New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An ALM Publication

Corporate Restructuring And Bankruptcy

WWW.NYLJ.COM

MONDAY, SEPTEMBER 23, 2013

BIGSTOCK

New Perspectives for Trademark Licensees in Licensor Bankruptcies

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As this article goes to press, an en banc panel of the U.S. Court of Appeals for the Eighth Circuit is scheduled to rehear arguments in *In re Interstate Bakeries*, relating to the rights of trademark licensees in the event of a licensor's bankruptcy.[1] The original panel of circuit judges determined that a perpetual, royalty-free, exclusive trademark license granted as part of a larger asset sale was subject to rejection as an executory contract pursuant to §365 of the Bankruptcy Code. However, that decision seemingly conflicts with other recent circuit court decisions allowing trademark licensees the continued use of licensed trademarks notwithstanding efforts by debtors to reject the licenses.

If the Eighth Circuit decides to proceed with the hearing en banc and the en banc panel reaches a different conclusion than the original panel that allows the licensee continued use of the license, this outcome could reflect an emerging trend among courts to provide protection to trademark licensees in the event of a licensor bankruptcy. If, on the other hand, the Eighth Circuit decides the appeal is moot and, as requested by Interstate Brands Corporation (Brands), vacates both the lower court decisions, then the Third Circuit's decision in *In re Exide Technologies* and the Seventh Circuit's decision in *Sunbeam Products v. Chicago American Manufacturing,* will be the key cases providing guidance to trademark licensees on the expected treatment in bankruptcy of trademark licenses that the debtor seeks to reject. This article examines the law regarding the rights of a trademark licensee in a licensor bankruptcy and provides certain suggestions for licensees to protect their rights in the event of a licensor bankruptcy.

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Section 365

One of the strongest tools a debtor in bankruptcy has is the ability to reject burdensome executory contracts under §365 of the Bankruptcy Code. Courts generally have adopted the so-called "Countryman definition" of executory contracts, which provides that a contract is executory where, as of the petition date, each of the parties still has unperformed obligations of such a nature that if either party fails to perform, such failure would be a material breach.[2] Under the Bankruptcy Code, rejection generally constitutes a breach of the debtor's obligations as of the petition date, giving rise to a pre-petition damage claim.

Protections for IP. Where the debtor licenses intellectual property (IP), there is a tension between the rejection power and the licensee's right to continued use of the intellectual property. This tension was resolved by the U.S. Court of Appeals for the Fourth Circuit soundly in favor of the debtor in *Lubrizol Enters. v. Richmond Metal Finishers*,[3] in which the court permitted the rejection of an IP license by a debtor-licensor, thereby depriving the licensee of continued use of the IP.

To correct the perceived inequity of the *Lubrizol* decision, Congress promptly enacted §365(n) of the Bankruptcy Code. Pursuant to §365(n), if a debtor-licensor rejects a license for "intellectual property" (as such term is defined in §101(35)(A) of the Bankruptcy Code), the non-debtor licensee may elect either (i) to treat the license as terminated if the breach caused by the rejection would, by the terms of the license, applicable non-bankruptcy law or an agreement made by the licensee with another entity, allow the licensee to do so, or (ii) as a general matter, to retain its rights under the license and any agreement supplementary to the license (including any exclusivity provision) and continue to use the licensed "intellectual property" (as such rights existed immediately before the filing of the bankruptcy case) as provided by the license for the term of the license and any term for which the license may be extended.[3]

Trademarks are not considered "intellectual property" under the Bankruptcy Code definition and are, therefore, expressly excluded from protection under §365(n). As a result, debtor-licensors have sought to use bankruptcy to reject trademark licenses and deprive licensees of their rights. To counter such actions, the non-debtor trademark licensee must address two issues: (i) whether the license is an executory contract and (ii) if the license is determined to be executory and is rejected, whether rejection is the equivalent of termination of the licensee's rights rather than just a breach by the rejecting debtor that allows the non-debtor licensee to retain the use of the trademark.

