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Prohibiting the Assignment of a License Contract – Who is Keeping the Faith?

ALAN TRACEY†

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† Mr. Alan Tracey received dual B.S. degrees in Production Operations and Procurement from Bowling Green State University. Mr. Tracey received his J.D. from The Ohio State University School of Law in 1994 and has been practicing law in the state of California since 1994. This is his second published article.

ABSTRACT

The recent Sixth Circuit case of *Cincom Systems v. Novelis Corp.* has commentators foreseeing the potential for copyright infringement on a massive scale. In *Cincom*, a simple corporate reorganization caused a "non-transferrable" software license to be transferred from one sister company to another. This Article provides an overview of the federal law governing the transfer of license contracts, and describes how the covenant of good faith and fair dealing may provide a sensible scheme to determining when a license contract may be reasonably transferred.

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I. INTRODUCTION

A legal maxim states, "The contract makes the law."[1] In the case of a license contract, however, it is not the contract that makes the law. Take, for example, a contract that does not include an express prohibition on the transfer of that contract. In such a case, the law reads into the contract a prohibition against that transfer.[2] While the legal maxim may state that "[t]he contract makes the law," when it comes to assignability of copyrighted works, the law will make the contract. Another legal maxim is, "An action is not given to him who has received no damage."[3] As logical as this sounds, when it comes to the transfer of a license contract, federal courts have ruled that even when the licensor has suffered no actual damage, the licensor has an action for "hypothetical" damages.[4] Cases such as the Sixth Circuit case of *Cincom Systems v. Novelis Corp.*[5] have commentators foreseeing the potential for copyright infringement on a massive scale, simply by application of federal law to a common corporate reorganization.[6] In Part II, this Article provides an overview of the federal law that governs the transfer and assignment of license contracts. Then, in Part III, this Article contrasts the rules established by the federal courts as applied to the transfer of license contracts

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[1] Richard Anthony, *Maxims of Law*, http://ecclesia.org/truth/maxims.html (last visited Jan. 2, 2015).

[2] *See infra* Part III (covering the restrictions as to assigning or transferring a license contract).

[3] Anthony, *supra* note 1 ("Maxims are but attempted general statements of rules of law and are law only to the extent of application in adjudicated cases.").

[4] *See infra* notes 126–140 and accompanying text.

[5] Cincom Sys., Inc. v. Novelis Corp., 581 F.3d 431 (6th Cir. 2009).

[6] Steven Seidenberg, *Unintentional Infringement: Software Infringement Suits on the Rise,* INSIDE COUNSEL (Jan. 1, 2010), http://www.insidecounsel.com/2010/01/01/unintentional-infringement.

against the normal freedom of parties to transfer commercial contracts, and also summarizes the damages available to an intellectual property owner if a license contract is transferred. Finally, Part IV provides a summary of the covenant of good faith and fair dealing, describing how its application provides a sensible scheme to determining when a license contract may be transferred without a cause of action, and urging commentators and advocates to further review the application of the duty of good faith and fair dealing to intellectual property licenses.

II. INTELLECTUAL PROPERTY AND ITS IMPORTANCE TO THE INFORMATION ECONOMY

A. An Overview

Over the past several decades, intellectual property has taken on an increasingly large role in the global economy. Virtually everyone is a user or a potential creator of intellectual property. Similarly, everyone has a vested interest in seeing that intellectual property protected. For example, a recent World Economic Forum Global Competitive Report indicates a correlation between the protection of intellectual property rights in a country and the overall economic competitiveness of that country.[7] Indeed, much of the value of the world's leading

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[7] INT'L CHAMBER OF COM., INTELLECTUAL PROPERTY: SOURCE OF INNOVATION, CREATIVE, GROWTH AND PROGRESS 1, 7 (August 2005), *available at* http://www.iccwbo.org/advocacy-codes-and-rules/bascap/value-of-ip/innovation,-creativity,-growth-and-progress (citing World Economic Forum, Global Competitiveness Report 2004-5). This Article urges the protection of intellectual property rights worldwide in each country's self-interest, using examples such as Korea, which had a per capita income of less than $100 in the 1960s and transformed to a highly industrialized country with a per capita income of $12,000 today. *Id.* at 9 (citing Chulsu Kim, Keynote Address at the WIPO/KIPO Ministerial

companies resides in their portfolios of intangible assets.[8] As of the creation of this Article, two of the three most valuable companies in the world, Apple and Microsoft, are in the technology business, which heavily relies upon the creation and protection of intellectual property rights.[9]

B. Intellectual Property Laws in the Knowledge Economy

The body of laws which protect intellectual property is the subject of this Article, and more specifically, the laws of copyright and patent and the rules of contract interpretation which frame the license of copyrightable and patentable works. The Intellectual Property Clause of the U.S. Constitution succinctly and directly expresses the motivation behind patent and copyright law by authorizing Congress "[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[10] The Supreme Court has explained that this clause of the U.S. Constitution was designed to "advance public welfare through the talents of

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Conference on Intellectual Property for Least Developed Countries: Integrating Intellectual Property into the National Development Policy: The Korean Experience).

[8] *See* Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 735 (2007). Mennel states, "According to one source, the ratio of the value of hard assets relative to intangible assets among the major industrial companies of the world went from 62 percent/38 percent in 1982 to 38 percent/62 percent a decade later." *Id.* (citing William J. Murphy & Thomas Ward, *Proposal for a Centralized and Integrated Registry for Security Interests in Intellectual Property*, 41 IDEA 297, 301 (2002)).

[9] *See List of Corporations by Market Capitalization*, WIKIPEDIA, http://en.wikipedia.org/wiki/List_of_corporations_by_market_capitalization (last visited Dec. 30, 2014).

[10] U.S. CONST. art. I, § 8, cl. 8.

authors and inventors in 'Science and useful Arts.' Sacrificial days devoted to such creative activities deserve rewards commensurate with the services rendered."[11]

The logic of copyright and patent law is straightforward. The creation of an invention or a work of authorship, such as a novel, film or software program, requires the investment of time and resources. If others are allowed to freely copy those works, it undermines the desire for the initial creator to endeavor the work of creation in the first place.[12] The introduction of a license scheme addresses the creator or inventor's problem of how to appropriate a stream of income

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[11] Mazer v. Stein, 347 U.S. 201, 219 (1954).

[12] *See* Mennel, *supra* note 8, at 738–39 ("To understand why the Framers thought exclusive rights in inventions and creations would promote the public welfare, consider what would happen absent any sort of intellectual property protection. Invention and creation often require the investment of resources, such as the time of an author or inventor, expenditures on facilities, prototypes, and supplies. In a private market economy, economically motivated individuals will not invest in invention or creation unless the expected return exceeds the cost—that is, unless they can reasonably expect to make a profit from the endeavor. To profit from a new idea or a work of authorship, the creator must be able either to sell it to others, or to put it to some use which provides a comparative advantage in the marketplace."); *see also* Shyamkrishna Balganesh, *Foreseeability and Copyright Incentives*, 122 HARV. L. REV. 1569, 1573 (2009) ("Of the various theories commonly advanced to justify copyright law, the utilitarian incentive-based one continues to dominate among scholars, judges, and policymakers. In this view, copyright exists primarily (if not entirely) to provide creators with an incentive to produce creative expression through the promise of limited exclusionary control over their creative work. Creators are presumed to be rational utility maximizers and therefore capable of being induced to create by the prospect of controlling a future market for their yet-to-be-created works.").

from their creation while effectively prohibiting others from directly copying the work.[13]

More than any other industry, the software industry is based upon the licensing model, which has certainly provided software vendors a "stream of income." The size of the worldwide software industry in 2013 was $407.3 billion.[14]The largest software companies are well recognized: Microsoft, Oracle Corporation, IBM, and SAP.[15] For a frame of reference, this amount of revenue makes the companies in the software industry on par with the entire gross domestic product of some countries, such as Taiwan and Argentina.[16] In 2014, Microsoft by itself garnered over $86 billion in revenue from software sales or services offered in connection with software.[17] The licensing of software allows the software publisher to license the same product to different users for different prices, limiting

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[13] *See* Mennel, *supra* note 8, at 739–40 ("Patents and copyrights directly address the problem of appropriating a stream of income from investments in innovation and creative expression. Subject to various exceptions, limitations, and defenses, these modes of protection effectively prohibit the use and sale of protected works without the authorization of the intellectual property owner. In this way, innovators (and those who invest in them) can prevent others from directly competing with them for the period that the works receive protection.")

[14] *See Software Industry,* WIKIPEDIA, http://en.wikipedia.org/wiki/Software_industry (last visited Jan. 5, 2015).

[15] *Id.*

[16] *See List of Countries by GDP (Nominal)*, WIKIPEDIA, http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal) (last visited Jan. 5, 2015).

[17] *See List of the Largest Software Companies*, WIKIPEDIA, http://en.wikipedia.org/wiki/World%27s_largest_software_companies (last visited Feb. 22, 2015).

the use of the product to specific places or to meet different requirements.[18]

III. SOFTWARE LICENSE CONTRACTS AND THE LAWS WHICH PROHIBIT ASSIGNMENT

A. Software as a License or Sale

Software transactions commonly involve both aspects of a sale and a license. In the retail setting, a consumer purchases a copy of the software product, much like other copyrightable works such as books or magazines. However, the software company typically requires that the product be used in accordance with a license agreement, which is often wrapped along with the software product or presented to the user to "click-through" before the product may be used. This underlies a basic rule regarding the intersection of copyright and contract law. If the copyright owner elects to sell a copy of the software, then first sale rule gives the buyer certain limited rights, such

[18] *See* Robert W. Gomulkiewicz, *Getting Serious About User-Friendly Mass Market Licensing for Software,* 12 GEO. MASON L. REV. 687, 690 (2004) ("For example, a software publisher might license word processing software to business users for one price, to home users for a lower price, academic institutions for an even lower price, and to charitable organizations for free. Certain types of software, such as server software and developer tools, must be licensed to be useful—a Copyright Act "first sale" does not provide sufficient rights." (footnotes omitted)). An increasingly common technique used by both copyright owners and licensers, is geographic price discrimination. Typically in a software licensing department, the world is divided into zones, and prices are adjusted within each zone to maximize the firm's profits. *See* William W. Fisher III, *When Should We Permit Differential Pricing of Information?*, 55 UCLA L. REV. 1, 6 (2007) (noting that the first sale doctrine is narrower in some European countries than in the United States, increasing opportunities for price discrimination).

as the right to resell or transfer that copy.[19] Specifically, under the first sale doctrine, the owner of the copyright in the software product relinquishes its rights to control the further distribution of a particular copy of the software product.[20] For this reason, nearly all copyright owners of software products elect *not* to sell the copy but to license them. A license in its most basic form is an agreement between the licensor and the

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[19] *See* Raymond T. Nimmer, *Copyright First Sale and the Overriding Role of Contract*, 51 SANTA CLARA L. REV. 1311, 1312 (2011). Nimmer describes that "[t]he first sale doctrine is simply a default rule applicable to property rights in reference to one type of market transaction. The doctrine does not require that works be transferred via sales of copies, but merely specifies the property rights consequences if a sale or gift occurs." *Id.* A variety of cases describe the distinction between the sale of software product, which would be covered by article 2 of the Uniform Commercial Code (U.C.C.) and a license. *See* Berthold Types Ltd. v. Adobe Sys. Inc., 101 F. Supp. 2d 697, 699–700 (N.D. Ill. 2000) (holding that while "a transaction involving a computer program can involve an Article 2 sale of goods, . . . an agreement that does not involve a transfer of title cannot be an Article 2 sale in Illinois. . . . A pure license agreement, like the 1997 agreement, does not involve transfer of title, and so is not a sale for Article 2 purposes").

[20] *See* Nimmer, *supra* note 19, at 1312. When analyzing the role of contracts and the first sale doctrine, Nimmer states, "The question is not *whether* contract terms can control application of first sale rules, but *how* they can exercise that control . . . . The determinative issue of whether there has been a first sale is whether there was an enforceable contract restricting use of the work in ways inconsistent with the rights of a first sale owner." *Id.* (emphasis in original); *see also* Michael V. Sardina, *Exhaustion and First Sale in Intellectual Property*, 51 SANTA CLARA L. REV. 1055, 1056 (2011); Vernor v. Autodesk, Inc., 621 F.3d 1102 (9th Cir. 2010); Wall Data, Inc. v. Los Angeles Cnty. Sheriff's Dep't, 447 F.3d 769 (9th Cir. 2006); Triad Sys. Corp. v. Se. Express Co., 64 F.3d 1330 (9th Cir. 1995); MAI Sys. Corp. v. Peak Computer, Inc., 991 F.2d 511 (9th Cir. 1993); Novell, Inc. v. Unicom Sales, Inc., No. C-03-2785 MMC, 2004 WL 1839117, at *1 (N.D. Cal. Aug. 17, 2004) (where distribution licenses were licenses, rather than first sales); Microsoft Corp. v. Harmony Computers & Electronics, Inc., 846 F. Supp. 208 (E.D.N.Y. 1994).

licensee that the licensor will not sue the licensee, provided the use of the software product is in accord with the license agreement.[21] It is a simple way in which the rights of patents or copyright are granted to a user.[22]

Ordinarily, an end-user licensee transfers title in a single copy of software, and the licensor retains all copyright ownership in the work.[23] A recent Ninth Circuit case provided an overview of the distinction between the sale of a software product and licensing those products, holding that a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license; (2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions on the use of the product.[24]

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[21] *See* De Forest Radio Tel. Co. v. United States, 273 U.S. 236, 242 (1927) (holding that a license is "a mere waiver of the right to sue" the licensee for infringement); Exxon Corp. v. Oxxford Clothes, Inc., 109 F.3d 1070, 1076 (5th Cir.1997) ("[A] license to use a mark . . . is a transfer of limited rights, less than the whole interest which might have been transferred." (citation omitted)); Spindelfabrik Suessen Schurr v. Schubert & Salzer, 829 F.2d 1075, 1081 (Fed.Cir.1987), *cert. denied*, 484 U.S. 1063 (1988) ("[A] patent license agreement is in essence nothing more than a promise by the licensor not to sue the licensee . . . [e]ven if [the promise is] couched in terms of '[L]icensee is given the right to make, use, or sell X' . . . .").

[22] *See* DONALD A. GREGORY ET AL., INTRODUCTION TO INTELLECTUAL PROPERTY LAW 274–315 (1994).

[23] *See* Stephen Y. Chow, *Intellectual Property Licensing Under UCC 2B*, 532 PLI/PAT 723, 726 (1998).

