Licensing Executives Society
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Glimmer of Daylight: Trademark Licensees in Bankruptcy

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You receive a panicked call: "My licensor has just declared bankruptcy! I have invested a ton of capital into bringing my product to market. If I can't use the trademark, I will be devastated."

Bankruptcy is often a dark place without even a glimmer of daylight for trademark licensees, and similarly situated franchise and dealership licensees. Especially in this economic climate, it is imperative that licensees understand three basic issues that will arise in a licensor's bankruptcy: the type of bankruptcy; whether the license is "executory;" and, permitted trademark usage, if any.

Types of Bankruptcy Proceedings: Liquidation and Reorganization

There are two basic kinds of company bankruptcies - reorganization (under Chapter 11 of the Bankruptcy Code) and liquidation (under Chapter 7). In both proceedings, an appointed Trustee is charged with managing the company's intellectual property assets and contractual obligations.

When the license is found to be an "executory" agreement – contracts with mutually unfulfilled obligations - the Trustee is charged with deciding whether to *assume* (*i.e.*, continue and/or assign) or *reject* the license, subject to Court approval. Rejection of the license, at a minimum, terminates the licensor's obligations to perform. As discussed below, a rejection is usually interpreted to extinguish the licensee's right to use the trademark.

Assumption of the license is more likely to occur in a reorganization proceeding since the company will continue to exist post-bankruptcy. Rejection is more likely to occur in a liquidation proceeding because the licensed trademark or intellectual property will be more attractive to a potential purchaser if unencumbered by a license.

Importantly, in a liquidation, if no action is taken by the Trustee within sixty days of the filing of the petition, then the license, as an executory agreement, is deemed *rejected*. 11 U.S.C. §365(d)(1).

After the Court approves the rejection of the license, the rejected licensee may file an unsecured claim for damages against the bankruptcy estate. When in a position to do so, the rejected licensee should consider negotiating to acquire the underlying licensor's trademarks through the Trustee.

Trademark Licenses Are Executory, Except When They Are Not

As mentioned above, the Trustee has an obligation to assume or reject "executory" agreements. Therefore, before this can occur, there must be an initial determination as to whether the license at issue is "executory" in nature.

Basically, a license will be considered "executory" where the failure of either party to complete performance would "constitute a material breach excusing the performance of the other." *In re Interstate Bakeries Corp*., 2011 U.S. Dist. LEXIS 29192, *13 (W.D. Mo. March 21, 2011) (citations omitted).

Oftentimes, the parties will have ongoing material obligations such as royalty payments and quality control. Quality control provisions create obligations for both parties in that the licensor must maintain and exercise control, and the license must produce goods and services in accordance with these standards.

The importance of quality control provisions in a trademark license cannot be overstated. While the degree of control required will vary depending on the circumstances, the failure of a licensor to exercise proper quality control can result in severe consequences, including the loss of all trademark rights. It is not surprising then, that trademark licenses are usually found to be executory. *Id.* 2011 U.S. Dist. LEXIS 29192, *13 (citing cases).

The *Exide* Decision

On the other hand, the recent *Exide* decision shows that under certain circumstances, the license will be considered non-executory. *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010). In *Exide*, the licensor (Exide) sought to reject the license, which permitted the licensee (EnerSys) to use the name EXIDE in the industrial battery market.

Importantly, Exide and EnerSys entered into an asset purchase agreement whereby EnerSys paid more than $135 million for the assets related to Exide's industrial battery division. Concurrently, the parties entered into a perpetual and royalty-free license agreement. Exide retained its right to use the mark in other businesses. Ten years into the license, Exide entered bankruptcy and sought rejection of the license so it could reenter the industrial battery business. The lower court found that the license was non-executory, not subject to rejection, because substantial performance had been completed and there were no outstanding material obligations.