Recent Decisions on Licensee Rights

'Interstate Bakeries': Eighth Circuit Permits Rejection of Trademark License. In *Interstate Bakeries*, the debtor, Interstate Bakeries Corp. (IBC) had, through one of its subsidiaries, Brands, divested certain of its assets prior to bankruptcy pursuant to an asset purchase agreement (APA).[5] In connection with the APA, Brands granted Lewis Brothers Bakeries (LB) a "'perpetual, royalty-free, assignable, transferable, [and] exclusive' license to use the brands and trademarks" in certain designated territories (the LB License).[6] The APA allocated approximately $12 million to the actual operations and the remaining $8.82 million to the intangible assets, which included the license.[7]

Almost 10 years later, IBC filed for bankruptcy along with Brands. IBC proposed a Chapter 11 plan that sought to utilize the trademarks held by LB and reject the LB License as an executory contract. LB argued the LB License was non-executory such that rejection would not terminate the LB License.

> While 'Exide' and 'Sunbeam' conflict with 'Lubrizol', these **recent circuit court decisions** provide trademark licensees **strong authority** to argue that a trademark license does not terminate in the event of a debtor's rejection.

The Eighth Circuit affirmed the lower court decisions, which held that the LB License was an executory contract subject to rejection under §365 of the Bankruptcy Code.[8] The Eighth Circuit found that a provision of the LB License indicating that a breach of its quality standards provision would be a "material breach" was important evidence of remaining material obligations.[9] The court found that the quality standards provision in the LB License was a material remaining obligation for LB, and that, for Brands, (i) the notice and forbearance and (ii) the trademark enforcement provisions were the remaining material performance obligations.[10] The court rejected LB's arguments that the quality standards provision was vague and, alternatively, that IBC should be estopped from arguing the LB License and the trademarks were not part of the sale under the APA because IBC had not listed the LB License as an asset or executory contract in its bankruptcy schedules.[11]

There was a vigorous dissent. The dissent noted that while the majority had focused on the LB License in isolation, the license was part of an integrated agreement that included the APA, which was not executory. For example, the APA contained an integration clause that included all the "exhibits and schedules thereto," including the LB License. Thus, the dissent argued, the proper inquiry should have been whether the integrated agreement was an executory contract.[12] Under such construct, when LB paid $20 million dollars for the operations and the trademarks, it had substantially performed its obligations under the APA. Following the lead of a recent decision from the Third Circuit, *In re Exide Technologies*,[13] the dissent reasoned that IBC's "obligations" in the LB License were not material to the APA and, therefore, the APA was not executory.[14]

Third Circuit Finds a Non-Executory Integrated Contract. Two years prior to the Eighth Circuit's decision in *Interstate Bakeries*, the Third Circuit in *Exide*, confronting essentially the same fact pattern, found that a trademark license was not an executory contract.[15]

Over a decade before its bankruptcy filing, Exide sold its industrial battery operations and trademark to EnerSys.[16] The sale was documented through 23 agreements, which included an Asset Purchase Agreement (the Exide APA) and a Trademark and Trade Name License Agreement (the EnerSys License).[17] Under the EnerSys License, Exide granted a perpetual, exclusive and royalty-free license to EnerSys to use the trademark "Exide" in the industrial battery business.[18]

Years later, Exide sought to re-enter the industrial battery market and produce batteries under its name, Exide. EnerSys rebuffed Exide's efforts to reclaim use of the Exide trade name and mark.[19] Two years later, Exide filed for bankruptcy and moved to reject the EnerSys License in order to regain the Exide trademark.[20]

The Third Circuit adopted the Countryman definition of executory contract and examined the Exide APA and EnerSys License as a single, integrated agreement. Under applicable New York law, the court found that for a breach to be material, it had to be of the nature that it would be "so substantial as to defeat the purpose of the entire transaction."[21] The court found that New York law also mandated that, "when a breaching party 'has substantially performed' before breaching, 'the other party's performance is not excused.'"[22]

In reviewing the record, the court found clear "inferences" that EnerSys had substantially performed by paying the purchase price and operating under the agreement for over a decade.[23] Any remaining EnerSys obligations under the EnerSys License, such as those found in the provisions regarding quality standards, restricted use, indemnity and further assurances, did not, in the court's assessment, outweigh the substantial performance rendered by EnerSys.[24] In particular, the court deemed the use restriction to be a "condition subsequent" and not a material obligation. Likewise, EnerSys' obligation to observe quality standards was minor, because it related to meeting the standards of the mark for each battery produced, and no specific standards had ever been provided. The indemnification obligation had expired. Finally, Exide had failed to identify any remaining required cooperation.[25] On these bases, the court concluded that, because it did not contain a single material obligation for EnerSys to perform, the integrated agreement was not executory and Exide could not reject the trademark license.