[24] *Vernor*, 621 F.3d at 1102. The Court in *Vernor* provides an overview that copyright is a federal law protection provided to the authors of "original works of authorship," including software programs. *See* 17 U.S.C. §§ 101–03 (2012). The Copyright Act confers several exclusive rights on copyright owners, including the exclusive rights to reproduce their works and to distribute their works by sale or rental. *Id.* § 106(1), (3). The exclusive distribution right is limited by the first sale doctrine, an affirmative defense to copyright infringement that allows owners of copies of copyrighted

The software license can take a variety of forms. As well-known commentator, Raymond Nimmer, states, "While simple outright sales of copyright works continue to occur in some of the industries, the increasingly common method of distribution is online access or downloading, or a distribution under licenses related to tangible copies."[25] Software is often pre-loaded onto computer systems and then the computer is distributed through retail channels. Such software is often made available based on a shrink-wrap or an "end user licensing agreement."[26] Larger transactions between the software vendor and customer are normally under a written contract.

This Article focuses on the situation where the software product is not sold, but licensed, particularly between business parties. Such agreements, which are common between large companies, are unmistakably licenses. For example, a company such as IBM with over 400,000 employees does not purchase

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works to resell those copies. The court provides an overview of three relevant cases, called the "MAI trio" of cases. *See Wall Data*, 447 F.3d at 769; *Triad Sys.*, 64 F.3d at 1330; *MAI Sys.*, 991 F.2d 511 (9th Cir. 1993). The factors discussed in the MAI trio were considered before the Court enunciated the three principles in identifying a sale versus a license.

[25] Nimmer, *supra* note 19, at 1322 .

[26] *See* Gomulkiewicz, *supra* note 18, at 690; *see also* Davidson & Assocs. v. Jung, 422 F.3d 630, 639 (8th Cir. 2005) (holding that a shrink-wrap license in the form of an end-user license agreement (EULA) that barred reverse engineering was not preempted by federal fair use law); ProCD, Inc. v. Zeidenberg, 86 F.3d 1447 (7th Cir. 1996) (holding that a shrinkwrap license agreement was valid and enforceable under conventional contract interpretation). Other cases where the court finds that shrink-wrap agreements are enforceable include: Bowers v. Baystate Techs., Inc., 320 F.3d 1317 (Fed. Cir. 2003); Step-Saver Data Sys., Inc., v. Wyse Tech., 939 F.2d 91 (3d Cir. 1991); Puget Sound Fin., L.L.C. v. Unisearch, Inc., 47 P.3d 940 (Wash. 2002); 1-A Equipment Co. v. Icode, Inc., No. 1460, 2003 WL 549913, at *1 (Mass. App. Div. Feb. 21, 2003).

de Nemours & Co. v. Shell Oil Co., the court held that the rights conveyed by a non-exclusive patent license are personal to the licensee and not to be sublicensed unless specific permission is given.[40] The court's holding is based on the concept that allowing the free assignability of a patent license would be inconsistent with the constitutional goal of encouraging invention by granting a monopoly to the inventor on the sales and marketing of her patented invention. The Ninth Circuit, in the case of *In re CFLC, Inc.*, stated:

> In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents. . . . Thus, any license a patent holder granted . . . would be fraught with the danger that the licensee would assign it to the patent holder's most serious competitor, a party whom the patent holder itself might be absolutely unwilling to license.[41]

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connection with its reorganization plan, unless approved by the licensor); Gilson v. Republic of Ir., 787 F.2d 655, 658 (D.C.Cir.1986) ("It is well settled that a nonexclusive licensee of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment"); PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1093 (6th Cir. 1979).

[40] 498 A.2d 1108, 1114 (Del. 1985).

[41] *In re* CFLC, Inc. 89 F.3d 673, 679 (9th Cir. 1996); *see* Elaine D. Ziff*, The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 BUS. LAW. 767, 772 (2002) (stating that "[t]his sentiment was echoed in *In re* Access Beyond Technologies, wherein the Delaware Bankruptcy Court noted that allowing the proposed assignee, a direct competitor of the licensor, access to the licensed technology eliminated any competitive advantage that the licensor may have as a result of the technology—exactly what the patent laws were designed to prevent" (citing *In re* Access Beyond Techs., 237 B.R. 32, 45 (Bankr. D. Del. 1999))).

While the law applicable to assigning a nonexclusive license under the patent law is settled, there are few cases considering the assignability of exclusive patent licenses.[42] In fact, in a Ninth Circuit bankruptcy case, the court expressly stated that it was not expressing an opinion regarding the assignability of *exclusive* patent licenses under federal law.[43] While the issue of assignability of software products licensed under the Patent Act may be open as a legal matter, it is closed as a practical one. The owner of the intellectual property rights in a software product, who licenses that product's use exclusively to a user, forecloses the product from any further distribution or income stream. Commercial software companies do not license their products on such a basis, and therefore, such licenses are not the subject of this Article.

D. Copyright Law Applied to the Transfer of a License Contract

Courts have long favored the copyright owner's ability to control the uses of his or her work. When it comes to nonexclusive copyright licenses, federal courts have uniformly held that consent is required to assign a nonexclusive copyright license unless the license *explicitly* allows the assignment.[44] In

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[42] *See* Ziff, *supra* note 41, at 772 (citing JAY DRATLER, JR., LICENSING OF INTELLECTUAL PROPERTY § 1.06[2] (2001) ("The extension of these nonassignability and nonassumption principles to *exclusive* licenses, even for patents, is still open." (emphasis in original))).

[43] *Catapult*, 165 F.3d at 750 n.3 (citing *CFLC*, 89 F.3d at 679).

[44] *See* SQL Solutions, Inc. v. Oracle Corp., No. C-91-1079 MHP, 1991 WL 626458, at *5 (N.D. Cal. Dec. 18, 1991); *see also In re* Sunterra Corp., 361 F.3d 257, 267 (4th Cir. 2004) (holding consent required to assign nonexclusive copyright/software license); Ariel (U.K.) Ltd. v. Reuters Group PLC et al., No. 05 Civ. 9646(JFK), 2006 WL 3161467, at *6 (S.D.N.Y. Oct. 31, 2006) (same); Realnetworks, Inc. v. DVD Copy Control Ass'n, 641 F. Supp. 2d 913, 944 (N.D. Cal. 2009); *In re* Golden Books Family Entm't, Inc., 269 B.R. 311, 319 (Bankr. D. Del. 2001) (holding non-

the often-cited case of *SQL Solutions v. Oracle Corp.*,[45] the federal court decided upon the issue of assignment of a software contract in the case of a reverse triangular merger. The court determined that the merger that occurred constituted a transfer of rights, which violated the anti-assignment clause. The merger statute was one of state law, and the court held that a nonexclusive copyright license that expressly restricted assignment was nonassignable absent licensor's consent, notwithstanding the language of the state statute. The court noted that as a result of the merger, a "fundamental change" in the licensee's form of ownership had occurred and that the change amounted to an assignment.[46] The requirement that the licensor must consent to an assignment is true even in cases where the contract itself is silent as to this requirement.[47]

Similar to the rulings involving assigning a patent license, there is a debate as to whether a software product licensed under an exclusive copyright license is assignable absent the agreement expressly allowing assignment.[48] The case of *In re Patient Educational Media* considered the transferability of a nonexclusive copyright license, which included an express prohibition on assignment.[49] The court noted in dicta the distinction copyright law makes between

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exclusive copyright license that restricts assignment to be non-assignable); *In re* Patient Educ. Media, Inc. 210 B.R. 237 (Bankr. S.D.N.Y 1997).

[45] *SQL Solutions*, 1991 WL 626458, at *5–6 (holding that a software license held by the surviving entity in a reverse triangular merger was improperly transferred as the licensee went through a fundamental change in its form of ownership).

[46] *Id.*

[47] *See infra* Part III.H; *supra* Part III.A.

[48] Ziff, *supra* note 41, at 775 ("Unlike patents, however, there are cases and statutes which expressly address the transferability of exclusive versus non-exclusive copyright licenses, with differing results.").

[49] 210 B.R. 237, 239–40 (Bankr. S.D.N.Y. 1997).

exclusive and nonexclusive licenses and considered the exclusive licensee to be on par with the copyright owner and able to transfer the licensee's rights without consent of the owner.[50] Not all courts, however, agree with this view.[51] In any event, the use of all commercially-licensed software products is licensed on a nonexclusive basis. These licensed products include the retail-oriented products that assist people in preparing their personal taxes, the email systems used to correspond with friends, and the licensed software this author

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[50] *Id.* at 240. The court stated:

> The holder of the exclusive license is entitled to all the rights and protections of the copyright owner to the extent of the license. Accordingly, the licensee under an exclusive license may freely transfer his rights, and moreover, the licensor cannot transfer the same rights to anyone else. By contrast, the nonexclusive license does not transfer any rights of ownership; ownership remains in the licensor. . . . Accordingly, the nonexclusive licensee is personal to the transferee, and the licensee cannot assign it to a third party without the consent of the copyright owner.

Id. (citations omitted).

[51] *See* Gardner v. Nike, Inc., 110 F. Supp. 2d 1282 (C.D. Cal. 2000), *aff'd*, 279 F.3d 774, 781 (9th Cir. 2002) ("[A]n exclusive licensee has the burden of obtaining the licensor's consent before it may assign its rights, absent explicit contractual language to the contrary."); Ziff, *supra* note 41, at 775 ("Cases and commentators favoring the free assignability of exclusive copyright licenses rely on the premise that, under the current 1976 Copyright Act, exclusive copyright licenses are considered equivalent to copyright ownership interests and would, therefore, be freely alienable, absent provisions to the contrary in the license agreement."); *e.g.*, Leicester v. Warner Bros., No. CV95-4058-HLH(CTX), 1998 WL 34016724, at *1, *3 (C.D. Cal. May 29, 1998) ("[G]rant of license may not be assigned or sublicensed by the licensee unless the grant of license is exclusive."); *In re* Golden Books Family Entm't, Inc., 269 B.R. 311 (Bankr. D. Del. 2001); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) ("[T]he licensee under an exclusive license may freely transfer [its] rights . . . .").

used to write this Article. It also includes the business-to-business software (B2B) used to run enterprise systems, store data, move products, manage personal medical data, and run countless other applications.

As the case of *SQL Solutions* made clear, the issue of assignment often arises in a complicated area where state and federal laws overlap. State law sets forth a regime as to how assets would be transferred from one company to the next in the event of a corporate merger or consolidation. Such a merger, by definition, requires the assignment of contracts, like software license contracts, as the assets of one company are merged with the assets of another. At the same time, federal law preempts any state law when it comes to the topic of assignability of a product licensed under the rights of copyright or patent.

E. Federal Preemption and Representative Cases

It is well established that federal law preempts any conflicting state law.[52] In the case of copyright law, the

[52] Nimmer, *supra* note 19, at 1324. Nimmer describes:

> [T]here are three conditions under which preemption might occur: [1] state law is preempted if a federal law *expressly* provides for such preemption (express preemption); [2] state law is preempted if federal law entirely and *exclusively occupies a* field and the state law attempts to intrude into that field (field preemption); and [3] state law is preempted if a state law is *inconsistent* with and impedes the achievement of federal policy as expressed in federal law or regulation (conflict preemption).

Id. (emphasis added).

Copyright Act contains an express preemption provision, stating:

> (a) *[All]* legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright . . . come within the subject matter of copyright [and] are governed exclusively by this title. [No] person is entitled to any such right or *equivalent right* in any such work under the common law or statutes of any State.[53]

Federal courts have made clear that federal law will preempt any conflicting state law as it pertains to the assignment of intellectual property rights.[54] What is the role of

[53] 17 U.S.C. § 301 (2012) (emphasis added).

[54] *See* PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1093 (6th Cir. 1979). Courts generally have recognized the need for a uniform national rule that provides that patent licenses are personal and non-transferable in the absence of an agreement authorizing assignment, contrary to the state common law rule that contractual rights are assignable unless forbidden by an agreement. Erie R. Co. v. Tompkins, 304 U.S. 64 (1938). The Erie case determined that federal courts must look to state law in construing "contracts or other written instruments and especially to questions of general commercial law." *Id.* at 71. The Erie doctrine, however, leaves room for federal courts to apply federal common law rules where a specific showing has been made that applying state law will create conflict or will pose a threat to some federal policy or interest. *See* Atherton v. FDIC, 519 U.S. 213 (1997). Other federal cases have upheld the federal common law rule of non-assignability of patent licenses unless expressly provided in the agreement. *See, e.g.*, Unarco Indus. v. Kelly Corp., 465 F.2d 1303, 1306 (7th Cir. 1972) (concluding that the patent "monopoly conferred by federal statute as well as the policy perpetuating this monopoly, so affects the licensing of patents, and the policy behind such licensing is so intertwined with the sweep of federal statutes, that any question with respect thereto must be governed by federal law" and therefore upholding

state law then, as pertaining to the assignment of a software license if federal law governs the topic? The issue of assignability frequently comes to forefront in the area of mergers and acquisitions. The intersection of federal law, contracts, and how restrictions on assignment are interpreted are best demonstrated by a handful of cases.

In the seminal case of *PPG Industries, Inc. v. Guardian Industries Corp.*,[55] the court stated, "Questions with respect to the assignability of a patent [or copyright] license are controlled by federal law.'"[56] In this case, PPG and Permaglass, Inc. were engaged in the fabrication of glass products that required that sheets of glass be shaped for particular uses. The parties entered into an agreement that stated that the license granted by PPG to Permaglass was personal and nonassignable except with the written consent of PPG.[57] Permaglass did not assign the contract outright, but the assignment occurred as a result of merger of Permaglass into Guardian Industries under the applicable merger statutes of Ohio and Delaware.[58] PPG sued based on the nonassignment language in the agreement. One of the defenses pled by Guardian argued that it had succeeded to the rights of Permaglass by virtue of the merger statutes in Ohio and Delaware, notwithstanding the terms of the agreement between PPG and Permaglass.[59] The Sixth Circuit disagreed, focusing on the language of the license agreement itself. The court stated, "If the parties had intended an exception in the event of

the federal common law rule relating to the non-assignability of patent licenses).

[55] 597 F.2d at 1090.

[56] *Id.* at 1093.

[57] *Id.* at 1092.

[58] *Id.*

[59] *Id.* at 1094.

a merger, it would have been a simple matter to have so provided in the agreement."[60] Ultimately the court analyzed the Ohio merger statute and decided that regardless of how the transfer was to occur, there had been a transfer, which was prohibited by the contract.[61] By so holding, the court made clear that regardless of the intended effect of the merger statute, the language of the contract and ability of the patent owner to limit which party has use of its patented item is of paramount importance.

