# PROTECTING THE RIGHTS OF A TRADEMARK LICENSEE AGAINST ITS LICENSOR'S BANKRUPTCY

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What happens to the rights of a trademark licensee when its licensor is in bankruptcy? The hoped-for answer is "nothing"—but, so far, only the Seventh Circuit Court of Appeals, covering Illinois, Indiana and Wisconsin, has agreed definitively in the recent Sunbeam decision.[1] Unfortunately, the Supreme Court declined to decide this important question.

## "REJECTION" OF A TRADEMARK LICENSE

Generally the Bankruptcy Code allows a debtor to assume or reject an "executory contract," which is a contract for which some material performance remains to be undertaken by both parties.[2] When that happens, the counterparty to the rejected contract is given an unsecured claim that is payable at whatever cents on the dollar, if any, allowed unsecured claims are granted.[3] But when a trademark license is deemed executory (a complicated issue not fully addressed in this article) and this executory contract is rejected by the licensor, what happens to the licensee's rights to use the trademark? Often the licensee has expended substantial sums in reliance upon its right to market the items or use the technology.

The seminal case is the shocking 1985 "Lubrizol" decision[4], in which the Court of Appeals for the Fourth Circuit (VA, MD, WV, NC, and SC) allowed a licensor to reject a fully paid-up technology license so that it could sell or license the technology to another party for one reason alone – more money. The court ruled the license vaporized; the licensee could no longer use the technology; and all the licensee had was an unsecured claim for damages payable at the unsecured claims percentage. Most everyone found this decision appalling for many reasons, especially because the license had been fully paid-up and perhaps the transaction, rather than being an executory contract, was actually in substance a completed sale documented in the parlance of a license.

Reacting to the outrage that followed[5], in 1988 Congress enacted § 365(n) of the Bankruptcy Code, which provides that, in a rejection of a license of "intellectual property," the licensee has the option of (1) treating the contract as terminated or (2) retaining its rights by continuing to make royalty payments without exercising any right of setoff or recoupment. The legislative history says that the purpose of the bill was to remove the Lubrizol decision's threat to technology by making it clear (a) that the rights of an intellectual property licensee to use licensed property cannot be unilaterally cut off by rejection of the license in the licensor's bankruptcy and (b) that Congress had never intended rejection to have the effect found by the Lubrizol court.

Unfortunately, the definition of "intellectual property," which includes patents, copyrights, and trade secrets, does not include trademarks.[6] One court, in dicta, described the law as follows:

> There is a split of authority as to whether such rights are terminated upon rejection or whether a bankruptcy court has equitable power to allow the holder of such rights to continue using the marks. Compare In re Old Carco, LLC, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009)("Trademarks are not 'intellectual property' under the Bankruptcy Code … [, so] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] trademark … ."),and In re Centura Software Corp., 281 B.R. 660, 674-75 (Bankr. N.D. Cal. 2002), with In re Exide Technologies, 607 F.3d 957, 966-68 (3d Cir. 2010) (reasoning that "[c]ourts may use§365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization[, but] [t]hey should not … use it to let a licensor take back trademark rights it bargained away").[7]

In 2012, the Seventh Circuit held in Sunbeam that the licensee of patents and trademarks could keep both the patents and the trademarks. It concluded that the Fourth Circuit had wrongly decided Lubrizol and the Lubrizol licensee should have been able to keep the licenses. Reasoning from nonbankruptcy law, not from § 365(n), it concluded that, when a licensor breaches its contract, the licensee has the option of treating the breach as ending its own obligations under the license or continuing to sell the product under the license. In other words, rejection does not vaporize the contract, but rather it merely frees the estate from the obligation to further perform affirmative acts.

Of course, Sunbeam in itself raises a number of issues. If licensees can continue to sell the product based on general rules of rejection rather than § 365(n), which imposes various obligations on the licensees, why would licensees choose to make the election to retain their licenses under § 365(n) which requires that licensees pay royalties without setoff? It seems that if a licensee does not make the § 365(n) election in a Sunbeam jurisdiction, it can still keep the rights under the general rules of rejection (rendering § 365(n) superfluous). There would have been more certainty had the Supreme Court chosen to consider these issues.

Given the uncertainty, a licensee contemplating taking a license from a licensor whose financial condition is weak should have bankruptcy counsel determine what, if anything, local bankruptcy and district courts have decided about whether a licensee can keep its trademarks, and should take steps based on local law to reduce the risks. Two examples of the way courts have handled this question will suffice.

In California, the Ninth Circuit Court of Appeals (CA and other western states) has not addressed the issue. A Northern California bankruptcy court[8], whose decision is not binding on other California courts, concluded, before the Sunbeam decision, that licensees are not entitled under § 365(n) to retain trademarks, and the licensee's remedy is to vigorously contest rejection of the license, before rejection occurs, on the grounds that all the licensor can be is a spoiler: if the licensee gets to retain the patent, copyright, and trade secrets associated with the same product, what use are the trademark rights to the licensor? However, the standard for a debtor licensor seeking to reject an executory contract is “business judgment,” which is upheld unless there is no justification whatsoever for the proposal, and that does not happen often. This conundrum is ripe for negotiation under which the spoiler licensor gets paid for agreeing to assign the trademark rights to the licensee (who already had the rights) and the licensee, seething at paying twice for the same rights, reluctantly agrees that some payment is better than outright loss of the trademark license.

