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Handling US trade mark licensees in bankruptcy

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An envelope arrives from the bankruptcy court. You open it and realize with a shock that one of your trade mark licensees has filed a bankruptcy petition and listed you as a creditor. Over the last two years, this has become an increasingly common event. But from a trade mark licensor's point of view, a licensee entering bankruptcy is not always the disaster it might appear to be.

This article will provide an overview of the main issues faced and decisions to be made by a trade mark licensor whose licensee has filed for bankruptcy.

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This article

- The article provides an overview of the main issues faced and decisions to be made by a trade mark licensor whose licensee has filed for bankruptcy in the USA.
- It covers the following four scenarios: (i) if the licensee seeks to assume and the licensor consents, (ii) if the licensee seeks to assume and the licensor objects, (iii) if the licensee seeks to reject and the licensor consents, and (iv) if the licensee seeks to reject and the licensor objects. The article also covers trade mark licence agreement performance after a bankruptcy filing.

US bankruptcy and trade mark law

First, here is a brief outline of bankruptcy and trade mark law in the USA. Bankruptcy is a process for adjusting the debts and adjudicating the property of a bankrupt debtor's estate. Trade marks are distinctive names, logos, designs, symbols, or other indicators to identify to consumers that the products or services on which the trade mark appears originate from a unique source, and to distinguish the trade mark owner's products or services from those of other entities. The Lanham Act, which codifies US trade mark law, does not address or even mention bankruptcy and the Bankruptcy Code, which codifies US bankruptcy law, does not address or even mention trade marks. Nonetheless, it is well understood that valid trade mark licence agreements are considered assets of the debtor subject to the provisions of the Bankruptcy Code.

The two main categories of business bankruptcy in the USA are Chapter 7 and Chapter 11. Chapter 7 is a so-called liquidation bankruptcy, in which a trustee carves up the debtor, liquidates its assets, and then distributes the proceeds to creditors according to a priority scheme contained in the Bankruptcy Code. Chapter 11 is a so-called reorganization bankruptcy, in which the debtor itself restructures its affairs, and pays off creditors a portion of what it owes them, usually from a combination of loans, selected asset sales, stock issuance, and current revenues. Chapter 11 bankruptcies are carried out according to a plan that must be voted on by creditors and holders of equity interests, and approved by the bankruptcy court. Reorganizations under Chapter 11 sometimes fail and convert to Chapter 7 liquidations, or sometimes are intentionally utilized by the debtor to liquidate its assets, similar to a Chapter 7 trustee.

Executory contracts

The Bankruptcy Code treats a valid licence agreement as a special kind of asset called an 'executory contract'. There is no definition of executory or executory contracts in the Bankruptcy Code, but the most commonly accepted definition in the case law is an agreement where substantial performance remains due by both parties. Most unexpired trade mark licences will meet the definition of executory contract because, typically, the licensee is required to observe the quality

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specifications of the licensor and pay royalties to the licensor, while the licensor is required to maintain quality control of the licensed product and refrain from suing the licensee for trade mark infringement.

Automatic stay

Most executory contracts are subject to the automatic stay provisions of the Bankruptcy Code.[1] That means that, once a licensee files for bankruptcy, the licensor is prohibited from taking any action to collect a debt from the licensee without the express approval of the bankruptcy court.

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors, stopping all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.[2]

As part of the automatic stay, the licensor is forbidden to make any attempt to terminate the licence agreement. Boilerplate provisions that state the licence agreement is automatically terminated if the licensee files for bankruptcy are so-called ipso facto clauses that are automatically invalid in bankruptcy.[3] A licensor should therefore definitely resist the impulse to send its bankrupt licensee a termination notice with a demand for immediate payment of all royalties due since such an action could be a violation of the automatic stay and put the licensor in contempt of the bankruptcy court.

Licensee must assume or reject

Another consequence of a licence agreement being executory is that the Bankruptcy Code requires the licensee to choose whether to 'assume' the licence agreement (ie accept it in full, both benefits and responsibilities, and render performance according to its original terms) or 'reject' it (ie terminate the agreement and excuse itself from any further performance obligations).[4] The rationale behind this right goes to the heart of bankruptcy law, namely to maximize the value of the bankruptcy estate by allowing the debtor to retain useful, profitable, and advantageous agreements, and reject unprofitable and disadvantageous ones. The licence agreement may be a revenue producer that is critical to the licensee's Chapter 11 reorganization efforts, or the licensee may wish to sell (assume and assign) the licence agreement to a third party as part of either a Chapter 11 or Chapter 7 asset sale.