The Sixth Circuit also decided the case of *Cincom Systems v. Novelis Corp*, which is illustrative to other would-be transferors of a software license.[62] Cincom agreed to license its software products to Alcan Rolled Products Division (Alcan Ohio), an Ohio-based corporation that would later become known as Novelis. The license agreement provided for "a non-exclusive and nontransferable license."[63] Under the license agreement, Alcan Ohio could only place the software on designated computers that the parties specifically listed in the contract. The license agreement further provided that Alcan Ohio could not transfer its rights or obligations under this Agreement without the prior written approval of Cincom.[64] Through a series of corporate reorganizations, Alcan Ohio became a subsidiary of the company Alcan Texas and changed its name to Novelis three years later.

Cincom filed suit, alleging that Novelis's actions violated the license agreement entered into by Alcan Ohio. The district court determined that Alcan Ohio's merger with Alcan

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[60] *Id.* at 1095.
[61] *Id.* at 1096.
[62] 581 F.3d 431 (6th Cir. 2009).
[63] *Id.* at 434.
[64] *Id.*

Texas affected a transfer of the license under Ohio law, and the district court entered summary judgment in favor of Cincom.[65] The parties agreed to an order stipulating the amount of damages Cincom had suffered as $459,530.00, equal to the amount of Cincom's initial licensing fee.[66]

In revisiting the *PPG* case, the Sixth Circuit noted, "We concluded that in the context of intellectual property, a license is presumed to be non-assignable and nontransferable in the absence of 'express provisions to the contrary.'"[67] The court went on to say that federal common law governs questions with respect to the assignability of a patent or copyright license.[68] The court explained that federal common law was unusual but justified in "the realm of intellectual property because '[t]he fundamental policy of the patent system was to encourage the creation'" of new technology, and allowing the states to permit the free assignability of patent or copyright licenses would undermine that system.[69] The court's analysis was ultimately simple. Regardless of the language of the state merger statute, which explicitly allowed for a transfer by law, the license required the express written approval of Cincom to transfer the license, and Novelis never sought nor received that approval.

Finally, in the case of *TXO Production Co. v. M.D. Mark, Inc.*,[70] a Texas court held that a merger of a subsidiary into its parent corporation did not violate a non-assignability

[65] *Id.* at 435.
[66] *Id.*
[67] *Id.* at 436 (citing PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1095).
[68] *Id.* (citing *PPG*, 597 F.2d at 1093 n.4).
[69] *Id.* (citing Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 150–51 (1989); *In re* CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996)).
[70] 999 S.W.2d 137 (Tex. Ct. App. 1999). http://scholar.google.com/scholar_case?case=3014646440897712801&hl=en&as_sdt=2,5&as_vis=1.

clause in a contract.[71] The court examined the substantially similar Texas, Ohio, and Delaware merger statutes and decided that under the Texas merger statute, rights vest "automatically" in surviving corporation and there is no "transfer" of any rights of the merging corporation.[72] It is clear that the intention of the state statute is to wholly skirt the issue of assignment by creating a transfer that occurs without the requirement of seeking consents that are often required to transfer intellectual property assets. The case was discounted by the Sixth Circuit Court of Appeals in *Cincom,* which stated, "While the Texas court fretted that 'a requirement that the surviving corporation pay a fee in the event of a merger unnecessarily hinders the free flow of those rights to the surviving corporation,' this is exactly the purpose of copyright law—to prevent the 'free flow' of information without the author's permission."[73] Thus, the *Cincom* court made clear that regardless of the intention of the merger statute, federal common law will uphold the contract between the licensor and licensee.

F. The Intersection of Federal and State Law — Mergers

Cases like *SQL Solutions* and *TXO Production* highlight the intersection of state and federal law. In these cases, merger statutes, which are a creation of state law, intersect with the assignment of intellectual property rights, which is preempted by federal law.[74] It appears settled that the

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[71] *Id.* at 143.
[72] *Id.* at 142.
[73] *Cincom*, 581 F. 3d at 439 (citing *TXO*, 999 S.W.2d at 142).
[74] *See* Joshua G. Graubart, Unintended Consequences: State Merger Statutes and Nonassignable Licenses (unpublished note), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1094&context=dltr (last visited Jan. 12, 2015). "While not an entirely settled question, assignment of patent and copyright licenses is generally held to be matter of

assignment of rights under a patent or copyright license is governed by federal common law. As one commentator puts it, "Unfortunately for licensees, federal common law prevents the application of state principles that favor transferability."[75]

As to whether a merger of a corporation affects an assignment, a number of states have adopted parts of the ABA Model Business Corporation Act (the "Model Act"). In 1984, the Model Act was revised, and the new provision provided that in the event of a merger, "the title to all real estate and other property owned by each corporation party to the merger is vested in the surviving corporation without reversion or impairment."[76] In states following the Model Act, the courts must construe the merger statute to determine whether the assets are assigned, and then, in such a way prohibited by a non-assignment clause in a contract.[77] By recent count, the Model Act is adopted fully by only twenty-four states.[78] Commentators have opined that inconsistency among the states has fostered continuing confusion regarding the efficacy of non-assignment provisions in contracts when confronted with

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Federal common law. However, whether a merger constitutes an assignment remains a matter of state law. The language of state merger statutes therefore determines the effect of mergers with respect to assignment of licenses and the states have taken various approaches to the problem of assignment via merger." *Id.* ¶ 5.

[75] Brandon M. Villery, *The Transferability of Non-Exclusive Copyright Licenses: A New Default Rule for Software in the Ninth Circuit?*, 22 HASTINGS COMM. & ENT. L.J. 153, 171 (1999).

[76] MODEL BUS. CORP. ACT § 11.07(a)(3) (1984); https://users.wfu.edu/palmitar/ICBCorporations-Companion/Conexus/ModelBusinessCorporationAct.pdf.

[77] Graubart, *supra* note 74.

[78] Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 844 (2005); *see* David Carnes, *Model Business Corporations Act*, LEGALZOOM, http://info.legalzoom.com/model-business-corporations-act-21003.html (last visited Jan. 17, 2015).

the merger of parties.[79] Even within one jurisdiction, sparse and ambiguous rulings often result in inconsistency based on the type of merger involved: forward mergers may constitute an impermissible assignment, while reverse mergers do not.[80]

Federal courts in the cases covered by this Article have made clear that a merger statute will not supersede the terms of a license agreement which restricts assignment. The Ninth Circuit attempts to explain the federal courts' reasoning in *In re CFLC, Inc.*:

> Allowing free assignability—or, more accurately, allowing states to allow free assignability—of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder *or* seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor–patent holder in the market for licenses under the patents. And while the patent holder could presumably control the absolute *number* of licenses in existence under a free-assignability regime, it would lose the very important ability to control the *identity* of its licensees. Thus, any license a patent holder granted—even to the smallest firm in the product market most remote from its own—would be fraught with the danger

[79] *See* Graubart, *supra* note 74. Graubart provides an overview of merger statutes and how the courts in Texas have treated those statues as opposed to other jurisdictions.
[80] *Id.*

> that the licensee would assign it to the patent holder's most serious competitor, a party whom the patent holder itself might be absolutely unwilling to license . . . . Few patent holders would be willing to grant a license in return for a one-time lump-sum payment, rather than for per-use royalties, if the license could be assigned to a completely different company which might make far greater use of the patented invention than could the original licensee.[81]

Assuming one agrees with the premise of the federal court in *CFLC* that the free assignability of licenses would have a chilling effect on the practice of licensing, does this merit the results in cases like *Cincom*? The parties in that case agreed to an order stipulating the amount of damages Cincom had suffered as $459,530.00, equal to the amount of Cincom's initial licensing fee.[82] In essence, the licensee paid twice for one product. The holding in that case is an important one, as any corporate reorganization may result in the payment of license fees for the identical product or its identical use by the same people who are simply employed by a company with a different name.[83] As one commentator has stated, "[W]henever

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[81] *In re* CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996) (emphasis in original).

[82] Cincom Sys. v. Novelis Corp., 581 F. 3d 431, 439 (6th Cir. 2009).

[83] *See* Ian McClure & Trevor M. Blum, *Sixth Circuit: Internal Corporate Restructuring Could Result in Violation of IP License or Infringement*, IP PROSPECTIVE (Oct. 7, 2009, 6:48 AM), http://www.ipprospective.com/copyright-caucus/internal-corporate-restructuring-could-result-in-violation-of-ip-license-or-infringement ("This holding should be observed not only by corporate lawyers in Ohio, but by those elsewhere as well. Although the corporate reorganization is generally a low-risk transaction for a corporate lawyer relative to other transactions, and checking the assignability of an intellectual property license is probably low on the checklist in a re-org, this

there's a corporate reorganization, there is potential of copyright infringement on a massive scale."[84] While some commentators have opined that the perception of greed or a poor business partner may deter this practice, there's no guarantee this will be the case.[85]

It does not matter how the issue of assignability arises, whether by merger statute, by virtue of the bankruptcy code, or by acquisition of a company that possesses intellectual property rights; one will need to gain the consent of the original copyright or patent owner to assign that contract if that's what the contract expressly requires.[86]

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case demonstrates a real consequence of neglecting to check all the boxes. In any merger, even if only an internal restructuring, all intellectual property licenses should be checked for assignability, and third-party permission should be obtained prior to effectuating the merger whenever necessary. Otherwise, a client could be hit with $460,000 (or similar) in intellectual property infringement damages, just like Novelis.")

[84] Seidenberg, *supra* note 6, at 1.

[85] *See* D.C. Toedt, *A Short-Sighted Software Vendor Move: Sue a Customer to Force a Re-Buy After an Internal Corporate Reorganization*, ON CONT. (Sept. 29, 2009), http://www.techlawnotes.com/a-short-sighted-software-vendor-move-sue-a-customer-to-force-a-re-buy-after-an-internal-corporate-reorganization ("You can bet that this customer is looking around for ways to ditch the vendor. And if the vendor has competitors (and who doesn't?), one of those competitors may well be offering a rip-out-and-replace deal, in which the customer gets the competitor's software for free in return for an agreement to pay maintenance for X-years.")

[86] *See id.*; *see also* Hirshman, Fatall & Spingola, *supra* note 38, at 197–98 (contrasting assignment under bankruptcy as compared to agreements that cover the licensing of intellectual property); Menell, *supra* note 8, at 735. In the same way that the assignment of contracts is frequent at issue in the case of mergers, it is also a frequent issue in bankruptcy, where a party interested in acquiring the assets of the bankrupt party must know if the intellectual property licenses they acquire will leave them subject to infringement claims. For this reason, how courts construe the assignment provisions in a

G. Assignment of a Commercial Contract

Even in the case of federal preemption, contract law still has a vital role in determining the rights of licensor and licensee. Contract law sets out doctrines that enable and enforce agreements that license the copyrightable or patentable subject matter. Copyright law is a property rights system, the rules of which apply to particular subject matter regardless of any agreement.[87] If that particular subject matter is covered by an agreement, however, the laws which govern the agreement will apply. For example, the laws of copyright will cover who is the proper owner of the rights in a copyrightable work. A contract, however, could transfer those ownership rights.

A case demonstrating the role of state commercial law in resolving a dispute over a copyrightable work is that of *ProCD, Inc. v. Zeidenberg*,[88] the first appellate ruling dealing with the enforceability of shrink-wrap licenses. The court in this case held that the shrink-wrap license was enforceable and that the contractual restrictions it placed on the use of a non-copyrightable database were not preempted by federal copyright law.[89] Numerous other cases have ruled similarly,

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license agreement is a topic that is frequently the subject of analysis as described in this Article.

[87] Nimmer, *supra* note 19, at 1311.

[88] 86 F.3d 1447 (7th Cir. 1996).

[89] *Id.* at 1454–55; *see* Nimmer, *supra* note 19, at 1311. "Contracts are based on agreements and enforceable promises. Enforcing the terms of these promises is not equivalent to enforcing property rights. The promise and the enforcement of that promise is the extra element that makes the contract and claims related to it different from the property rights themes of copyright law." *Id.* at 1327 (citing Lynn v. Sure-Fire Music Co., Inc., 237 F. App'x. 49, 54 (6th Cir. 2007) (holding that copyright did not preempt contract claims).

holding that federal law does not preempt all contract claims.[90] In the business setting, the role of contracts is clear. Contracts cover both the development of intellectual property, as well as a licensing regime to exploit what is developed.[91] Contract terms will also determine the availability, type, and amount of contract remedies.[92] As Nimmer puts it, "These contractual arrangements do not conflict with copyright law, but are part of the expected interaction between copyright and marketing choices by the copyright owner."[93]

Unlike the federal law applicable to the assignment of licenses, the basic presumption of contract law is that rights under agreements are assignable unless the agreement itself, a statute, or public policy provides otherwise.[94] When one or

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[90] *See* Grosso v. Miramax Film Corp., 383 F.3d 965, 968 (9th Cir. 2004) (holding that an extra element precludes preemption of contract claim); Telecom Technical Servs. Inc. v. Rolm Co., 388 F.3d 820, 833 (11th Cir. 2004) (holding that a claim requiring proof that defendants had violated the terms of the plaintiffs software license had an additional element that precluded preemption); Architectronics, Inc. v. Control Sys. Inc., 935 F. Supp. 425, 442–43 (S.D.N.Y. 1996) (holding that copyright did not preempt contract claim).

[91] *See generally* Mennel, *supra* note 8, at 734. "Viewing the world from an ex ante perspective, intellectual property laws seek to foster investment in research and development. Freedom of contract plays a central role in maximizing the potential value of intellectual property by encouraging a robust licensing market to exploit the value of intellectual creativity." *Id.* at 735.

[92] *ProCD*, 86 F.3d at 1454–55; *see* Nimmer, *supra* note 19, at 1312 ("Thus, contract terms dominate both as to contract remedies and as to the existence of the property rights exemption. The question is not *whether* contract terms can control application of first sale rules, but *how* they can exercise that control." (emphasis in original)).

[93] Nimmer, *supra* note 19, at 1328.