Judge Thomas L. Ambro's concurring opinion took on the second challenge faced by the non-debtor licensee by questioning the lower courts' reliance on *Lubrizol* for the proposition that rejection of the EnerSys License would have left EnerSys without the right to use the Exide mark. Ambro noted that certain courts had inferred that because Congress did not cover trademarks when it enacted §365(n), *Lubrizol* still controlled the treatment of trademarks. He believed that the inference was at odds with 365(n)'s legislative history, which indicated that Congress was postponing action on trademarks to "allow the development of equitable treatment of this situation by bankruptcy courts."[26] Therefore, even if a trademark license were executory and subject to rejection, rejection (which the Bankruptcy Code merely treats as a breach of contract) should not strip a licensee of "its fairly procured trademark rights."[27]

Even though the fact patterns of the two cases were substantially similar, the Eighth Circuit in *Interstate Bakeries* distinguished *Exide* by finding that there were outstanding "material obligations." The court focused on the specificity and expansiveness of the quality standards provision in the license.[28] Another important factor for the Eighth Circuit was that, unlike in *Exide*, the parties stated in the LB License that a breach of the quality standards provision would be "material."[29]

However, the Eighth Circuit's approach of separating out the license agreement from what the parties contractually agreed was an integrated APA seems somewhat problematic. By focusing on the LB License in isolation, and ignoring the APA in its executory contract analysis, the court allowed a debtor who received more than $8 million for intangible assets, which included the use of the trademarks, to potentially reap a windfall. If the rehearing en banc by the Eighth Circuit proceeds, it remains to be seen whether the Eighth Circuit will provide trademark licensees with greater clarity and resolve the seeming inconsistency between the holdings in *Interstate Bakeries* and *Exide*.

Seventh Circuit Says Rejected License Is a Breach and Licensee Retains Its Rights. In *Sunbeam Products v. Chicago American Manufacturing*,[30] the Seventh Circuit, building upon Judge Ambro's dissent in *Exide*, directly tackled the proposition that *Lubrizol* remained the controlling law regarding rejection of trademark licenses in light of the exclusion of trademarks from the protections of §365(n). The court acknowledged the issue that the exclusion of trademarks from the Bankruptcy Code's definition of "intellectual property" had created but stated that "an omission is just an omission."[31]

The Seventh Circuit squarely addressed the question of whether rejection of an executory trademark license terminates the right of the licensee to use the licensed trademark post-petition. In agreeing with Ambro's dissent in *Exide*, the Seventh Circuit rejected the *Lubrizol* court's decision regarding the effect of rejection of an executory IP license.[32]

In the Seventh Circuit's view, the *Lubrizol* court had mistakenly expanded the consequences of a debtor's rejection.[33] The Seventh Circuit noted that, "[o]utside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property."[34] Given that §365(g) of the Bankruptcy Code simply treats rejection as a breach, the Seventh Circuit reasoned that rejection does not "vaporize" the licensee's rights to use the trademarks under the license.[35] As such, the court held that rejection merely freed the estate of an obligation to perform but did not deprive the licensee of the right to use the trademark at issue.[36]

While *Exide* and *Sunbeam* conflict with *Lubrizol* (which is still potentially controlling law in the Fourth Circuit with respect to the rejection of trademark licenses), these recent circuit court decisions provide trademark licensees strong authority to argue that a trademark license does not terminate in the event of a debtor's rejection.