In New York, the Second Circuit Court of Appeals (NY, CT and VT), in another case pre-dating Sunbeam, has also not really addressed the issue. In a case[9] which turned on other issues, the Second Circuit gratuitously said a trademark licensee whose license has been rejected (1) cannot retain the trademark rights, (2) might be able to retain those rights, and (3) can retain those rights. This decision addressed the issue providing three different answers and no useful guidance.

## WHAT TO DO (IF POSSIBLE) WHEN NEGOTIATING THE TRANSACTION

A. Structure the transaction as a completed sale, not an “executory” contract. Only executory contracts can be rejected; a contract is executory when material duties remain to be performed by both parties. To stand a chance, the substance of the transaction must be a sale, with no material duties remaining for the licensor and the only duty of the licensee being the payment of money in installments. But even if the licensor has no other duties, some courts conclude the duty of the licensor not to transfer the same rights elsewhere is a material duty, rendering the contract executory.[10] And most licenses require the licensor to produce more product, making this strategy available only in a “one-off” transaction in which the licensor transfers the rights and makes no commitments about future product.[11]

For example, suppose a licensee is about to acquire the exclusive U.S. rights to manufacture and sell a designer’s handbags and shoes for spring in 2014, with the prototype handbags available in June 2013, and the shoes in September 2013. This transaction can be structured as an exclusive license under which the designer delivers the prototype handbags in June and the shoes in September. Alternatively, it can be structured as a sale in June 2013 of the rights to the handbags (where the remaining duty of the buyer is to make payments as due under the sales agreement), followed by a sale in September of the rights to the shoes (with the same ongoing buyer’s duty to make payments under the contract). The economics of the deal can be the same whether it is called a license agreement or a sales contract, but the odds increase greatly if the court views the agreement as one calling for the sale of the goods rather than a license to use the designs, and so the buyer is more likely to be able to keep the rights he or she originally bargained for.

B. Take a security interest in the property of the licensor. This approach would secure the licensor’s obligations under the license and would be in the form of a written document recorded in the manner necessary to “perfect” the security interest. That way, if a bankruptcy court later decides the license has vaporized, the licensee argues he has a secured claim for damages that takes precedence over all unsecured claims. The existence of such a secured claim may in itself deter the licensor from contemplating rejecting the license or may cause the court to deny the debtor the right to reject the license.

The example here is the licensee’s right to liquidated damages (say, for failure to deliver product in a timely manner) could be secured by a lien on sufficient inventory and equipment at the licensor’s premises (probably junior to the lessor’s revolving loan, which provides working capital). The documentation would set forth the extent of the lien, and the UCC-1 form would secure the lien rights once timely and properly recorded.

C. Ask the principals of the licensor for a “bad boy” guarantee. This is a guarantee that springs into being if the licensor goes into bankruptcy. It is a deterrent to a company’s voluntary filing of a bankruptcy case, and, so far, courts have upheld “bad boy” guarantees.[12]

A “bad boy” guarantee penalizes the principals when the licensor exercises its right to file bankruptcy. If the license provides the licensor’s filing of a bankruptcy petition is an automatic default, as most licenses do, that is not enforceable under the Bankruptcy Code.[13] But if a guarantee of the individual principals provides that licensor’s bankruptcy constitutes a default of their guarantee and entitles licensee to undertake immediate collection, that is enforceable, at least so long as the principals have no right of offset or indemnity against the debtor licensor—the Bankruptcy Code protects the debtor, not the principals. Should the principals know they will be sued immediately on their “bad boy” guarantees, they may find a way to avoid bankruptcy or in bankruptcy work more cooperatively with the licensee by choosing to assume the license rather than reject it.

## WHAT TO DO AFTER THE BANKRUPTCY FILING

Vigorously oppose any attempt by the debtor to reject the license, making three arguments if they are applicable:

A. The transaction is a completed sale and not an executory contract.
B. Rejection is not a valid business decision by the licensor when all that will be accomplished is the licensee’s loss of the trademark rights, and no gain can be obtained for the licensor, who cannot remarket the trademark rights because the licensee will retain the copyright and trade secret rights, which will ensure the trademark is not valuable to any other party. Put another way, the balance of harms favors the licensees. (Many judges will order the parties into the hall to negotiate a price for the trademark rights.)
C. Argue the reasoning of the Sunbeam decision, which held the licensee of patents and trademarks could keep both the patents and the trademarks because rejection does not vaporize the contract, but rather it merely frees the estate from the obligation to further perform affirmative acts.

## CONCLUSION

Under current bankruptcy law, a licensee cannot be certain it can retain its trademark rights after its licensor is in bankruptcy. However, by adopting the strategies suggested here, licensees reduce the risk of losing those rights.

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