[94] *See* U.C.C. § 2-210(2) (2008); 3 RESTATEMENT (SECOND) OF CONTRACTS § 317(2) (1981); 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 11.2, 11.4 (2d ed. 1998).

more parties choose to limit the ability of the other parties to assign and transfer rights, it is commonly accomplished through the inclusion of anti-assignment and anti-transfer provisions.[95] Unlike the federal law that disfavors the transferability of a copyrightable work that is licensed under an agreement, the norm as to the agreement itself is that it is freely transferable. The general rule is in § 317(2) of the RESTATEMENT (SECOND) OF CONTRACTS, which states:

> A contractual right can be assigned unless:
>
> (a) The substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or

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[95] Note, *Effect of Corporate Reorganization on Nonassignable Contracts*, 74 HARV. L. REV. 393, 394–95 (1960); *see, e.g.*, Old Colony Crushed Stone Co. v. Cronin, 176 N.E. 804, 806 (Mass. 1931) ("The provision prohibiting the assignment of any money payable under the agreement or of the contractor's claim thereto without the written consent of the commission is a valid agreement binding upon the parties and upon anyone undertaking to assert rights thereunder."); *see also* HOWARD J. ALPERIN, MASSACHUSETTS PRACTICE SERIES: SUMMARY OF BASIC LAW § 5-81 (4th ed. 2011) ("A contract right is not assignable if the parties have clearly expressed in the contract their intention to forbid such and assignment."); RAYMOND T. NIMMER & JEFF DODD, MODERN LICENSING LAW § 9:23 (2011).

> (b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or
>
> (c) assignment is validly precluded by contract.[96]

Even in the case when the assignment is "validly precluded by contract," § 322 provides that a contract term that specifically prohibits assignment of contract rights makes its violation a breach, but does not render the transfer ineffective.[97] Section 2-210 of the Uniform Commercial Code (U.C.C.) adopts the same principles.[98] Although courts recognize and enforce anti-assignment provisions in contracts, they may construe anti-assignment provisions narrowly.[99] Stepping back, one is left to ask that if a popular maxim of the law is "The contract makes the law," then shouldn't the holdings that apply to the assignment of a contract also apply to the issue of assignment?

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[96] RESTATEMENT (SECOND) OF CONTRACTS § 317(2).

[97] *Id*. § 322(2)(b).

[98] U.C.C. § 2-210. *Compare* U.C.C. § 2-210(2)–(3) (1996) *with* RESTATEMENT (SECOND) OF CONTRACTS §§ 317(2), 322(2)(b).

[99] *See* HOWARD O. HUNTER, MODERN LAW OF CONTRACTS § 21:16 (2011). For example, even in the face of an anti-assignment provision, a court may not allow a party to refuse to consent to assignment when doing so would be unreasonable. *See, e.g.*, Larese v. Creamland Dairies, Inc., 767 F.2d 716, 718 (10th Cir. 1985) (holding that under Colorado law, a franchisor did not have the right to unreasonably withhold consent to a franchisee's assignment of its franchise agreement despite the fact that franchise agreement prohibited assignment without the franchisor's consent, and contained no reasonableness requirement).

H. The Assignment of a License Contract in California

As in other jurisdictions, the issue of assignment of a copyright license absent the copyright owners consent in California is one of settled law. The Ninth Circuit's decision in *Harris v. Emus Records Corp.* established the default rule for the assignment of a non-exclusive copyright license by a licensee.[100] In this 1968 case, the singer Emmylou Harris recorded six songs and licensed a company called Jay-Gee the right to reproduce and distribute the songs as the album was released.[101] In 1971, Jay-Gee filed for bankruptcy, and its trustee sold part of the company's assets to Suellen Productions Inc., which in turn transferred its rights to reproduce and distribute the Harris recordings to the defendant, Emus Records.[102] As expressed by the court, "[T]he ultimate question [was] whether copyright licenses can be transferred by a mere licensee."[103] Relying in part on case law discussing the transferability of patent licenses, the court concluded that a copyright license cannot be transferred by the licensee without the express authorization of the licensor, even in the case where the contract itself was silent as to the issue of assignability.[104] While the legal maxim may state, "The contract makes the law," when it comes to assignability of copyrighted works, the law will make the contract even when the contract does not expressly limit a transfer.

Given the importance of a licensing regime to the software and entertainment industry it is interesting to note holdings in California on the topic of assignment of license

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[100] *See* Harris v. Emus Records Corp., 734 F.2d 1329, 1333 (9th Cir. 1984).
[101] *Id.*
[102] *Id.* at 1332.
[103] *Id.* at 1333.
[104] *Id.* at 1333–34.

contracts.[105] In the 2004 case *GN Hello Direct, Inc. v. Platronics, Inc.*, the California Court of Appeals stated that "no California state court has yet addressed the question of whether a reverse triangular merger effects an assignment of the target corporation's assets by operation of law. Nor will we."[106] However, in 1991, the U.S. District Court for the Northern District of California did consider this issue. In an often-cited, but unpublished case, *SQL Solutions*, the Ninth Circuit held that a licensee violated an anti-assignment provision of a non-exclusive software license by transferring the license through a reverse triangular merger.[107] The court noted, among other things, that as a result of the merger, a "fundamental change" in D&N's form of ownership had occurred.[108] Similar to the case of *Cincom*, the use of the software product, users and number of copies had not changed. However, the court followed a strict reading of the non-assignment provision in the contract. The decision in *SQL Solutions* was not published in the federal reporters and has never been expressly overruled.

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[105] *See* Wallace Walrod, *Economic Consequences on Software Piracy in California*, ORANGE CTY. BUS. COUNCIL, http://www.ocbc.org/wp-content/uploads/Economic-Consequences-of-Software-Piracy-on-California.pdf (last visited Jan. 18, 2015) (noting that California has almost 20 percent of the nation's IT employment and the effect of illegal copying on the state's employment).

[106] *GN Hello Direct, Inc. v. Platronics, Inc.*, No. H025605, 2004 Cal. App. Unpub. LEXIS 7416, at *27 (Cal. Ct. App. Aug. 10, 2004).

[107] *See* No. C-91-1079 MHP, 1991 WL 626458, at *1 (N.D. Cal. Dec. 18, 1991).

[108] *Id.* at *3.

IV. DAMAGES

A. Overview

The court in *CFLC* stated that if licenses were freely assignable under state merger statutes, the copyright owner would be damaged as every licensee would become a potential competitor.[109] Is this a real concern, though, of a company selling a mass-market software product at a retail outlet? Is it a realistic concern when it comes to software that is licensed to corporations for use by employees that number in the millions? What about the cases of *Cincom* or *TXO*, where due to a corporate reorganization, the use of the product and the individuals who were using those products were the same before and after the transfer? What are the measurable damages in such a situation? To better answer these questions, an overview of the damages applicable to such transfers is relevant. What are the normal types of damage awarded to a licensor of a software product when a license to use the software product is assigned from one party to another party?

B. Damages Under Copyright Law

The damages available to a copyright holder in a software product are defined in the United States Code (Code) as follows: "The copyright owner is entitled to recover the actual damages suffered by him or her as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages."[110] The plaintiff can also pursue statutory damages, which range from $750 to $30,000

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[109] *In re* CFLC, Inc. 89 F.3d 673, 679 (9th Cir. 1996).
[110] 17 U.S.C. § 504(b) (2012).

per copyrighted work.[111] The "actual damages" referred to in the Code are usually determined by the loss in the fair market value due to the copyright infringement, measured either by the copyright owner's lost profits or by the value of the use of the copyrighted work to the infringer.[112]

C. Contract Damages Distinguishable but Related

The contract is an integral tool that allows the copyright owner a method to market the copyrighted product.[113] Logically, one would expect a strong relationship between the damages available to a copyright owner under copyright and the damages available under the contract. However, deciding upon appropriate damages in the cases where a license contract is breached puts one squarely at the intersection of federal law and state commercial law. For example, a common tenet of commercial contract damages states that "[i]n awarding compensatory damages, the effort is made to put the injured party in as good a position as that in which he would have been

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[111] *See* 17 U.S.C. § 504(c); Microsoft Corp. v. Software Wholesale Club, Inc., 129 F. Supp. 2d 995, 1002 (S.D. Tex. 2000); Microsoft Corp. v. Grey Computer, 910 F. Supp. 1077, 1091 (D. Md. 1995).

[112] *See* Kenbrooke Fabrics, Inc. v Holland Fabrics, Inc., 602 F. Supp. 151 (S.D.N.Y. 1984); Pret-A-Printee, Ltd. v. Allton Knitting Mills, Inc., No. 81 Civ. 3770 (WCC), 1982 WL 1788, at *1 (S.D.N.Y. Sept. 16, 1982); *see also* Fitzgerald Publ'g Co. v. Baylor Publ'g Co., 670 F. Supp. 1133, 1138 (E.D.N.Y. 1987) (stating that (1) "[t]he primary measure for the recovery of actual damages under 17 U.S.C. § 504(b) is the extent to which the market value of the copyrighted work at the time of the infringement has been harmed or destroyed by the infringement"; and (2) "[t]he best method available for measuring this diminution in market value is the profit lost by the [copyright owner] due to the infringements").

[113] *See* Nimmer, *supra* note 19, at 1329 ("These contractual arrangements do not conflict with copyright law, but are part of the expected interaction between copyright and marketing choices by the copyright owner.").

put by full performance of the contract."[114] Yet, courts have ruled that it is an error to award damages under a copyright infringement action which would put the copyright owner in as good a position as it would have been if the infringing party has performed its contract.[115]

A case highlighting the distinctions between contract and copyright damages is *McRoberts Software, Inc. v. Media 100 Inc*.[116] In this case, McRoberts developed a computer software program and licensed it to Media 100, a computer hardware manufacturer.[117] At a later point in time, Media 100 entered into a contract with a third party to make a Windows-compatible version of the McRoberts computer program, based on McRoberts' program. McRoberts complained and ultimately, Media 100 replaced the McRoberts product with a third-party product developed independent of the McRoberts software. Nonetheless, McRoberts sued Media 100 in federal district court based on copyright, trade secret, and breach of contract claims. A jury found in favor of McRoberts on all of its claims.[118]

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[114] RESTATEMENT (1ST) OF CONTRACTS § 329 cmt. a (1932).
[115] *See, e.g.*, Fitzgerald Publ'g Co. v. Baylor Publ'g Co., 807 F.2d 1110, 1117–18 (2d Cir. 1986). ("The district court awarded Fitzgerald $27,948.14 in actual damages for the infringements of the copyrights of volumes twelve through sixteen of *Golden Legacy*. The actual damages awarded were based essentially upon a contractual measure of damages, that is to say, they purported to put Fitzgerald in as good a position as it would have been had Baylor performed the contract. . . . Both parties contend, and we agree, that this award was a plain error of law.").
[116] 329 F.3d 557 (7th Cir. 2001); *see also* O'Connor v. Cindy Gerke & Assocs., Inc., 300 F.Supp.2d 759, 774–75 (W.D. Wis. 2002) (finding that the plaintiff was permitted to argue the value of use measure of damages for copyright infringement claim but denied damages for breach of contract claim because plaintiff suffered no damages).
[117] *McRoberts*, 329 F.3d at 562.
[118] *Id.* at 563.

The contract contained a cap on damages in an amount of $85,000, and the jury awarded McRoberts that full amount as to *contract* damages.[119] In addition, McRoberts was awarded $2.1 million in damages attributable to the copyright infringement, which was made up of $1.2 million in actual damages and $900,000 in lost profits. In its appeal, Media 100 demonstrated that it realized no profits from the sale of the infringing products that incorporated McRobert's software. Media 100 also argued that the $900,000 award for lost profits was a case of double counting.[120] The court disagreed. In the case of double counting, the court attributed the $1.2 million of actual damages as the cost of creating a non-infringing product if Media 100 had not based their Windows compatible product on McRobert's program. [121]The court also stated that McRoberts was entitled to the lost profits on the sales of the product that competed with the McRoberts program. "Without this rule, Media 100 could infringe MSI's [McRoberts] copyright without the risk of losing more than it would have had to pay not to infringe and with the benefit of keeping whatever profits it made by infringing."[122] When it came to the matter of Media 100 failing to have made any profit from its actions, the court determined, "It is not improper for a jury to consider either a hypothetical lost license fee or the value of the infringing use to the infringer to determine actual damages, provided the amount is not based on undue speculation."[123]

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[119] *Id.* at 571.
[120] *Id.* at 568.
[121] *Id.* at 571.
[122] *Id.* at 569.
[123] *Id.* at 566. The court cites On Davis v. The Gap, Inc., 246 F.3d 152, 166 (2d Cir. 2001) and Interactive Pictures Corp. v. Infinite Pictures, Inc., 274 F.3d 1371 (Fed.Cir.2001), which upheld an award of actual damages based on estimated lump sum royalty payment from infringer's projected sales.

This author has written previously about the strange result of this case. [124] Media 100's actions of copying McRoberts' program was a breach of contract, which resulted in an award of contract damages equaling the maximum the parties bargained for under the contract. The same copying was also a copyright infringement, which yielded damages more than twenty-five times the contract damages, even though McRoberts never distributed a copy of the infringing program.[125] In this case, McRoberts was not put in as good a position as it would have been if Media 100 had not breached the contact. It was placed in an exponentially better position. *Media 100* makes clear actual damages can be made of "hypothetical lost license fee."

D. The Hypothetical Lost License Fee and Defenses

Another case awarding damages of a hypothetical license fee is *Thoroughbred Software Intern., Inc. v. Dice Corp.*[126] In this case the parties entered into a license agreement which authorized Dice Corp. to make and distribute copies of Thoroughbred's software based on a royalty model. Dice Corp. failed to pay required royalties. The key issue in the case was whether Dice Corp should pay damages for copies that were made, but unused and unsold.[127] The Sixth Circuit Court decided the case based on a Second Circuit case, *On Davis v. Gap, Inc.*,[128] where the plaintiff eyeglasses designer sued a retail store, The Gap, for using his sunglasses in an ad campaign without permission or payment. The Second Circuit

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[124] *See also* Alan J. Tracey, *The Contract in the Trade Secret Ballroom—A Forgotten Dance Partner?*, 16 TEX. INTELL. PROP. L.J. 47 (2007).
[125] *McRoberts*, 329 F.3d at 566.
[126] 529 F. Supp. 2d 800 (E.D. Mich. 2007).
[127] *Id.* at 804.
[128] 246 F.3d at 167.

held that the license fee that Davis *could* have received from The Gap was sufficient to constitute actual damages, even without a showing of lost sales. The Second Circuit stated, "In our view, as between leaving the victim of the illegal taking with nothing, and charging the illegal taker with the reasonable cost of what he took, the latter, at least in some circumstances, is the preferable solution."[129] The *Thoroughbred* case was decided on similar reasoning. The court decided that Dice Corp. was liable for the unpaid license fees for all the unauthorized copies it made, regardless of whether these copies were accessible, used, or would have been sold.[130] Each of these cases demonstrates the judicially created doctrine of

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[129] *Id.* at 166. Notably, the court in *On Davis* describes the situation as follows: "Assume that the copyright owner proves that the defendant has infringed his work. He proves also that a license to make such use of the work has a fair market value, but does not show that the infringement caused him lost sales, lost opportunities to license, or diminution in the value of the copyright. The only proven loss lies in the owner's failure to receive payment by the infringer of the fair market value of the use illegally appropriated. Should the owner's claim for 'actual damages' under § 504(b) be dismissed? Or should the court award damages corresponding to the fair market value of the use appropriated by the infringer? Neither answer is entirely satisfactory. If the court dismisses the claim by reason of the owner's failure to prove that the act of infringement cause economic harm, the infringer will get his illegal taking for free, and the owner will be left uncompensated for the illegal taking of something of value. On the other hand, an award of damages might be seen as a windfall for an owner who received no less than he would have if the infringer had refrained from the illegal taking. In our view, the more reasonable approach is to allow such an award in appropriate circumstances." *Id.* at 164.