A Chapter 7 licensee (or, more precisely, the trustee of its bankruptcy estate) must elect to assume an executory licence agreement within 60 days of the bankruptcy filing unless it obtains an extension from the bankruptcy court, or the licensee is deemed to have automatically rejected the agreement.[5] The Chapter 7 licensee (or the trustee) would typically notify the licensor by serving notice of a motion to assume executory agreements. A Chapter 11 licensee has until confirmation of its plan of reorganization (which is usually at least six months after the bankruptcy filing but could be longer—sometimes more than a year) to elect to assume or reject the licence agreement.[6] However, many Chapter 11 licensees make that decision much earlier—often as part of a pre-confirmation asset sale—and send their licensor a notice of intention to assume as part of the sale.

So what can a trade mark licensor do when a licensee makes its election to assume or reject?

If licensee seeks to assume and licensor consents

Trade mark licensors would normally want their licensees to assume licence agreements, especially if the licensees are in default of their agreements, which bankrupt licensees almost always are. The reason is that in order for a licensee in default to assume, the Bankruptcy Code requires it to

(A) cure, or provide adequate assurance that it (or the trustee) will promptly cure, such default;

(B) compensate, or provide adequate assurance that it will promptly compensate, a party other than the debtor to the licence, for any actual pecuniary loss to such party resulting from such default; and

(C) provide adequate assurance of future performance under such licence.[7]

1 s 362(a) of the Bankruptcy Code.

2 Notes of Committee on the Judiciary, Senate Report No 95–989.

3 ss 365(e)(1) and 541(c) of the Bankruptcy Code.

4 s 365 of the Bankruptcy Code. Technically speaking, s 365(d)(2) of the Bankruptcy Code states that a Chapter 11 debtor 'may' assume or reject until the confirmation of its plan of reorganization, but see n 6 and its text.

5 See s 365(d)(1) of the Bankruptcy Code.

6 Although not required to do so, in actuality most Chapter 11 debtors either make an affirmative election to assume or reject, or their contractual counterparties file motions to compel them to do so.

7 s 365(b)(1) of the Bankruptcy Code.

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Among other things, this means that the licensor must receive 100 cents on the dollar of what it is owed, as well as assurances that the licensee will meet payment and all other contractual obligations in the future.

But even if the licensor is prepared to accept the assumption of the licence agreement, it should carefully review the notice of intention to assume, and file an objection in bankruptcy court if it believes the licensee has not met its burden under any of these factors. Obviously, under (A) above, the licensor should determine whether the licensee has listed the correct cure amount for any arrears, both pre- and post-petition. Under (C), the licensor should determine whether the licensee has shown that it or any proposed assignee has the resources available to continue performing all contractual obligations. And the good news for licensors is that under (B), if the licence contains an attorneys' fees provision that applies to bankruptcy proceedings and is valid under state law, the licensor can request to be compensated for its reasonable attorneys' fees arising out of its filing of such objection (although whether as an unsecured creditor it can actually collect will depend on the law of that judicial district).[8]

If licensee seeks to assume and licensor objects

In contrast, the licensor may believe that the licensee or its proposed assignee is incapable of properly performing the licence agreement. One of the fundamental principles of US trade mark law is that a licensor must control the quality of the goods and services provided by the licensee under the licensed mark. This rule is designed to fulfil the public policy objective of consumer protection, in that trade mark laws help prevent the public from being misled as to the quality of branded products and services. A prohibited 'assignment in gross of a mark'[9] or other failure to maintain quality control standards could give rise to a so-called naked licence claim.[10] The consequences of such a claim can be quite severe. In particular, 'a court may find that the trade mark owner has abandoned the trade mark, in which case the owner would be estopped from asserting rights to the trade mark'.[11]

To prevent such damage from occurring, the licensor may object to a licensee's assumption or assumption and assignment of a licence agreement on the following four grounds:

1. The licence agreement was terminated prior to the bankruptcy filing. A licence agreement that has been terminated prior to the licensee entering bankruptcy is no longer executory, and therefore not subject to assumption, provided that all the conditions for termination have occurred prior to the bankruptcy filing (including, in the event of a material breach, the expiration of any permitted remedy or cure periods);
2. The licence agreement is not executory. If either party to a licence agreement has substantially performed its material obligations under the agreement, the licence may no longer be considered executory. For example, the Third Circuit recently held a perpetual, exclusive, and royalty-free trade mark licence entered into in connection with an asset purchase agreement to be non-executory, because the licensee had no royalty payment obligations, and none of its other obligations could be considered material;[12]
3. The licensee cannot possibly fulfil its requirements for assumption, in the case of a defaulted contract. In other words, the licensee cannot satisfy its burden of proof that it is capable of promptly curing all defaults, compensating third parties for their pecuniary losses, and providing adequate assurances of future performance by the licensee or its assignee;[13] or
4. The licence agreement is not assumable and/or assignable. By its literal language, the Bankruptcy Code prohibits a debtor from *assuming* an agreement without the consent of the other party when the debtor does not have the explicit right to *assign* the agreement under 'applicable law' in the absence of a bankruptcy.[14] 'Applicable law' is often interpreted to mean state law and federal common law prohibitions on assignments of agreements that are 'personal' in nature. The two courts that have directly considered the issue of when a trade mark licence is assignable under non-bankruptcy

8 See *Travelers Casualty & Surety Co. v Pacific Gas & Electric Co.*, 549 US 433 (2007) (no blanket prohibition in the Bankruptcy Code against recovery of attorneys' fees). But compare *Ogle v Fidelity & Deposit Co. of Maryland*, 586 F.3d 143 (2d Cir. 2009) and *In re SNTL Corp.,* 571 F.3d 826 (9th Cir. 2009) (unsecured creditors permitted to recover attorneys' fees) with *Adams v Zimmerman*, 73 F.3d 1164 (1st Cir. 1996) and *Waterman v Ditto,* 248 BR 567 (BAP 8th Cir. 2000) (unsecured creditors not permitted to recover attorneys' fees).

9 s 1060 of the Lanham Act.

10 *Barcamerica Int'l USA Trust v Tyfield Importers*, 289 F.3d 589, 596, 62 USPQ.2d (BNA) 1673 (9th Cir. 2002).

11 id.

12 See *Exide Technologies v EnerSys Delaware Inc.*, 607 F.3d 957 (3d Cir. 2010).

13 See s 365(b)(1) of the Bankruptcy Code and above text at n 8.

14 See s 365(c)(1)(A) of the Bankruptcy Code.

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law concluded that non-exclusive trade mark licences are unassignable without the licensor's consent. The first court reasoned that 'the grant of a non-exclusive license is an "assignment in gross" under the Lanham Act, that is, one that is personal to the assignee and thus not freely assignable to a third party'.[15] The second court reasoned that 'copyright and trade mark licensors share a common retained interest in the ownership of their intellectual property – an interest that would be severely diminished if a licensee were allowed to sub-license without the licensor's express permission'.[16] Other courts have permitted the transfer of trade mark licences without the licensors' consent, but usually without full analysis of precisely what is 'applicable law' as required by the Bankruptcy Code.[17] Further, as may be inferred from the statutory language above, the non-assignability of the licence may affect not only the licensee's ability to assume it and assign it to a third party, but also merely to assume it and continue performance itself as prior to the bankruptcy.[18]

If licensee seeks to reject and licensor consents

What happens if the licensee decides not to accept, but rather to reject an executory licence agreement? As mentioned above, an executory agreement in a Chapter 7 bankruptcy is deemed automatically rejected if the licensee does not announce its intent to assume within 60 days of the bankruptcy filing. In a Chapter 11 bankruptcy, the motion to assume will normally state that any agreements not listed as being assumed will be deemed rejected.

A rejected licence agreement is treated as a breach of contract effective as of the date of the bankruptcy filing, and the licensor would normally file a claim for damages on that basis. Usually, the claim will be an unsecured one, meaning that the licensor will have to stand in line with all the other general unsecured creditors and probably receive no more than the proverbial '10 cents on the dollar', at least as to amounts due as of the bankruptcy filing date (but see below regarding post-petition amounts).

If licensee seeks to reject and licensor objects

If the licensor is opposed to the licensee's rejection, it can in theory file an objection, but judges will usually not overturn the licensee's decision to reject if it was made in good faith and with reasonable business judgment as to what is most beneficial to the bankruptcy estate.

