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Key Court Holds Trademark License Survives Bankruptcy Under §365

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In *In re Interstate Bakeries Corp.*,[1] the U.S. Court of Appeals for the Eighth Circuit found that the license agreement between Interstate Brands Corporation (IBC), the subsidiary of Interstate Bakeries Corp. (Interstate Bakeries), and Lewis Brothers Bakeries (LBB) was part of a single integrated agreement and not executory. In so holding, the court joined the U.S. Court of Appeals for the Third Circuit in allowing a trademark licensee to continue to use its licensed trademarks free from the tactical threat by the debtor that it will reject its licenses pursuant to section 365 of the Bankruptcy Code.

Executory Contracts

The power of the debtor to reject what it deems to be burdensome executory contracts under section 365(a) of the Bankruptcy Code has always been one of the strongest tools a debtor has in bankruptcy. Generally, courts, including the courts of the Eighth Circuit, 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] In counterpoint, section 365(n) of the Bankruptcy Code allows non-debtor licensees covered by section 101(35)(A) of the Bankruptcy Code whose licenses are found to be executory and rejected by the debtor to either (i) treat the license as terminated if the breach caused by the debtor's rejection would allow the licensee to do so, or (ii) retain their rights under the license and continue to use the licensed "intellectual property" as provided by the license for the term of the license and for any term for which the license may be extended.[3]

As a result, at the cross-section of bankruptcy and intellectual property, there has always been a tension between the debtor's rejection power and the licensee's right to continue to use the intellectual property under its prepetition license. Trademark licensees have an additional challenge in protecting their rights in their licensed trademarks because trademarks were not included within the definition of "intellectual property" as set forth in section 101(35)(A) of the Bankruptcy Code. Excluded from the protections of section 365(n) of the Bankruptcy Code, these licensees have been more vulnerable to attempts by debtor-licensors to use section 365(a) to reject trademark licenses and deprive them of their rights.

Perpetual License

In order to comply with a 1996 final judgment from an antitrust action commenced by the Department of Justice, Interstate Bakeries had been required to divest itself of its "Butternut Bread" and "Sunbeam Bread" trademarks and operations in the territories of Chicago and central Illinois. Interstate Bakeries divested itself of these assets pursuant to an asset purchase agreement (APA).[4]

In connection with the APA, IBC granted LBB a "'perpetual, royalty-free, assignable, transferable, [and] exclusive' license to use the brands and trademarks" in certain designated territories.[5] The APA allocated approximately $12 million to the actual operations and the remaining $8 million to the intangible assets, which included the license.[6]

Almost 10 years later, in September 2004, Interstate Bakeries, along with its subsidiary brands, filed for bankruptcy. Four years after Interstate Bakeries filed its petition for relief, it proposed a Chapter 11 plan that sought to utilize the trademarks held by LBB and reject the license as an executory contract. LBB reacted by seeking a declaratory judgment that the license was non-executory and, therefore, IBC could neither reject nor terminate the license.[7] IBC countered by moving to reject the license agreement and seeking a declaration that it was an executory contract.

Both the bankruptcy court and the district court agreed with IBC, finding that both IBC and LBB had at least one remaining material obligation to each other under the license agreement. Accordingly, the lower courts held that the license was executory and that IBC had the right to reject the same.[8] Initially, the Eighth Circuit agreed with the lower courts and held the license granted as part of a larger asset sale was subject to rejection as an executory contract pursuant to section 365 of the Bankruptcy Code.[9] This decision was in direct conflict with the Third Circuit's decision in *In re Exide Technologies*,[10] a decision that allowed a trademark licensee the

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continued use of its licensed trademarks by finding that the trademark license at issue was not an executory contract subject to rejection.

LBB requested that an en banc panel of the court rehear arguments as to whether its rights, as a trademark licensee, should survive the bankruptcy of its licensor, IBC, and its attempt to reject the license under section 365(a).[11] On the eve of the hearing, IBC filed a motion to dismiss the rehearing of the appeal on the basis that the appeal was moot.[12] IBC claimed that it would no longer pursue the rejection of the license agreement with LBB under section 365 of Bankruptcy Code and, magnanimously, decided to waive any right it had to reject the license agreement. IBC explained that it sold its interest in the trademarks at issue, and could no longer realize any value from the rejection of the license agreement.

IBC also claimed that its parent, Interstate Bakeries, had sold all of its material assets and was winding up its remaining operations under a wind-down order issued by the Bankruptcy Court for the Southern District of New York.[13] As a result, IBC was now all too willing to "erase" the record that—until the affirmative decision to hold an en banc hearing—had been in its favor.