[130] *Id.*; for examples of circuit court cases that followed the same method of hypothetical lost sales in calculating actual damages under 17 U.S.C. § 504(b), see, e.g., Polar Bear Prods., Inc. v. Timex Corp., 384 F.3d 700, 708–09 (9th Cir. 2004); *McRoberts*, 329 F.3d at 566–67; Bruce v. Weekly World News, Inc., 310 F.3d 25, 28–30 (1st Cir. 2002); Kleier Adver., Inc. v. Premier Pontiac, Inc, 921 F.2d 1036, 1040 (10th Cir. 1990).

awarding a hypothetical license fee for the purpose of awarding infringement damages.[131]

In the recent case of *Oracle America, Inc. v. Google, Inc.*,[132] the court held that "[i]n the context of copyright infringement, the hypothetical lost license fee can be based on the fair market value of the copyright at the time of infringement." The court held further that to determine the work's market value at the time of infringement, the court should consider "what a willing buyer would have been reasonably required to pay to a willing seller for the owner's work."[133]

Considering the case of a license transfer that is not approved by the licensor, it is difficult to identify the actual loss to the licensor in cases where the licensed product is transferred by one party to another where the use of the product before and after the transfer is the same. However, the licensor does not need to show its actual loss. It may instead argue for a hypothetical license fee. Using the construction of damages demonstrated in *McRoberts, Thoroughbred*, or *On Davis,* it is clear that if the court is confronted with the choice between giving the licensor nothing, because it was not damaged by a

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[131] Kevin Bendix, *Copyright Damages: Incorporating Reasonable Royalty from Patent Law*, 27 BERKELEY. TECH. L.J. 527, 534 (2012) (citing 4 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 14.02[B]). In this Article, the author states there are three things required in a case of hypothetical lost damages: "First, the loss to the copyright owner must be difficult to quantify, thus precluding recovery of lost profits. Second, the infringement must produce no gain to the infringer, rendering disgorgement unavailable. Lastly, the copyright owner must fail to timely register the work, thus sacrificing the ability to recover the fallback remedy of statutory damages." *Id.*

[132] 847 F. Supp. 2d 1178 (N.D. Cal. 2012).

[133] *Id.* at 1182.

software transfer, or giving the licensor something, it will elect the latter option. Applying the holding of the case of *Oracle America*, one can easily see how a commercial software company would determine the market value of a software product at the time of the infringement by simply identifying the purchase price it charged to other customers for a similar product with similar use.[134]

However, this is not to say that the licensee has no arguments regarding the hypothetical lost damages that may be claimed. In the case of *Oracle USA, Inc. v. SAP AG*,[135] for example, after a trial on this issue of damages, a jury awarded the plaintiff $1.3 billion, basing the damage award on a "hypothetical license." On post-trial motions, the court granted judgment as a matter of law that the plaintiff had not presented non-speculative evidence of a hypothetical license.[136] To restrain a copyright owner from claiming unreasonable amounts as a damage award, in the case of *On Davis,* the court noted that the law "expects that the amount of damages may not be based on undue speculation."[137]

In the case of *Quinn v. City of Detroit*,[138] for example, Quinn sought damages against the City of Detroit ("the City") for the City's alleged infringement of his copyright to a computer program entitled Litigation Management System/Claims Management System ("LMS"). The City used

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[134] *See* Interactive Pictures Corp. v. Infinite Pictures, Inc., 274 F.3d 1371 (Fed.Cir. 2001). This is another case showing that it is not necessary to prove actual damages for lost sales, as the court held an award of actual damages based on estimated lump sum royalty payment from infringer's projected sales.
[135] No. C 07-1658 PJH, 2011 WL 3862074, at *1 (N.D. Cal. Sept. 1, 2011).
[136] *Id.* at *13.
[137] On Davis v. The Gap, Inc., 246 F.3d 152, 166 (2d Cir. 2001).
[138] 23 F. Supp. 2d 741 (E.D. Mich. 1998).

the program developed by Quinn without purchasing a license that Quinn repeatedly demanded. The court found that Quinn provided no evidence that the alleged unauthorized use by the City harmed his ability to earn profits from his product, nor that the City's act diminished the overall marketability of the product.[139] Quinn was also unable to recover on a theory asking what a willing buyer would have reasonably paid a willing seller for the same product, as Quinn provided no evidence that the City would have purchased a case management system.[140] This case and its analysis have obvious similarities to the common commercial software company and licensee. The company that acquires the software license through a merger or bankruptcy similarly is using a copyrightable work, but that transfer would not diminish the overall marketability of the product. However, unlike Quinn, most commercial software companies would be able to show what other buyers would be willing to pay for the same product, as they have multiple customers already buying the same product.

When a copyright owner confronts a situation where a licensee has breached its license agreement by transferring the use of a software product, the owner may seek damages on the basis of breach of contract or under copyright. In pursuing a breach of contract theory, the parties will rely on traditional contract theories. In the case of copyright, the copyright owner may seek actual damages or, if there are no actual damages,

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[139] *Id.* at 751.

[140] *Id.* (citing Deltak, Inc. v. Advanced Sys., Inc., 767 F.2d 357 (7th Cir. 1985)). The court notes, "Quinn, however, has presented no evidence that the City would have spent $125,000 on a case management system. To the contrary, the only evidence offered at trial of the cost of replacing LMS was the testimony of Brenda Miller. Ms. Miller testified that the City was charged $3,500.00 for a new system." *Id.*

hypothetical damages. In the case of the reverse triangular merger, the software product will typically be used in the exact manner before and after the merger. The courts have made clear that damages are available to the copyright owner in such event, provided that the contract did not allow the assignment of the software product. But this begs the question: Why are damages available in such a situation? How is this different from any other breach of contract where the parties must prove the damages it suffered? Is there a method to provide copyright owners with protection against the use of their copyrightable works by competitors while still allowing for a process to transfer software licenses in a reasonable commercial fashion? A stricter application of the duty of good faith and fair dealing may provide that method.

V. SUMMARY OF THE LAW OF GOOD FAITH AND FAIR DEALING

A. Overview

The duty of good faith and fair dealing is implied in nearly every commercial contract.[141] In addition, it is

[141] *See* Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 ST. JOHN'S L. REV. 559, 559–62 (2006); *see also* Thomas A. Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery*, 47 HAST. L.J. 585, 585 n.1 (1996) ("[An] overwhelming majority of jurisdictions apply [good faith] as a matter of common law."); Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 87 (1993) (stating that "courts in the vast majority of American jurisdictions agree that a general obligation of good faith and fair dealing is implied in every contract"). In fact, good faith and fair dealing apply throughout Europe as well.

recognized in nearly every jurisdiction.[142] The requirements of good faith and fair dealing arise both under the U.C.C. and the RESTATEMENT (SECOND) OF CONTRACTS. Section 205 of the RESTATEMENT (SECOND) OF CONTRACTS states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Similarly, the U.C.C. states that "[every] contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[143] It defines good faith generally as "honesty in fact in the conduct or transaction concerned."[144] In the case of a merchant, that standard is even higher, including honesty in fact and "the observance of reasonable commercial standards of fair dealing in the trade."[145] On the other hand, with respect non-merchants, "Good faith means honesty in fact in the conduct or transaction concerned."[146] Therefore, non-

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[142] Dubroff, *supra* note 141, at 559–62; *see also* Diamond & Foss, *supra* note 141, at 585 n.1 (citing RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981)); Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 228 n.4 (2005) ("The doctrine's widespread acceptance is due in large part to the inclusion of the duty of good faith in the Uniform Commercial Code.").

[143] U.C.C. § 1-203 (2012); see also Dubroff, *supra* note 141, at 559–62, for an overview of the history of good faith and fair dealing.

[144] U.C.C. § 1-201(19).

[145] *Id.* § 2-103(1)(b). As to the objective standard, even though the party engaging in the challenged behavior believes his or her action to be reasonable, the law will not excuse it if it violates commercial norms of fair dealing. Merchants are held to a higher standard of good faith because they "have expertise with respect to the customs and standards of their trade." Robert S. Alder & Eliot M. Silverstein, *When David Meets Goliath: Dealing with Power Differentials in Negotiations*, 5 HARV. NEGOT. L. REV. 1, 50 n.202 (2000).

[146] U.C.C. § 1-201(19). As to a subjective standard, this is reasonableness of a person's belief is irrelevant to good faith. If a person has a "pure heart and an empty head," he or she acts in good faith. Alder & Silverstein, *supra* note 145, at 50 n.201.

merchants have an obligation of mere subjective good faith while merchants are held to an objective standard. Taken as a whole, the term "good faith" is used at least sixty times in the U.C.C. itself.[147]

In addition to its wide spread application, the duty of good faith and fair dealing is a term that cannot be written out of a contract.[148] The U.C.C. provides that "obligations of *good faith, diligence, reasonableness and care prescribed by this act may not be disclaimed by agreement* but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."[149]

B. The Application of the Duty of Good Faith

The RESTATEMENT (SECOND) OF CONTRACTS states that a party performs in good faith if it acts with a "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."[150] As the concept of good faith

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[147] *See* Dubroff, *supra* note 141, at 561 (stating that good faith has become a commonly used term in commercial litigation, and provides a cite indicating a LEXIS search for "implied covenant w/1 good faith" returned a total of 10,715 cases using this phase between 1954 and 2004).

[148] Professor Corbin has described the covenant: "While it is true that courts impose an obligation of good faith in every aspect of the contractual relationship . . . the obligation of good faith is 'constructive' rather than 'implied' because the obligation is implied by law and cannot be disclaimed." ARTHUR LINTON CORBIN, 8 CORBIN ON CONTRACTS § 32.2A(3) (2nd ed. 1993).

[149] U.C.C. § 1-102(3) (emphasis added).

[150] RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981); *see* Gerard Mantese & Marc L. Newman, *Still Keeping the Faith: The Duty of Good Faith Revisited*, 76 MICH. B. J. 1190, 1191 (1997) (citing Banque Nationale de Paris, SA v. Ins. Co. of North America, 896 F. Supp. 163, 165 (S.D.N.Y. 1995)).

is ubiquitous throughout the U.C.C., it is understandably held by courts and commentators to have a variety of meanings. Courts have opted to address cases relying on the duty of good faith and fair dealing on a fact-specific basis.[151] The duty of good faith and fair dealing has been applied recently by courts as to disputes arising from a stock purchase agreement, a landlord tenant agreement, a commercial real estate transaction, and a distribution agreement.[152]

Some have hailed the duty of good faith and fair dealing as an indispensable measure of "contractual morality."[153] Others argue it should be narrowly applied because it hinders the ability of business people and their attorneys "to predict the legal consequences of voluntary transactions."[154] In all cases, there is a tension between

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[151] Tory A. Weigand, *The Duty of Good Faith and Fair Dealing in Commercial Contracts in Massachusetts*, 88 MASS. L. REV. 174, 174 (2004); *see also* Rumis v. Brady Worldwide, No. 05CV1758 J (NLS), 2007 U.S. Dist. LEXIS 37190, at *13 (S.D. Cal. May 21, 2007) (noting that implying terms to ensure the parties expectations are fulfilled is "fact intensive").

[152] *See* TORY A. WEIGAND & CHRISTOPHER QUINN, IADC COMM. NEWSLETTER: BUS. LITIG., THE DUTY OF GOOD FAITH AND FAIR DEALING IN COMMERCIAL CONTRACTS 5 (2008), *available at* http://www.iadclaw.org/assets/1/19/Bus%20Lit%20March%2008.pdf (citing Gabana Gulf Distr., Ltd. v. Gap Int'l Sales, Inc., No. C 06-02584 CRB, 2008 U.S. Dist. LEXIS 1658 (N.D. Cal. Jan. 9, 2008) (regarding a distribution agreement); McLain v. Octagon Plaza LLC, 71 Cal. Rptr. 3d 885 (Cal. Ct. App. 2008) (regarding a landlord tenant dispute); *Rumis*, 2007 U.S. Dist. LEXIS 37189, at *1 (regarding a stock purchase agreement); Knucklehead Land Co. v. Accutitle, Inc., 172 P.3d 116 (Mont. 2007) (regarding a commercial real estate transaction)).

[153] *See* Weigand, *supra* note 151, at 174.

[154] Clayton P. Gillette, *Limitation on the Obligation of Good Faith*, 1981 DUKE L.J. 619, 621(1981); *see* Samuel V. Jones, *The Moral Plausibility of Contract: Using the Covenant of Good Faith to Prevent Resident Physician Fatigue-Related Medical Errors*, 48 U. LOUISVILLE L. REV. 265, 289

implying general obligations of good faith and contractual relations where the parties are able to freely construct their bargains without a court undoing those bargains in the name of commercial reasonableness.[155] The courts are mindful that the implied covenant of good faith and fair dealing should not be applied to give plaintiffs contractual protections that they failed to secure for themselves at the bargaining table.[156]

(2009); *see also* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith,* 94 HARV. L. REV. 369, 370 (1980) (stating that the doctrine of the duty of good-faith performance acts "as a license for the exercise of judicial or juror intuition" and leads to unpredictable results and inconsistent applications). This was cited by Michael G. Bridge, *Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith,* 9 CAN. BUS. L.J. 385, 401 (1984), where Bridge's view is that whatever useful role the duty of good faith and fair dealing can bring that is outweighed by the uncertainty presented in the application of the duty. He states that the implied covenant of good faith and fair dealing is the intellectual equivalent of uncertainty because it is "tantamount to saying that the good faith duty is breached whenever a judge decides that it has been breached . . . [which] hardly advances the cause of intellectual inquiry[,] and it provides absolutely no guide to the disposition of future cases." *Id.* at 398.