Potential Strategies for Trademark Licensees

With the law regarding the consequences of rejection of trademark licenses continuing to develop, trademark licensees may wish to consider the following strategies to defend against the potential rejection of a trademark license:

- Where a trademark license is entered into as part of an asset sale or other broader transaction, explicitly state that the trademark license agreement is part of a single integrated agreement. Include an integration clause that meaningfully links the license with the asset purchase and/or other agreement effecting the overall transaction.
- In the relevant agreement(s), specifically tie trademarks to other IP that falls within the Bankruptcy Code's definition of protected "intellectual property," and expressly state an intent that trademarks benefit from the protections of §365(n).
- Eliminate extraneous language from the agreement that would allow an inference that the licensor or licensee still has material ongoing obligations to perform. Where possible, try to avoid referring to obligations as material or stating that breaches of obligations under the license will be considered material.
- If there is a period where there will be actual monitoring and/or enforcement of the trademark by the licensor, demarcate it as a transition period, and then detail how the transfer of such obligations shall be effected after the transition period without the requirement of further action by the licensor.
- Perfect a security interest in the trademark as a further indication of the parties' intent that a transfer of an interest in the trademark has occurred.
- If the transaction is in furtherance of a judgment or consent decree requiring the licensor to divest itself of the trademark, reference that judgment or order.
- Finally, since courts will look for the parties' intent in determining whether the license is executory, licensees should express their intent with respect to the treatment and control of the trademark in the license agreement.

1. On Sept. 13, 2013, Interstate Brands Corporation (Brands) filed a motion to dismiss the rehearing of the appeal before the Eighth Circuit en banc. See Motion of Appellee to Dismiss Appeal As Moot, *Lewis Brothers Bakeries and Chicago Baking Co. v. Interstate Brands Corporation*, No. 11-1850 (8th Cir. 2013), ECF No. 84 (Entry ID: 4075440). In short, Brands has sold, at a loss, its interest in the trademarks at issue in the appeal. As a consequence, Brands claims that it has neither an economic interest in the appeal nor the ability to perform its obligations under the LB License (as defined herein). Given the sale, Brands affirmatively indicates that it will not pursue the rejection of the LB License under §365 of Bankruptcy Code. Accordingly, Brands argues that the appeal should be dismissed as moot. If the dismissal is combined with an order vacating the decisions of the bankruptcy and district courts, Brands believes that the Appellants should be amenable to resolution of the appeal in this manner; vacating these decisions would effectively "erase" the record of the relief that Brands had sought and obtained, i.e., the rejection of the LB License.

2. *In re Interstate Bakeries*, 690 F.3d 1069, 1073 (8th Cir. 2012). See also Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L.Rev. 439, 460 (1973). The definition of what is an executory contract as constructed in this article has been adopted by several circuits. See, e.g., *In re Exide Technologies*, 607 F.3d 957, 962, fn.2 (3d Cir. 2010) and *In re Penn Traffic*, 524 F.3d 373, 379 (2d Cir. 2008).

3. 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

4. 11 U.S.C. §365(n)(1)-(3).

5. *Interstate Bakeries*, 690 F.3d at 1072. In order to comply with the resulting final judgment from an antitrust action commenced by the Department of Justice, IBC had been required to divest itself of its "Butternut Bread" and "Sunbeam Bread" trademarks and operations in the territories of Chicago and Central Illinois. Other than mentioning the antitrust action at the outset of the opinion, the court did not place significant weight on the fact that license was in furtherance of that judgment. Id. at 1071.

6. Id. at 1072.

7. Id.

8. Id. at 1075-76.

9. Id. at 1074-75.

10. Id.

11. Id. at 1075-76.

12. Id. at 1076.

13. 607 F.3d 957 (3d Cir. 2010).

14. *Interstate Bakeries*, 690 F.3d at 1079.

15. Id. at 964.

16. *Exide*, 607 F.3d at 960.

17. Id. These two agreements, together with an Administrative Services Agreement and a Letter Agreement, were determined by the bankruptcy court to be a single integrated agreement. Neither Exide nor EnerSys challenged the bankruptcy court's determination. Id. at 961.

18. Id.

19. Id.

20. Id.

21. Id. at 962.

22. Id. at 963.

23. Id.

24. Id. at 963-64.

25. Id.

26. Id. at 967 (citing S. Rep No. 100-505 at 5).

27. Id. at 967 (citing cf. *In re Matusalem*, 158 B.R. 514, 521-22 (Bankr. S.D. Fla. 1993).

28. *Interstate Bakeries*, 690 F.3d at 1075.

29. Id.

30. 686 F.3d 372 (7th Cir. 2012).

31. Id. at 375.

32. Id. at 376.

33. Id.

34. Id.

35. Id. at 377.

36. Id. at 377-78.