In response, the court acknowledged that IBC had sold its interest in the Butternut trademarks, which were probably the most significant trademarks at issue, but, by IBC's own admission, those were just four of the 12 trademarks covered by the license agreement. Moreover, even though IBC was now willing to waive its rights, the court found that this "waiver" was neither an "ironclad assurance" nor comparable to the agreement at issue in another case,[14] which contained a covenant not to sue that eliminated the possibility of litigation not only by the complainant but also by its successors and assigns. Thus, the court found that LBB still faced the possibility of future challenges to the license agreement and a decision on the merits would be relevant to LBB's rights in the remaining trademarks. Therefore, the court decided to proceed with the hearing on the merits because the appeal was not moot.[15]

Scope of the Agreement

Turning to the appeal, before it could determine whether the license agreement was an executory contract subject to rejection pursuant to section 365(a) of the Bankruptcy Code, the court first needed to decide the scope of the agreement to be analyzed for purposes of determining whether it could be rejected by IBC. Was it the license agreement by itself or was it a larger asset purchase agreement that included the license agreement?

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The court noted that the bankruptcy court, the district court and the original panel of the court had focused on the license agreement in isolation. From the court's perspective, that focus had been overly narrow, and it believed that "the proper analysis" required consideration of "an integrated agreement that include[d] both the [APA] and the license agreement."[16] The court found seven elements that led it to consider the APA and the license agreement as a single integrated agreement:

1. Interstate Bakeries and IBC, on the one hand, and LBB, on the other hand, had entered into the [APA] and the license agreement contemporaneously on Dec. 28, 1996.
2. The APA listed the license as an asset sold to LBB pursuant to the sale.
3. The APA directed the parties to enter into the license agreement.
4. Both the APA and the license agreement define the "entire agreement" as including both agreements.
5. The APA defined the agreement to include "the exhibits and schedules hereto," and the form of license agreement was an attached exhibit.
6. The license agreement makes reference to the APA throughout the agreement.
7. Consideration for the license was set forth in the Allocation agreement described in Section 2.3 of the APA.[17]

Thus, the court held that separating the APA from the license agreement would "run counter" to both the wording in the documents themselves that they be considered as one integrated agreement and the stated allocation for the license within the overall purchase price paid under the APA.[18] Having now determined that the APA and the license agreement were a single integrated agreement, the next question addressed by the court was whether this integrated agreement was an executory agreement subject to rejection pursuant to section 365(a) of the Bankruptcy Code.

The court held that Interstate Bakeries had substantially performed its obligations under the APA "and its failure to perform any of its remaining obligations would not be a material breach of the integrated agreement."[19] In order to comply with the antitrust judgment that called for Interstate Bakeries' divestiture of its bread-making business in the specified territories in a single comprehensive transfer, LBB had purchased Interstate Bakeries' business. The court noted again that, of the purchase price paid for that business, $8.12 million had been allocated toward the intangible assets that included the license at issue.

From the court's perspective, the facts at hand were analogous to the facts that the Third Circuit had confronted in *Exide*, a case in which the Third Circuit found that a trademark license that was part of a larger asset sale transaction could not be rejected as an executory contract. As in *Exide*, any remaining obligations under the APA "did not 'outweigh the substantial performance rendered [by LBB] and the benefits received by'" IBC.[20] Therefore, in reversing the judgment of the district court, the court concluded that "the license agreement between IBC and LBB [was] not executory."[21]

Dissent's Perspective

The dissent agreed that the "full purpose" of the integrated agreement was for "IBC to divest itself of the tangible assets reasonably necessary to allow the purchaser to make effective ongoing use of the license."[22] Except, in the dissent's view, the license was the core of the agreement and everything else was an "add-on" to make LBB's use of the license functional. The dissent argued that the majority had minimized the license's materiality. When combined with the ongoing obligations contained in the license agreement itself, which the parties designated as material—specifically, LBB's quality and character standards and IBC's territorial non-compete and infringement protections—the dissent was of the opinion that neither LBB nor IBC had substantially performed because each of the parties had ongoing obligations that would result in a material breach if not performed.

The dissent's focus on the importance of the license to the integrated agreement arguably is not misplaced. However, in allocating importance to the remaining obligations under the license agreement in order to find that IBC and LBB had not substantially performed—the dissent attributed no value to the $20 million purchase price. There was only one payment under the APA and the license agreement and Interstate Bakeries had already accepted the cash. There was never going to be a stream of subsequent royalty payments that one would expect to see in connection with a license agreement.[23] LBB had substantially performed by purchasing the trademarks and the related operations. From this vantage point, it becomes apparent that by attempting to reject the license, IBC was arguably attempting to resell what it had irrevocably sold already through its grant of a "perpetual" license.