[155] Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1252–53 (1999) ("Under this view, in short, the doctrine of good faith performance can operate, at some undefined level to displace even an informed, explicit agreement between the parties."); James J. Brudney, *Reluctance and Remorse: The Covenant of Good Faith and Fair Dealing with American Employment Law Good Faith and Fair Dealing in the Individual Employment Relationship*, 32 COMP. LAB. L. & POL'Y J. 773, 789 (2011) ("[C]ourts have focused on tension between the covenant's imposition of a duty and the employer's pre-existing right to terminate for any reason—including a bad faith reason."); E. Allen Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); *see also* WEIGAND & QUINN, *supra* note 152, at 2.

[156] *See, e.g.*, Winshell v. Viacom Int'l, Inc., 55 A.3d 629, 636–37 (Del. Ch. 2011) (citing Aspen Advisors LLC v. United Artists Theatre Co., 861 A.2d 1251, 1260 (Del. 2004) ("The court must be mindful that the implied covenant of good faith and fair dealing should not be applied to give

The Ninth Circuit explained that the covenant of good faith and fair dealing requires a party to do everything that the contract presupposes that he will do to accomplish the purpose of the contract.[157] Other courts have made similar decisions, indicating a party must refrain from unreasonable conduct which prevents one party from receiving the benefit of the agreement.[158] Relevant to the subject matter of this Article, the duty of good faith and fair dealing "prevents one party to the contract from exercising a judgment conferred by the express

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plaintiffs contractual protections that 'they failed to secure for themselves at the bargaining table.'")); Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1032–33 (Del. Ch. 2006) ("[I]mplied covenant analysis will only be applied when the contract is truly silent with respect to the matter at hand, and only when the court finds that the expectations of the parties were so fundamental that it is clear that they did not feel a need to negotiate about them."); *see also* Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) ("[The court] must assess the parties' reasonable expectations at the time of contracting and not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal.").

[157] L.A. Mem'l Coliseum Comm'n v. Nat'l Football League, 791 F.2d 1356, 1361 (9th Cir. 1986) (citation omitted); Sheppard v. Morgan Keegan & Co., 266 Cal. Rptr. 784, 786–67 (Cal. Ct. App. 1990); Floystrup v. City of Berkeley Rent Stabilization Bd., 268 Cal. Rptr. 898, 903–04 (Cal. Ct. App. 1990) (stating that the duty of good faith and fair dealing imposes the duty to do everything the contract presupposes to accomplish purpose of contract).

[158] *Winshell*, 55 A.3d at 636 n.25 *(*citing RICHARD A. LORD, 23 WILLSTON ON CONTRACTS § 63:22 (4th ed. 2010) ("Every contract imposes an obligation of good faith and fair dealing between the parties in its performance and its enforcement, and if the promise of the defendant is not expressed by its terms in the contract, it will be implied."); *see also* Fitzgerald v. Cantor, No. C.A. 16297-NC. 1998 WL 842316, at *1 (Del. Ch. Nov. 10, 1998) ("All contracts are subject to an implied covenant of good faith and fair dealing."); Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986) ("Modern contract law has generally recognized an implied covenant to the effect that each party to a contract will act in good faith towards the other with respect to the subject matter of the contract."); *see also* LORD, *supra*, § 63:22).

terms of agreement in such a manner as to evade the spirit of the transaction or so as to deny the other party the expected benefit of the contract."[159]

In application, the duty of good faith and fair dealing creates "an obligation imposed by law to prevent opportunistic behavior, that is, the exploitation of changing economic conditions to ensure gains in excess of those reasonably expected at the time of contracting."[160] One of the important roles for the implied covenant has been the resolution of disputes that arise after contract formation, such as those disputes that arise when a contract does not squarely cover the subject or when applying the contract would yield an unfair result.[161] The duty is implicated where the contract is either silent or ambiguous as to the conduct at issue, with the duty viewed as an interpretative aid. Its most prominent role is to regulate post-formation conduct.[162] Professor Robert Summers

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[159] Amecks v. Sw. Bell Tel., 937 S.W.2d 240, 243 (Mo. Ct. App. 1997); *see also* Schell v. LifeMark Hosps. of Mo., 92 S.W.3d 222, 230 (Mo. Ct. App. 2002); Mo. Consol. Health Care Plan v. Cmty. Health Plan, 81 S.W.3d 34, 45 n.3 (Mo. Ct. App. 2002) ("That duty prevents one party to the contract to exercise a judgment conferred by the express terms of agreement in such a manner as to evade the spirit of the transaction or so as to deny the other party the expected benefit of the contract."); Diamond & Foss, *supra* note 141, at 586 (stating that the duty of good faith has also been described to impose limits upon one contracting party's ability to negatively impact the contract's value to the other contracting party).

[160] Spencer Reed Grp., Inc. v. Pickett, 163 S.W.3d 570, 574 (Mo. Ct. App. 2005).

[161] Dubroff, *supra* note141, at 561(urging that rather than applying the covenant of good faith and fair dealing, one should apply common gap-filling principles and principles of contract construction).

[162] Weigand, *supra* note 151, at 185. The author provides an overview of the duty of good faith and fair dealing as applied in Massachusetts, stating that contracts containing "satisfaction clauses" were subject to "reasonableness" and "good faith," with the courts. If the service at issue was satisfactory to a reasonable person in view of all the circumstances "there is read into the

has offered a widely adopted interpretation of the term, describing good faith as an "excluder," namely a "phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith."[163]

Can the results of the *Cincom* case be reconciled with an application of the duty of good faith and fair dealing? The licensee of Cincom "transferred" the non-transferrable software product by virtue of a corporate reorganization. At the end of the transfer, the software was used in the same way as originally licensed. Given the totality of the circumstances, isn't it true that Cincom negatively impacted the value of the underlying agreement? The duty of good faith and fair dealing prevents one party to the contract from exercising its rights as set forth in the agreement in such a manner as to deny the other party the expected benefit of the contract.[164] Didn't the plaintiff in Cincom do just that, exercising its rights under the contract in such a manner as to deny the licensee the bargained-for use of the product? Or would any other outcome give the licensee a contractual protection it failed to secure for itself at the bargaining table? Could a software company be accused of failing to cooperate, for example, when restricting an

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contract the rule that, that which the law says a party ought to be satisfied with, the law will say he is satisfied with." *Id.* at 176 (citing Gleason v. Smith, 63 Mass. (9 Cush.) 484, 486 (Mass. 1852)). Weigand points out that Massachusetts continues to give the utmost primacy must be given to the words and terms used in the parties' express agreement. *Id.* at 177; *see also* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. of Corp. L. 1 (2007). There, Steele states that under Delaware law the covenant of good faith and fair dealing is a freestanding regulator of conduct. *Id.* at 16.

[163] *See* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968).

[164] *Id.* at 199.

assignment as having occurred by virtue of merger such as in *SQL Solutions*?

C. Context as Determining the Duty of Good Faith

"Good faith" is a term that derives its meaning from the context. A state supreme court recently held that the duty of good faith is to be applied in order to effectuate the reasonable contractual expectations of the parties, but added that "the party invoking its expressed, written contractual rights does not, merely by so doing, violate its duty of good faith."[165] A

[165] Uptown Heights Assocs. Ltd. P'ship v. Seafirst Corp., 891 P.2d 639, 645 (Or. 1995); *see* Mantese & Newman, *supra* note 150, at 1192 (providing examples of instances where a contract reserved for a party the right to compete, and the court refused to add terms to the contract that would limit that right). In another case, Goodyear Tire & Rubber v. Whiteman Tire, 935 P.2d 628 (Wash. Ct. App. 1997), the court held that the duty of good faith and fair dealing did not prevent Goodyear from exercising its express contractual right to establish its own outlets and to sell tires in the dealer's trade area as the language was unconditional and does not call for the exercise of discretion. *See also* Weigand, *supra* note 151, at 183. Weigand notes that "consistent with the notion that the implied duty of good faith and fair dealing is dependent upon the particular contract and context, Massachusetts courts have slightly varied the generalized standard in response to the specific contractual relationship. Indeed, it is the specific contract, contractual relation and context that provide the duty its functional meaning." *Id.*; *see also* MC Corp. v. Deprofio, No. CVNH 9008-3925., 1991 WL 303793, at *1 (Conn. Super. Ct. 1991). The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. *Id.* at *2. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness." *Id.* The likely purpose behind the ambiguity is to provide flexibility in safeguarding victims' rights. *See* Palmieri, *supra* note 141, at 80 (noting that "a majority of commentators . . . recognize . . . it is probably better that the definition of

number of cases recognize that the duty of good faith and fair dealing can encompass "inaction" or the failure to cooperate. In the case of Brennan v. Carvel Corp, the court explained that "a party may be under the duty not only to refrain from hindering or preventing the occurrence of his own duty or the performance of the other party's duty, but also to take positive steps to cooperate with the other party in achieving these objectives."[166] Underlining the importance of the context of the situation, however, the Supreme Judicial Court of Massachusetts decided in *Uno Restaurants, Inc. v. Boston Kenmore Realty Corp.* that "[i]naction amounts to a lack of good faith in contract performance only when the contracting party had a duty to act."[167]

VI. APPLYING THE DUTY OF GOOD FAITH TO THE ASSIGNMENT OR TRANSFER OF A SOFTWARE LICENSE AGREEMENT

A. Introduction

When it comes to the assignment of a software license agreement, the duty of good faith and fair dealing may be applicable in two common situations. It is applicable when the software license sets forth that the license cannot be transferred or assigned without the consent of the licensor, and that consent "will not be unreasonably withheld." It is also applicable when the software license sets forth that the license cannot be transferred or assigned without the consent of the licensor, and the contract is silent as to the reasonableness of

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good faith and fair dealing remains amorphous so that the doctrine can be applied on a case-by-case basis").

[166] No. 810595-N, 1989 U.S. Dist. LEXIS 16104, at *17 (D. Mass. July 25, 1989).

[167] 805 N.E.2d 957, 965 (Mass. 2004).

the licensor. This Article will also consider other common applications of the duty of good faith and fair dealing to commercial disputes that are similar to the situation of a licensor and licensee, focusing in specific on the jurisdictions of California and New York.

B. When the Agreement Requires the Reasonable Consent of the Licensor to Transfer the Agreement

The Florida case of *First Nationwide Bank v. Florida Software Services, Inc.*[168] is one of the few cases where a court clearly applies the duty of good faith and fair dealing standard to a software contract. In this case, the federal district court refused to enforce an anti-assignment provision of a software license governed by Florida law because the licensor had no good-faith basis for refusing to consent to assignment. The anti-assignment provision at issue in the case reads:

> "[The licensee] shall not, without prior written consent of [licensor], sell, lease, transfer or assign its interest as [l]icensee under [the software license] . . . . Such consent shall not be unreasonably withheld."[169]

The licensor refused to consent to the assignment of the software license primarily because the proposed assignee would not pay an increased license fee.[170] The court applied the implied covenant of good faith and commercial reasonableness, which it noted is implied in every contract.[171] The *First Nationwide Bank* court concluded that the licensor did not act

[168] 770 F. Supp. 1537 (M.D. Fla. 1991).
[169] *Id.* at 1539–40.
[170] *Id.* at 1543.
[171] *Id.* at 1542.

in good faith in refusing to consent to assignment in order to receive a new and substantially larger license fee from the assignee, and, thus, could not refuse consent.[172] In reaching its conclusion, the court referred to Florida's version of the U.C.C., which imposes an obligation of good faith in a contract's performance or obligation. It described the fee requirement imposed by the licensor as an "undeserved windfall" for the licensor.[173]

It may be the case, that unlike the situation in *Cincom*, the perception of greed or of seeking an underserved windfall will restrict licensors from seeking a license fee to allow an otherwise harmless transfer of a software license contract. The court in *First Nationwide Bank* held that one does not need to rely upon a licensor's restraint. Instead, the duty of good faith requires a transfer be allowed unless there is a reasonable basis to refuse one. This was decided under Florida law in 1991 and has not been cited by any other case containing the same fact situation. Thus, it is not a well-established precedent, even in Florida.

However, other courts have applied the duty of good faith and fair dealing when a contract confers one party the right to approve a transfer or other change, and that approval is to not be unreasonably withheld. Take the case of *Anthony's Pier Four, Inc. v. HBC Assocs., Inc.*,[174] in which Anthony's entered into an agreement with HBC for HBC to develop a parcel of land. The agreement conferred upon Anthony's a limited right to approve changes to the development plan for the parcel. The agreement set forth that Anthony's approval to changes to the development plan would not be unreasonably

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[172] *Id.* at 1543.
[173] *Id.*
[174] 583 N.E.2d 806 (Mass. 1991).

withheld or delayed.[175] In this case, HBC submitted modifications to the development plan, but Anthony's refused to consent to those modifications. Given Anthony's refusal, HBC could not move forward with the plan with needed financing.[176] The Supreme Judicial Court of Massachusetts held that Anthony breached the implied covenant of good faith and fair dealing in refusing to consent to the modifications to the plans. Anthony's basis for refusal was not due to a substantive problem with the proposed modifications, but simply because Anthony wanted more money.[177]

Applying the reasoning in *Anthony's Pier* to a software license, would the software licensor be deemed to be unreasonable if it refused the consent of a software contract for no reason except that it wished to extract an extra payment? Or would the deference given to federal law in the case of intellectual property transactions effectively negate this view of reasonableness? Notably, federal courts have provided that the licensor has wide discretion regarding the appropriate licensees of its products given the concern that "every licensee would become a potential competitor."[178] In the event that the

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[175] *Id.* at 811–12. The contract provided that approval "shall not be unreasonably withheld or delayed and shall be deemed given if Athanas [Anthony's] has failed to respond with specified objections within fourteen days after receipt by Athanas of HBC's request and the requisite information." *Id.* at 812.

[176] *Id.* at 815.

[177] Some evidence of Anthony's conduct included a finding by the judge that Anthony told HBC that he would "rather look out of [his] window on nothing than on a lousy deal." *Id.* Anthony explained to HBC's representatives that he wanted "more money" than the agreements provided. *Id.* at 820. The judge further found that although Anthony's purported to disapprove the plan, but admitted: "I'm not really disapproving the project. I want to get more money." *Id.*

[178] *In re* CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996); *see also* Ziff*, supra* note 41, at 772 ("This sentiment was echoed in *In re* Access Beyond

agreement required the reasonable consent of the licensor in case of a transfer, if the licensee wished to transfer the license to a competitor then the licensor could reasonably refuse that transfer. In the cases of *First Nationwide Bank* and *Anthony's Pier,* the courts found it unreasonable to refuse consent when the *only* basis was a desire to extract more money from the underlying transaction.

