainties in our hypothetical and similar cases involving a breach of a contract pertaining to copyrighted works. In fact, the case has spawned two rather different approaches to the breached license agreement scenario. Both claim fidelity to the Second Circuit's analysis.

One line of cases has strived to weed out "garden-variety contract disputes" masquerading as copyright claims. That was the First Circuit's approach in *Royal v. Leading Edge Products, Inc.*, 833 F.2d 1 (1st Cir. 1987). This case involved a software company whose former employee claimed entitlement to royalties on software he had developed under a separate royalty agreement that he claimed took him out of the "work-for-hire doctrine." That doctrine provides that the employer owns the copyright in a work prepared by the employee within the scope of employment absent a written agreement to the contrary. 17 U.S.C. §§ 101, 201(b).

The employee claimed that the employer's breach of the royalty agree-

ment by nonpayment of royalties entitled him to rescind the agreement and restored copyright ownership to him. The First Circuit held that the employee's case was nothing but a contract dispute that, if the employee prevailed, would entitle him to damages. The court declined to exercise jurisdiction, notwithstanding the employee's "heroic efforts to costume" the case as a copyright action.

A few years after *Royal*, the Second Circuit attempted to create an analytical framework for deciding when a copyright claim was really a state contract claim over which federal jurisdiction was lacking. In *Schoenberg v. Shapolsky Publishers, Inc.*, 971 F.2d 926 (2d Cir. 1992), the court set forth a three-part test to determine whether an alleged copyright infringement claim arising from a breached contractual relationship arises under the Copyright Act and affords federal jurisdiction.

Under *Schoenberg*, the court analyzed whether the infringement claim is "incidental" to a determination of the parties' contractual rights; whether the contractual provision allegedly breached was a condition precedent to the licensee's rights (in which case the licensee's contract rights to use the copyrighted work would not arise at all); and whether the contract breach was so substantial as to give the copyright owner the right to rescind any rights granted under the license.

Schoenberg's test was not easy to satisfy. The cases tended to view nonpayment of a portion of the license fee as insufficient to grant a rescission right unless the failure to pay was virtually complete. The result was that infringement claims arising from alleged contract breaches — especially nonpayment of license fees — had difficulty avoiding dismissal from federal court.

The Second Circuit pendulum, however, has now swung toward a more hospitable approach to federal jurisdiction in these cases. Earlier this year, in *Bassett v. Mashantucket Pequot Tribe*, the Second Circuit abandoned the *Schoenberg* test. 204 F.3d 343 (2d Cir. 2000). *Bassett* holds that "[w]hen a complaint alleges a claim or seeks a remedy provided by the Copyright Act, federal jurisdiction is properly invoked."

The *Bassett* court said that it was returning to the *T.B. Harms* framework, and it criticizes *Schoenberg's* "incidental" framework as a vague and unworkable. The court appeared particularly concerned that under *Schoenberg*, decisions over subject matter jurisdiction, which are typically decided early in the case before the facts are fully developed, were limiting copyright plaintiffs to contract remedies rather than the broader range of remedies afforded by the Copyright Act.

Third Circuit Precedent

The Third Circuit has not directly addressed the jurisdictional issue raised by *Client v. Licensee Co.* District court decisions in this circuit and an analogous case in the patent area, however, make it less likely that the case would survive a jurisdictional challenge in the district of New Jersey than it would, for example, in New York.

In *Wagner v. B.C. Wagner Group, Inc.*, 1990 WL 198104 (E.D. Pa. 1990), and *Wolfe v. United Artists Corp.*, 583 F. Supp. 52 (E.D. Pa. 1983), for example, the district court dismissed claims that purported to arise under the Copyright Act for lack of subject-matter jurisdiction. In both cases, the court construed claims concerning alleged copyright infringement as stating contract breaches only. Both cases relied on *T.B. Harms*.

This line of cases dates back at least to 1879 in this circuit. In *Haworth v. Nystrom*, 11 F. Cas. 885 (E.D. Pa. 1879), the plaintiff sought injunctive relief for copyright infringement based on whether a copyright had been assigned under a revision of the parties' agreement. The court wrote: "The question, though nominally about a copyright, is really whether the original contract was changed."

The closest the Third Circuit has come to addressing the issue appears to be *The Clausen Co. v. Dynatron/Bondo Corp.*, 889 F.2d 459 (3d Cir. 1989), cert. denied, 495 U.S. 933 (1990). This decision involved a patent holder's claim that a defendant in a previous infringement action had breached a settlement agreement requiring it to pay a royalty for each infringing article the defendant sold after the date of the settlement agreement. After the alleged infringer

filed for bankruptcy protection, the patent holder filed a proof of claim to collect the royalty.