A Way Forward

Without a doubt, section 365(a) of the Bankruptcy Code, which enables a debtor to reject burdensome executory contracts, remains one of a debtor's strongest tools in its toolbox. Both the Third and Eighth circuits have tempered only a debtor's ability to use section 365 to either retrade with the licensee or resell, to a new party, trademarks that, in their essence, have been sold outright by the licensor to the licensee.

By removing the potential conflict between the circuits, *Exide* and *Interstate Bakeries* provide constructive guidance for determining (i) the nature of integration required in connection with the sale of trademarks and their related assets in order for an asset purchase agreement and trademark license to be analyzed as a single, integrated agreement for purposes of determining whether a contract is an executory contract subject to rejection pursuant to section 365 of the Bankruptcy Code, (ii) when substantial performance has occurred and what is required for a finding of the same, and (iii) what must occur to move an agreement to the point where it is no longer executory for purposes of section 365. As a consequence, *Interstate Bakeries* reduces the viability of abusive challenges by licensors that a license agreement is executory and subject to rejection when the licensee ensures that:

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- Each of the key documents in an asset sale that includes trademarks explicitly states that it is part of a single integrated agreement.
- Extraneous language is eliminated from the documentation that would allow an inference that either the licensor or licensee still has material ongoing obligations to perform.
- If there will be actual monitoring and/or enforcement of the trademark by the licensor, the agreement specifies, in detail, the nature of the licensor's obligations, when these obligations shall end and, if appropriate, whether the licensee shall assume these responsibilities.
- If the transaction is in furtherance of a judgment or consent decree requiring the licensor to divest itself of the trademark, reference is made in the documentation to that judgment or order.

Thus, when trademark licensees purchase their trademarks under documentation that clearly articulates the comprehensiveness of the sale and removes any ambiguities as to the roles of the parties thereafter, *Interstate Bakeries* will allow those licensees to invest in the businesses supported by these trademarks on a more secure footing.

1. *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. June 6, 2014).
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). In addition to the adoption of Countryman's definition of an executory contract by the court in this case, several other circuits have adopted the definition. See, e.g., *In re Exide Technologies*, 607 F.3d 957, 962, fn.2 (3d Cir. 2010) and *In re Penn Traffic Co.*, 524 F.3d 373, 379 (2d Cir. 2008).
3. 11 U.S.C. §365(n)(1)-(3).
4. *Interstate Bakeries*, 751 F.3d at 958 and *In re Interstate Bakeries Corp.*, 690 F.3d 1069, 1072 (8th Cir. Aug. 30, 2012), rehearing en banc granted, opinion vacated (June 18, 2013). Other than mentioning the antitrust action at the outset of the opinion, the initial panel of the court did not place significant weight on the fact that the license was in furtherance of the antitrust judgment. 751 F.3d at 958 and 690 F.3d at 1071-72. See also *Lewis Brothers Bakeries*, 2014 WL 2535294 (No. 11-1850), oral argument available at http://8cc-www.ca8.uscourts.gov/OAaudio/2013/10/111850eb.mp3. Oral Argument at 00:20 -11:04.
5. Id. at 958.
6. Id. at 958-59.
7. Id. at 959.
8. Id.
9. Id. and *Interstate Bakeries*, 690 F.3d at 1076.
10. 607 F.3d 957 (3d Cir. 2010).
11. *Interstate Bakeries*, 751 F.3d at 959-60. See also Brian Trust, et al., "Corporate Restructuring and Bankruptcy: New Perspectives for Trademark licensees in Licensor Bankruptcies," NYLJ, Sept. 23, 2013 (LEXIS, N.Y.L.J. Library).
12. See Motion of Appellee to Dismiss Appeal as Moot, *Lewis Bros. Bakeries Inc. v. Interstate Brands Corp.*, No. 11-1850 (8th Cir. 2013), ECF No. 84 (Entry ID: 4075440) (Motion to Dismiss).
13. Motion to Dismiss at 3.
14. *Interstate Bakeries*, 751 F.3d at 960-61 (citing *Already LLC v. Nike,* 133 S.Ct. 721, 727-29 (2013)).
15. Id.
16. Id.
17. Id at 962.
18. Id.
19. Id at 963.
20. Id. at 964 (citing *In re Exide Technologies*, 607 F.3d 957, 963-64 (3d Cir. 2010)).
21. Id.
22. Id. at 965.
23. Oral Argument at 0:58 and 1:56. LBB's counsel indicated the license was royalty-free.