Take for example a contract between franchisor and franchisee. Like a license contract, the franchisee receives a license to trademarks, to any copyrightable works in connection with advertising the franchise such as signage and print advertising, and a license to any patentable methods. In the case of *Richter v. Dairy Queen of South Arizona*,[179] the plaintiffs were operators of a Dairy Queen store under an agreement with the franchisor. The contract between Dairy Queen and the franchisee stated that the transfer or assignment of the contract was not authorized without the written consent of Dairy Queen, where that consent would not be withheld unreasonably.[180] The plaintiffs brought an action seeking a declaratory judgment that the franchisor unreasonably withheld its consent to the assignment. The judgment in favor of the plaintiff was later affirmed.[181] The decision hinged on the fact that the proposed assignee had the financial means to continue the operation, and therefore the refusal to consent to the transfer was unreasonable.[182]

Technologies, wherein the Delaware Bankruptcy Court noted that allowing the proposed assignee, a direct competitor of the licensor, access to the licensed technology eliminated any competitive advantage that the licensor may have as a result of the technology–exactly what the patent laws were designed to prevent.").

[179] 643 P.2d 508 (Ariz. Ct. App. 1982).

[180] *Id.* at 596.

[181] *Id.* at 597.

[182] *Id.*

Another common contract that is transferred is one between a lessor and lessee. In the case of lessees and lessors, factors to consider when determining whether a lessor is acting reasonably include: the financial responsibility of the proposed assignee, the "identity" or "business character" of the assignee, the legality of the use by the lessee and other factors.[183]

In the case of a software license contract, would it be similarly unreasonable to refuse an assignment to a party, provided that party was not a competitor and provided that the party possessed the financial means to make the licensor whole in case of any breach of the agreement? The cases of *Richter, Anthony's Pier* and *First Nationwide Bank* seem to indicate so.

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[183] Fernandez v. Vasquez, 397 So.2d 1171, 1174 (Fl. Dist. Ct. App. 1981). The court cites: B & R Oil Co., Inc. v. Ray's Mobile Homes, Inc., 422 A.2d 1267 (Vt. 1980); Carleno v. Vollmert Tire Co*.,* 540 P.2d 1149 (1975); Segre v. Ring, 170 A.2d 265 (1961); Grumen v. Investor's Diversified Servs., 78 N.W.2d 377 (1956). *Id.* at 1171; *see also* Jacob L. Todres & Carl M. Lernery, *Assignment and Subletting of Leased Premises: The Unreasonable Withholding of Consent*, 5 FORDHAM URB. L.J. 195 (1976). Todres and Lernery focus on the interpretation of lease contracts where the landlord is obligated to "not unreasonably withhold his consent to a transfer of the lease. The authors note: "Frequently used in commercial and residential leases, the provision is generally assumed to have a clear and well-established meaning. Several jurisdictions have even enacted statutes proscribing the unreasonable withholding of consent in certain circumstances. Yet most jurisdictions which have passed such legislation do not define the concept of 'unreasonable withholding of consent,' presumably concluding that it has a 'well-established' or 'generally known" usage.'" *Id.* at 196. The authors focus on the various factors that would suggest a landlord is acting reasonably if refusing to consent to the assignment of a contract, stating that objective criteria must be used to determine reasonableness, including the financial ability of the lessee to pay, the reputation of the lessee and the use of the leased premise. *Id.* at 202–19.

C. When the Agreement is Silent as to the Reasonable Consent of the Licensor to Transfer the Agreement

The duty of good faith and fair dealing is used to carry out the intention of the parties and injects a level of reasonableness into the expectations of the parties when it comes to their interpretation and implying contractual terms.[184] Even in cases where the requirement of reasonableness is not express, the U.C.C. requires that reasonableness be applied in every contract.[185] What if a license contract sets forth that is may not be transferred or assigned without the consent of the licensor, and the agreement does not require any specific level of reasonableness? Similarly, what if the contract does not include a restriction on transfer or assignment? Federal law makes clear that the licensor's consent will be required to allow the transfer or assignment of licensed product, even if the topic is not covered in the agreement. This Article will consider the situation where the parties have not agreed to a standard of reasonableness to be applied to that request for consent.

Given the scarcity of cases which have applied the duty of good faith and fair dealing to the transfer of a license contract, it is necessary to look at analogous situations. A type of contract that is frequently assigned is a lease contract. May a

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[184] See Dubroff, *supra* note 141, in which he compares the views of the article of the late Professor E. Allan Farnsworth of Columbia University, who Dubroff states was critical of the earlier "definition of good faith in Article 1 of the U.C.C. as too restrictive because it provided for judging conduct based solely on the honesty of the actor and did not include a requirement of reasonableness, as was required by Article 2 in the case of merchants." *Id.* at 587.

[185] The California Commercial Code, Section 2, which governs the sale of goods mentions "reasonable" or "reasonably" 107 times. *California Commercial Code*, CAL. L., http://www.leginfo.ca.gov/.html/com_table_of_contents.html (last visited March 15, 2015).

lessor refuse the assignment of a lease which provides that the lessee shall not assign or sublease the premises without written consent of the lessor, and the lease is silent as to whether the lessor must be reasonable? In the majority of jurisdictions in the United States, when a lease requires written consent prior to assignment or subleasing but does not contain any language limiting the withholding of that consent, courts hold that such consent may not be arbitrarily or unreasonably refused.[186] In one such case, the Florida District Court of Appeals held that a blanket lease provision prohibiting assignment by the tenant could not be enforced in an arbitrary or capricious manner.[187] The court concluded that breach of the duty of good faith produced an affirmative claim for relief and was to be measured by objective criteria, not the subjective state of mind of the landlord.[188] Courts in certain jurisdictions state that it is "the now well-accepted concept" that the lease contract is governed by the general contract principles of good faith and

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[186] Fernandez v. Vasquez, 397 So.2d 1171, 1173 (Fla. Dist. Ct. App. 1981). The court cites: B & R Oil Co., Inc. v. Ray's Mobile Homes, Inc., 422 A.2d 1267 (Vt. 1980); Carleno v. Vollmert Tire Co., 540 P.2d 1149 (Colo. App. 1975); Segre v. Ring, 170 A.2d 265 (N.H. 1961); Grumen v. Investor's Diversified Services, 78 N.W.2d 377 (Minn. 1956). *Id.* at 1172. The case provides the footnote: "The court in *Grumen* [] lists the following nineteen jurisdictions as permitting arbitrary refusal: District of Columbia, Alabama, Arkansas, California, Connecticut, Delaware, Florida, Illinois, Indiana, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Nebraska, New Jersey, New York, Ohio, Pennsylvania, and Texas. Since this case was decided, at least five of the states (Alabama, Illinois, New Jersey, New York and Ohio) have changed their laws. Massachusetts remains with the majority but not without protest." *Id.* at 1172 n.3 (citations omitted).

[187] *Fernandez,* 397 So.2d at 1173.

[188] *Id.* at 1174. Objective criteria include the "(a) financial responsibility of the proposed subtenant, (b) the 'identity' or 'business character' of the subtenant, i.e., suitability for the particular building, (c) the need for alteration of the premises, (d) the legality of the proposed use, and (e) the nature of the occupancy, i.e., office, factory, clinic, etc." *Id.*

commercial reasonableness, one of which is that a party's good faith cooperation is an implied condition precedent to performance of a contract.[189] In such cases, courts provide factors to consider when deciding if a lessor breached the lease by acting unreasonably in withholding consent of the lessee's assignment. The factors included the financial responsibility of the proposed assignee, the "identity" or "business character" of the assignee, the legality of the use, and other factors.[190] In such cases, courts provide factors to consider when deciding if a lessor breached the lease by acting unreasonably in withholding consent of the lessee's assignment. Courts have found that refusing to consent to the assignment of a lease contract constitutes a breach of the implied covenant of good faith and fair dealing, which is imposed on each party.[191] In the case of a license contract, where the license is silent as to the reasonableness required of a licensor to consent to an assignment, would a similar standard be implied in license contracts requiring the licensor to act reasonably or at least in a non-arbitrary manner?

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[189] *Id.* at 1173, 1174; *see also* Cohen v. Ratinoff, 195 Cal. Rptr. 84 (Cal. Ct. App. 1983). "When a lease allows assignment or subletting only with the lessor's prior consent, the lessor may refuse consent only where he has a good faith reasonable objection to the assignment or sublease, even if no provision prohibits the unreasonable or arbitrary withholding of consent." Stanton T. Mathews & Kevin Lancaster, *Breach of Implied Good Faith and Fair Dealing: Elements*, *in* CALIFORNIA CAUSES OF ACTION (1998), *available at* http://www.jameseducationcenter.com/articles/breach-of-contract-good-faith.

[190] *Fernandez*, 197 So.2d at 1174; *see* Todres & Lernery, *supra* note 183, at 195 (noting that "[a]bsent any qualifications on his right, the landlord may withhold his consent even if that withholding is unreasonable" (citing WARREN'S WEED N.Y. REAL PROP. § 1804 (4th ed. 1976)).

[191] *See, e.g.*, Warner v. Konover, 553 A.2d 1138 (Conn. 1989).

D. Using Franchise Agreements as a Basis to Determine Reasonableness

Like a license contract, a franchise agreement typically contains a license to intellectual property rights of the franchisor such as a trademarks or copyrightable works. A case decided in federal court implying reasonableness into a franchise agreement that was otherwise silent as to reasonableness is *In re Vylene Enterprises,* where the Ninth Circuit held that a franchisor negotiated the renewal of a contract in bad faith.[192] In this case, the contract obligated the parties "to bargain in good faith on the terms and conditions of a renewal."[193] The court found the franchisor breached its duty to negotiate in good faith when it offered a new and different agreement with conditions that were unreasonable. Specifically, the franchisor opened a competing business in the vicinity of the franchisee and offered terms to the franchisee that were not economically viable.[194]

Courts have held that a franchisor's withholding of consent to a transfer of the franchisees without a strong and legitimate business interest behind their actions is unreasonable.[195] In cases where the factors that will form the basis of a franchisor's reasonable consent are spelled out in the contract, the franchisor is considered to be acting reasonably when it acts in accordance with those interests, regardless of whether the factors themselves are arguably unreasonable.[196] In *Schott Enterprises, Inc. v. Pepsico, Inc.*, for example, "Pepsico

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[192] *In re* Vylene Enters., 90 F.3d 1472, 1476 (9th Cir. 1996).
[193] *Id.*
[194] *Id.* at 1477,
[195] *See* Terrence M. Dunn, *The Franchisor's Control over the Transfer of a Franchise*, 27 FRANCHISE L.J. 233 (2008).
[196] *Id.* at 234.

conditioned its consent on Schott's dismissal of a lawsuit against Pepsico, execution of a mutual release, and the purchaser's agreement to conditions similar to those in the existing franchise."[197] Pepsico was found to be reasonable when acting in its interests relative to those factors, as those factors were agreed upon in the contract. In sum, courts have endorsed a variety of "reasonable" grounds for disapproving a proposed transfer. Some examples include a) the transferee's lack of business experience; b) possible dilution of sales because the transferee sells a competitor's product; c) the transferee's unrealistic sales predictions, failure to account for capital improvements, insufficient working capital, and debt load; d) the transferee's conditioning its purchase on an application to relocate the franchise e) the transferee's unacceptable character; f) the transferee's failure to provide required and necessary financial information concerning a major investors; g) the transferee's poor sales record with its current franchise; h) and others.[198]

Absent an express list of criteria in the contract, the requirements of what is considered reasonable vary greatly from jurisdiction to jurisdiction and are based on the context. A federal district court in Michigan held that a clause in a distributorship agreement where the manufacturer's consent was required to transfer the business gave the manufacturer unlimited authority to withhold its consent.[199] The court opined that if the parties did not impose any reasonability or other

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[197] *Id.* (citing Schott Enters., Inc. v. Pepsico, Inc., 520 F.2d 1298 (6th Cir. 1975)); *see also* Franchise Mgmt. Unlimited v. Am.'s Favorite Chicken, 889 F. Supp. 916 (E.D. La. 1995) (holding that a franchisor acts reasonably by requiring certain conditions, including execution of a release, as a prerequisite to approval of an assignment).
[198] *Id.* at 234–35.
[199] *Id* at 235.

requirements upon themselves in their agreement, then none was required.[200] Similarly, a Florida court opined that a requirement of reasonability would only be applied in a contract if the parties specifically agreed to it.[201] However, in Colorado, the Tenth Circuit held that an agreement that requires a franchisor's consent without defining standards for that consent does not give the franchisor the absolute right to disapprove of that transfer.[202] As this disparity indicates, some jurisdictions provide that reasonability will not be imposed where the contract does not specify it. As this Article makes clear, whether a court will construe a level of reasonableness as required for a party to consent to the transfer of a franchise agreement when the agreement does not explicitly require it depends on the context and the court. An agreement that is silent on that standard creates the risk that a court will either allow an arbitrary denial or will require a non-arbitrary reason to deny an assignment. This creates inherent risks for both parties, and it would be inadvisable to leave an agreement silent on this point.[203]

E. Refusing the Assignment of a Contract Compared to Terminating an Agreement for Convenience

A comparison can be drawn between contracts where a party has a right to terminate an agreement at-will and a licensor that refuses the assignment of a contract. As a practical matter, in the case of a corporate reorganization, or when a transfer occurs by virtue of acquisition in bankruptcy, if a licensor refuses to consent to a transfer, reasonably or

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[200] *Id.* (citing James v. Whirlpool Corp., 806 F. Supp. 835 (E.D. Mo. 1992)).
[201] *Id.* (citing Gans v. Miller Brewing Co., 560 So.2d 281 (Fla. Dist. Ct. App. 1940)).
[202] *Id.* at 236.
[203] *Id.*

unreasonably, it has the practical effect of terminating the license contract. In the case of *Taylor Equipment, Inc. v. John Deere*,[204] the Eighth Circuit reviewed a South Dakota Supreme Court case involving the former dealer of heavy equipment, Taylor, which sued the equipment manufacturer John Deere for a breach of the implied covenant of good faith and fair dealing, after John Deere refused to approve Taylor's proposed assignment of its dealership. The Eighth Circuit provided an overview of cases in the district courts, noting that they have been reluctant to apply the implied covenant of good faith and fair dealing to block a party's right to refuse the assignment of a contract.[205] Notably, the *Taylor Equipment* court cites *In re Bellanca Aircraft Corp.*,[206] which held that the U.C.C.'s good faith obligation did not impose a duty to not unreasonably withhold consent to assign a contract right.[207] The Eighth Circuit ultimately held in *Taylor* that, as a matter of law, the implied covenant could not override the contract's express terms requiring defendant's prior written consent and that there was no proof that defendant failed to exercise honesty in fact.[208] Notably, the court's reasoning was affected by the fact that the Deere–Taylor dealer contract was terminable by either

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[204] 98 F.3d 1028, 1030 (8th Cir. 1996).