Licence agreement performance after the bankruptcy filing

As mentioned above, in the absence of a court order, usually by way of a licensor's motion to lift the automatic stay or to compel the licensee's assumption or rejection of an executory agreement, the licensee is permitted to exercise its rights under the licence agreement after the bankruptcy filing, unless and until the agreement is rejected. An important clarification is necessary: the licensor's prospect, as described above, between receiving 100 cents on the dollar if the licensee assumes versus only cents on the dollar if the licensee rejects, applies only to amounts owing as of the bankruptcy filing date. A different set of rules applies as to amounts due during the limbo period after the filing date, but before assumption/rejection goes into effect.

Specifically, the Bankruptcy Code requires the debtor to reimburse creditors for the benefits that they provide to the bankruptcy estate during such limbo period.[19] In the licence context, this is commonly interpreted to mean that the licensee must pay all post-filing running royalties.[20] The debtor in a

15 *In re Travelot Co.,* 286 BR 447 (SD Ga 2002).

16 *N.C.P. Marketing Group, Inc. v BG Star Productions, Inc. et al.*, 279 Fed. Appx. 561 (9th Cir. 2008).

17 *In re Varisco*, 16 BR 634 (Bankr. MD Fla 1981); *In re Rooster, Inc.*, 100 BR 228 (Bankr. ED Pa 1989); *In re Sunrise Restaurants, Inc.,* 135 BR 149 (Bank. MD Fla 1991).

18 The Third, Fourth, Ninth, and Eleventh Circuits and several bankruptcy courts have interpreted this rule to mean the debtor cannot assume the agreement in bankruptcy without the other party's consent *regardless* of whether the debtor intends to assume the agreement for itself and not actually assign it to a third party (ie the hypothetical test). Thus, licensors in a 'hypothetical' jurisdiction will probably be able to block either the debtor's assumption or assumption and assignment of a non-exclusive trade mark agreement. However, the First and Fifth Circuits and several bankruptcy courts have interpreted this rule to mean the debtor cannot assume the agreement in bankruptcy without the other party's consent only if the debtor actually intends to assign it to a third party (ie the actual test). This disagreement between the circuits has existed for several years and, even though the US Supreme Court was recently presented with a clear opportunity to resolve the conflict, it declined to do so. See *N.C.P. Marketing Group, Inc. v BG Star Productions, Inc. et al.*, No 08–463 (23 March 2009).

19 s 503(b)(1)(A) of the Bankruptcy Code.

20 Cf *In re Dak Industries, Inc.*, 66 F.3d 1091 (9th Cir. 1995), an unusual Ninth Circuit opinion which appears to hold that if a software licence agreement is structured to contain minimum guaranteed royalty payments, it should be treated as a sale, not a licence, for bankruptcy purposes, and that any guarantee payments scheduled to be paid after the bankruptcy filing should be treated entirely as pre-petition general unsecured claims, even if the licensee continues to use the software after filing. (The wiser course would have been to allow administrative expense claims to the extent of the post-filing running royalties, and treat any

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Chapter 11 bankruptcy will sometimes pay post-filing royalties voluntarily, especially for a licence agreement that it plans to assume but, more often, the licensor in both Chapter 7 and Chapter 11 bankruptcies is required to file a so-called administrative expense claim for post-filing royalties. Sometimes courts allow filing of such claims on the same pre-printed form as an unsecured claim with no motion required, but more frequently, they require a separate motion to be filed. Since the administrative expense claim is treated as one of the most preferred of 'priority' claims in business bankruptcies,[21] the licensor will usually receive 100 cents on the dollar, or something close to it, rather than the general unsecured claimant's cents on the dollar.

Post-shock realization

After the initial shock of the licensee's bankruptcy wears off, licensors may realize that such an event puts them in an even better position than they were previously. But trade mark licensors should retain an attorney knowledgeable about the intersection of bankruptcy and trade mark law to help guide them through an arcane and specialized process and assist them in maximizing the likelihood of a positive outcome.

excess payments required by the minimum guarantees as general unsecured claims.) As a precaution, a trade mark licensor that is owed substantial minimum guaranteed royalties in the post-filing 'limbo' period should seek advice from its bankruptcy attorney.

21 See ss 503(b)(1)(A) and 507(a) of the Bankruptcy Code.

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