On appeal, Exide argued that the licensee had a number of ongoing substantial obligations under the license, including (1) an obligation to satisfy a quality standards provision; (2) an obligation to observe a use restriction on the trademark; and (3) an obligation to observe an indemnity provision. *Id*. at 963. The Third Circuit Court of Appeals rejected these arguments, holding these obligations were either a condition subsequent, which is not a material obligation, or too minor to affect substantial performance under the license. Therefore, the license could not be rejected and the licensee could continue to use its trademark under the terms of the license agreement.

Importance of Quality Control

Oftentimes, whether quality control is actually observed and how quality control is treated in the agreement, will be critical in the executory versus non-executory determination.

In the *Exide* case, the Third Circuit observed that Exide never provided EnerSys with any quality standards and no standards were ever discussed. Accordingly, it held that: "[i]t is an untenable proposition to find an obligation to go the very root of the parties' Agreement when the parties themselves act as if they did not know of its existence." *Id. at 964.*

It is clear, therefore, that the licensor exercised no actual quality control in this relationship. Had this dispute arisen in a non-bankruptcy context, it seems very possible that the trademark rights could have been found abandoned by the licensor on this basis. *See, e.g., Eva's Bridal Ltd. v. Halanick Enterprises, Inc.*, No. 10-2863 (7th Cir. May 10, 2011)(affirming district court ruling that trademark rights had been abandoned by plaintiff-licensor and defendant-former licensee could continue use without payment to licensor).

A different result might be reached if the license itself provides that the duty to maintain quality standards is a material obligation. For example, the license could provide that the failure of a licensee to maintain the character and quality of the goods constitutes a "material breach" and grounds for termination by the licensor. *See In re Interstate Bakeries Corp.,* 2011 U.S. Dist. LEXIS 29192, *15-16 (W.D. Mo. March 21, 2011)(holding that quality control provision defined obligation as material and therefore license was executory).

Accordingly, a licensee seeking to avoid rejection will need to carefully review the language of the license agreement. Furthermore, whether the parties actually observe the quality control and other provisions may also be a key consideration in the executory determination.

Trademarks Are Not Intellectual Property?

It is not entirely settled whether trademark licensees enjoy the same protections as other intellectual property licensees under the Bankruptcy Code. Particularly, Section 365(n) permits intellectual property licensees to continue use of their licensed property after a rejection.

Through this provision, Congress sought "to make clear that the rights on an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy." *In re Exide Technologies*, 607 F.3d 957, 965 (3d Cir. 2010) (citations omitted).

Upon rejection, Section 365(n) allows a licensee of intellectual property to retain its licensed rights, along with its duties, absent any obligations owed by the debtor-licensor for the duration of the license, and for any included extensions.

The relevant definition of "intellectual property," however, is defined to include: trade secrets; patents; pending patent applications; copyrights; and, mask works, but not trademarks. 11 U.S.C. §101(35A).

Because trademarks are not listed in the definition, most courts by negative inference have found that trademark licensees are not entitled to the protections of Section 365. *See e.g., In re Old Carco, LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003); *In re Centura Software Corp.*, 281 B.R. 660, 675-75 (Bankr. N.D. Cal. 2002).

However, Judge Ambro's concurring opinion in *Exide* suggests that drawing a negative inference is not appropriate. Instead, he contends that Congress' decision to exclude trademarks was to allow the Courts to develop equitable treatment of this situation in consideration of the "control of the quality of the products or services sold by the licensee." *In re Exide Technologies*, 607 F.3d at 968. Judge Ambro would therefore be open to post-rejection use of a trademark by the licensee where equitable considerations would dictate and future courts may follow this opinion.

Accordingly, in facing a potential rejection, a licensee may be able to leverage the uncertainty of its post-rejection rights in its dealings with the Trustee.

Summary

In sum, trademark licensees need to understand that their rights to use a trademark are placed into serious jeopardy once their licensor declares bankruptcy. By understanding the nature of the bankruptcy, whether the license is executory, and its uncertain post-rejection rights, the licensee will be best positioned to navigate through the dark terrain.