[205] *Id.* at 1032; *see also* Van Arnem Co. v. Mfrs. Hanover Leasing Corp., 776 F. Supp. 1220, 1223 (E.D. Mich. 1991) (stating the duty of good faith "does [not] require a party to ignore, forego or waive its express contractual rights").

[206] 850 F.2d 1275 (8th Cir. 1988).

[207] *Id.* at 1285. The Eighth Circuit also cites the following cases as examples where the implied covenant of good faith and fair dealing did not create an obligation of reasonableness in a contract dispute: Hubbard Chevrolet Co. v. General Motors Corp., 873 F.2d 873, 877-78 (5th Cir. 1989) and Tidmore Oil Co. v. BP Oil Co., 932 F.2d 1384, 1391 (11th Cir. 1991), where no breach of the implied covenant where supplier refused to approve a jobber's expansion under a contract stating that the supplier "must approve each outlet."

[208] *Taylor*, 98 F.3d at 1034.

party without cause, suggesting that Deere's right to disapprove an assignment of the contract was intended to be absolute, because Deere in any event would be free to terminate an unwanted successor without cause.[209] In states where the courts refuse to imply into a licensor's right to consent or refuse consent, they are behaving like the court in *Taylor*, where the court was simply attempting to enforce the agreed-upon contract term.[210]

On the other hand, where a contract is terminable at-will, some courts have held that parties violated the duty of good faith and fair dealing when invoking that right. In one case, the plaintiff was awarded damages for wrongful termination of a distribution agreement.[211] In that case, the defendant, a party to a distribution agreement, had the contractual right to terminate the contract; however, the reasons that motivated the defendant to terminate the contract violated the duty of good faith and fair dealing, as the defendant terminated the distribution arrangement on only four days–notice and with the goal of putting the distributor out of business.[212] In another case, a state supreme court held that even though the jury determined that a contracting party was not in breach of a termination clause of a contract, it was permitted to find that the contracting party was still in breach of its duty of good faith and fair dealing in exercising its rights

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[209] *Id.* at 1031–32.
[210] *Id.* at 1031 ("Where parties have addressed an issue in the contract, 'no occasion to divine their intent or supply implied terms arises." (quoting Cambee's Furniture, Inc. v. Doughboy Recreational, Inc., 825 F.2d 167, 175 n.13 (8th Cir. 1987))).
[211] Cherick Distribs. v. Polar Corp., 669 N.E.2d 218, 219 (1996).
[212] *Id.* at 220 (stating the reason found for violating the duty was the party's desire to place the other party under a distribution agreement at a disadvantage in gathering needed support of other distributors to form a coalition).

to terminate the contract.[213] The court noted that "[t]he obligation to perform in good faith exists in every contract, including those contracts that contain express and unambiguous provisions permitting either party to terminate the contract without cause."[214] In other cases, courts have held similarly, usually when the termination occurred under egregious circumstances.[215]

One could foresee an argument that refusing the assignment of a license contract is effectively a termination, and the same logic and duty should apply to the analysis, assuming similarly egregious circumstances. The counter to this argument would again be the deference given to the licensor by federal courts to safeguard the rights of intellectual property owners

F. Comparing Two Jurisdictions: New York and California

What is the level of reasonableness that a court will require to the transfer of a license or franchise contract? This is clearly a question of what the contract requires and a jurisdiction-by-jurisdiction question. Specifically, it may depend on how the jurisdiction applies the duty of good faith and fair dealing to cases where a party is able to exercise its discretion in its "sole discretion" or when a duty of reasonableness is not express in the provision covering the transfer. Take for example the jurisdictions of New York and California.

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[213] Sons of Thunder v. Borden, 690 A.2d 575, 589 (N.J. 1997).
[214] *Id.* at 586.
[215] Linkage Corp. v. Trustees of Bos. Univ. 679 N.E.2d 191 (Mass. 1997). In this case, Boston University terminated a contract with a service provider in an effort to solicit and hire its employees despite a do-not-hire restriction relationship.

1. New York

In New York, courts have applied the covenant of good faith and fair dealing to limit a party's exercise of discretion accorded to it under a contract.[216] The presence of unilateral discretion in a contract, such as the right to refuse the assignment of a contract by a licensor, does not excuse the parties from fulfilling their duties under the contract fairly and in good faith.[217] Exercise of an unfettered discretion accorded by a contract might breach the implied obligation of good faith and fair dealing if that exercise frustrates the basic purposes of the agreement and deprives the plaintiff of its right to the benefits of the contract.[218] Reviewing the Second Circuit case of *Travellers International, A.G. v. Trans World Airlines, Inc.*,[219] the plaintiff Travellers asserted that the defendant airline breached its contract by failing to produce and distribute a sufficient number of tour brochures to promote their business relationship, despite the contract that specifically conferred upon the defendant the right to determine in its sole discretion the level of promotion required. Despite the "sole discretion" language, the court held that the nature and extent of the

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[216] Glen Banks, 28 N.Y. PRAC., CONTRACT LAW § 11:22 (2014) (citing Dalton v. Educ. Testing Serv., 663 N.E.2d 289 (N.Y. 1995)).

[217] *Id.* (citing G-I Holdings, Inc. v. Baron & Budd, 179 F. Supp. 2d 233, 268 (S.D.N.Y. 2001); Zurakov v. Register.com, Inc., 304 A.D. 2d 176, 179 (N.Y. 2003)).

[218] *Id.* (citing Travellers Int'l, A.G. v. Trans World Airlines, Inc., 41 F.3d 1570, 1575 (2d Cir. 1994); Carvel Corp. v. Diversified Management Group, Inc., 930 F.2d 228, 231 (2d Cir. 1991) (holding that a grant of discretion does not relieve a party of its duty to act in good faith); Cross & Cross Props., Ltd. v. Everett Allied Co., 886 F.2d 497, 502 (2d Cir. 1989) (holding that the parties' "fields of discretion under a contract are bounded by the parties' mutual obligation to act in good faith")).

[219] *Travellers Int'l*, 41 F.3d at 1570.

defendant's efforts did not reflect good faith business judgments.[220] Similarly, the Second Circuit decided in *Zilg v. Prentice-Hall*, *Inc.*[221] that a publisher's exercise of discretion in promoting a book was reasonably fulfilled by the initial printing of the book and marketing activities.[222] In each case, the *Travellers* and *Zilg* decisions illustrate the courts' requirement that some reasonable level of performance is required or expected given the nature of the contract. The second point made by these decisions is that the exercise of discretion under a contract must be guided by a party's good faith business judgment and not by improper motives. In the Southern District of New York case of *Mickle v. Christie's Inc.*,[223] the court sought to determine when a party given sole discretion under a contract regarding the sale of an artwork exercised that discretion in good faith. Rather than implying a level of required reasonableness into the behavior of Christie, the court recognized its right to act in a way that was subjectively acceptable to Christie. However, the court decided that the duty of good faith required one of the recognized measures of good faith and fair dealing, particularly whether the discretion exercised by the plaintiff: (1) represented an informed choice; (2) was based on an honest belief; (3) was preceded by due diligence against a backdrop of a real rather than a fancied prospect of liability; (4) was compelled and constrained by authority deriving from the agreements or other rules governing the relationship between the parties; (5) was taken for the stated reason as opposed to some other pretextual purpose; (6) was consistent with a motive to effectuate the parties' express common purpose and reasonable expectations rather than to frustrate the contract; (7) caused it to forego a

[220] *Id.*
[221] Zilg v. Prentice-Hall, Inc., 717 F.2d 671 (2d Cir. 1983).
[222] *Id.*
[223] Mickle v. Christie's Inc., 207 F. Supp. 2d 237, 249 (S.D.N.Y. 2002).

benefit or lose an opportunity it bargained for and reasonably anticipated from the consummation of the agreement.[224] There are no cases in New York that directly apply this duty of good faith and fair dealing to the assignment of a license contract. However, it would appear that New York would require that any matter of consent of the licensor be applied one of the recognized measures of good faith.

2. California

Compared to New York, courts in California appear to graft the duty of good faith upon a discretion clause only if necessary to avoid rendering the parties' obligations illusory or finding an unenforceable agreement. In the case of *Third Story Music, Inc. v. Waits*,[225] the defendant had the right to license, convey, or otherwise exploit the recordings of the musical artist Tom Waits. A clause of the contract specifically stated that Warner "may at our election refrain from any or all of the foregoing" where the foregoing described its rights to exploit the musical recording of Tom Waits.[226] The defendant therefore argued that the application of this clause precludes application of any implied covenant, including the duty of good faith and fair dealing.[227] The court reviewed a variety of applicable cases analyzing whether the ability of a party to fail to perform would make the underlying contract illusory and summarized as follows:

> The conclusion to be drawn is that courts are not at liberty to imply a covenant directly at odds with a contract's express grant of

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[224] *Id.* at 250.
[225] Third Story Music, Inc. v. Waits, 41 Cal. App. 4th. 798 (1995) .
[226] *Id.* at 801.
[227] *Id.*

> discretionary power except in those relatively rare instances when reading the provision literally would, contrary to the parties' clear intention, result in an unenforceable, illusory agreement. In all other situations where the contract is unambiguous, the express language is to govern . . . .[228]

The court concluded that the contract would not be considered illusory as the contract contained other consideration.[229] The court then made short work of applying a standard to Warner's behavior, stating, "The courts cannot make better agreements for parties than they themselves have been satisfied to enter into or rewrite contracts because they operate harshly or inequitably."[230]

In another case, *Infostream Group Inc. v. PayPal Inc.*,[231] the plaintiffs alleged that PayPal breached the implied covenant by terminating plaintiffs' accounts under a user agreement. PayPal argued that the contract had no "reasonability requirement" because PayPal could, at its sole discretion, terminate an account for any reason and at any time.[232] The court reviewed various cases setting forth the requirement of a party to behave reasonably if the failure to do so would render the contract illusory.[233] The district court held

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[228] *Id.* at 808.
[229] *Id.* at 809 (noting the plaintiff "was free to accept or reject the bargain offered and cannot look to the courts to amend the terms that prove unsatisfactory.")
[230] *Id.* at 809 (quoting Walnut Creek Pipe Distribs., Inc. v. Gates Rubber Co., 39 Cal. Rptr. 767, 771 (Cal. Dist. Ct. App. 1964)).
[231] No. C 12-748 SI, 2012 U.S. Dist. LEXIS 122255, at *1 (N.D. Cal. Aug. 28, 2012).
[232] *Id*. at *23.
[233] *Id.* at *25.

that the ability of a party to act in its sole discretion does not in itself negate the requirement to apply the duty of good faith and fair dealing, and in this case, defendant could be found at trial to have acted in bad faith in terminating an agreement.[234] In the case of *Haggarty v. Wells Fargo Bank*,[235] the defendant sought summary judgment against a good faith and fair dealing assertion as the contract at issue reserved to it the ability to act in its "sole discretion" and as such the contract was not subject to the implied covenant of good faith and fair dealing regarding that discretionary decision. The court recognized that "sole discretion" clauses and the implied covenant are in tension, but ultimately decided that good faith requires that a party exercise a power granted to it under the contract in good faith. In this case, the contract allowed the defendant to use its sole discretion which it did, and the court did not inquire further into the behavior of the defendant. The court noted that this narrow reading of what the implied duty requires would allow the defendant to ignore "overwhelming evidence" in exercising its discretion, but this is what the parties had bargained for.[236] Like in New York, there are no cases in California that directly test the boundaries of the duty of good faith and fair dealing to the assignment of a license contract. However, it would appear California would not require any specific measure of good faith applicable to the licensor's consent unless it was specifically included in the contract.

[234] *Id.* at *26.
[235] No. C 10-02416 CRB, 2012 WL 4742815, at *1 (N.D. Cal. Oct. 3, 2012).
[236] *Id.* at *6 ("True, the Court's reading of the contract would in theory permit Wells Fargo to insist that no substantial recalculation occurred in the face of overwhelming evidence to the contrary, or to refuse to consider the matter at all.").

VII. CONCLUSION

Cases, such as the Sixth Circuit case of *Cincom*, have commentators foreseeing the potential for copyright infringement on a massive scale, simply by application of federal law to a common corporate reorganization. Federal law governing the transfer and assignment of license right favors the rights of the intellectual property owners or licensor to dictate the terms of using those intellectual property rights. Such licensors are in a position to demand a second (often increased) licensing fee for the use of the same product, used in the same manner, depending upon the terms of the license contract. Notably, federal courts have provided that the licensor has wide discretion regarding the appropriate licensees of its products given that "every licensee would become a potential competitor with the licensor–patent holder in the market for licenses under the patents."[237] This limitation on the transfer of a license contract is in contrast to the normal freedom of parties to transfer commercial contracts. In all cases the express terms of the contract itself are of paramount importance. If a contract sets forth that a contract may be assigned subject to a licensor's reasonable discretion, this will be construed differently than if that discretion is expressed as the sole and arbitrary discretion of the licensor.

The Florida case of *First Nationwide Bank*[238] is one of the few cases where a court clearly applies the duty of good faith and fair dealing to a license contract. In construing a license contract which required the licensor's "reasonable" consent to an assignment, the court in *First Nationwide Bank* concluded that the licensor did not act in good faith in refusing the assignment of that contract in order in order to receive a

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[237]*In re* CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996).
[238] 770 F. Supp. 1537 (M.D. Fla. 1991).

new and substantially larger license fee from the assignee.[239] In reaching its conclusion, the court referred to Florida's version of the U.C.C., which imposes an obligation of good faith in a contract's performance or obligation. It described the fee requirement imposed by the licensor an "undeserved windfall" for the licensor.[240]

Notably, in the case of *Cincom*, commentators have opined that the perception of greed or of seeking an underserved windfall will restrict licensor's from seeking a license fee to allow an otherwise harmless transfer of a software license contract. The court in *First Nationwide Bank* held that one does not need to rely upon a licensor's restraint. Instead, the duty of good faith requires a transfer be allowed unless there is the reasonable basis to refuse one. Any party that desires to argue the duty of good faith and fair dealing should allow the transfer of a license contract must do so in the face of a long string of cases giving deference to the federal court decisions, which favor the licensor's ability to protect its intellectual property rights. A robust application of the duty of good faith and fair dealing could provide a sensible scheme to determining when a license contract may be transferred without a cause of action, as has been shown when applied to the transfer of franchise contract. Would the application of the covenant of good faith and fair dealing allow the transfer of license contracts when the transferee is not a competitor and is financially able to perform the obligations under the license contract? Only time and the advocacy of practitioners will answer that question.

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[239] *Id.* at 1543.
[240] *Id.*