The Third Circuit held that the claim did not arise under the patent laws. Rather, it was for enforcement of the settlement agreement. The court relied heavily on the Supreme Court holding in *Luckett v. Delpark, Inc.*, 270 U.S. 496 (1926), in which the plaintiff pleaded both a patent infringement claim based on a licensee's breach of a license agreement and a breach of contract claim.

In *Luckett*, the high court held that if the plaintiff seeks damages or other relief under the license agreement — including asking the court to rule that the license is forfeited by the breach — the case does not arise under the patent laws. That is so, the Court held, even if the patent holder also seeks relief based on infringement of the patent.

Clausen and Luckett offer guidance for *Client v. Licensee Co.*, even though they are patent rather than copyright cases. Both patent and copyright cases enjoy a grant of exclusive federal jurisdiction under the same statute, 28 U.S.C. § 1338(a). Patent cases construing the "arising under" language should therefore be instructive in copyright cases as well. Indeed, the Second Circuit relied in part on *Luckett* when it decided *T.B. Harms*.

The Final Analysis

So, is there federal jurisdiction in *Client v. Licensee Co.*? As is hopefully apparent by now, the answer to the question whether your federal district court complaint will survive a motion to dismiss for lack of subject-matter jurisdiction is maybe. Several factors will shape the answer.

Perhaps the most important factor is venue. The Second Circuit has now placed itself in the pro-jurisdiction camp. In the Third Circuit, however, the court is much more likely to parse the complaint and decide whether the essence of the dispute sounds in contract or copyright.

A second factor is how you draft the complaint. As *Luckett* reflected, the draftsman may truly be the master of the complaint's federal fate. A complaint that relies solely on the Copyright

Act is more likely to survive a jurisdictional challenge than a complaint that also asserts state contract claims. However, forgoing the state claim to improve the chances of federal jurisdiction may have its own pitfalls.

A third factor is whether resolution of the contract issue will fully dispose of the case. If, for example, Licensee Co. is selling goods bearing an exact copy of your client's print and simply asserts contractual defenses to nonpayment (perhaps there is a claim of offset arising from another part of the business relationship, for example), the federal court is more likely to decline jurisdiction. On the other hand, if copyright law issues will also affect the outcome — for example, if the Licensee Co. is marketing a somewhat different design that the client says is a derivative work of her design — the federal court is more likely to assume jurisdiction.

Conclusion

The Second Circuit's opinion in *T.B. Harms* approached formulation of a rule for federal jurisdiction in these hybrid copyright/contract cases with trepidation, terming the area "treacherous." That characterization remains apt.

Resolution of the question whether federal jurisdiction exists, moreover, may not end the difficulties. Even if the court affirms *jurisdiction* because the complaint asserts infringement and seeks relief under the Copyright Act, the plaintiff might still be held upon resolution on the merits to have stated a contract, rather than a copyright, claim.

Returning to *Client v. Licensee Co.*, the client's infringement claim is based on Licensee Co.'s failure to make payment. The client asserts, in essence, that Licensee Co. is infringing because it has forfeited its contractual rights to reproduce her work.

Whether Licensee Co.'s failure to pay actually works a forfeiture of those rights or merely gives your client a cause of action for damages, however, is a question that must be determined by reference to state contract law. The Second Circuit's framework in *Schoenberg* may still have vitality in determining this question, even though that court has abandoned it as a test for jurisdiction. That decision suggests that

forfeiture of the licensee's contract rights would occur if continuing payment was a condition precedent to Licensee Co.'s license rights. Forfeiture would also occur if Licensee Co.'s breach is sufficiently substantial to give the client a right of rescission under state contract law.

Even if the federal court assumes

jurisdiction based on the facial assertion of claims under the Copyright Act, therefore, it could still conclude that Licensee Co.'s nonpayment does not give rise to an infringement claim. That conclusion would relegate your client to contract law remedies. A complaint drafted too carefully to claim federal jurisdiction, therefore, could result in a

failure to plead a state law claim that is the client's only avenue for relief.

For the draftsman of a copyright license, that suggests it is still wise to make payment a condition to the licensee's continued license rights. For the litigator, there remain dangerous shoals to navigate in the hybrid copyright/contract case. ■