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New Considerations for Trademark Licenses in a 363 Sale

On October 31, 2014, Bankruptcy Judge Kaplan of the District of New Jersey addressed two issues critically important to intellectual property licensees and purchasers: (i) can a trademark licensee use section 365(n) of the Bankruptcy Code to keep licensed marks following a debtor-licensor's rejection of a license agreement?; and (ii) can a "free and clear" sale of intellectual property eliminate any rights retained by a licensee? *In re Crumbs Bake Shop, Inc., et al.*, 2014 WL 5508177 (Bankr. D.N.J. Oct. 31, 2014). He concluded that section 365(n) protects trademark licenses, notwithstanding the omission of trademarks from the Bankruptcy Code's definition of protected "intellectual property," and that a "free and clear" sale does not extinguish a licensee's section 365(n) rights, absent clear and knowing consent by the licensee.

Background

Crumbs was a specialized retailer of cupcakes and other baked goods that stopped operating in early July 2014. The company and its affiliates filed for chapter 11 and tried to sell substantially all of their assets in a section 363 sale. On August 27, 2014, the court approved the sale of those assets to the debtors' existing lender, free and clear of all liens, claims, encumbrances and interests.

Soon after entry of the sale order, the debtors moved to reject executory contracts the purchaser had not acquired, including various trademark licensing agreements for the use of the Crumbs trademark and trade secrets. A third party—a brand licensing servicer of the licenses for the Crumbs trademarks—responded that licensees could retain their rights to the trademarks pursuant to section 365(n) of the Bankruptcy Code. The debtors withdrew their motion to the extent it related to the trademark licenses in favor of a later determination of the effect of the sale order on rights to the Crumbs trademark.

Section 365(n) & Trademark Licenses

Under section 365(n) of the Bankruptcy Code, a non-debtor licensee may retain the right to use "intellectual property" under a rejected license. In essence, this provision allows the licensee to "reject" the debtor's rejection if, among other things, the licensee continues to pay the royalties due under the license.

Congress enacted section 365(n) after a 1985 Fourth Circuit ruling that a debtor's rejection of a patent license extinguished the licensee's rights in the patented technology. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). Congress was concerned that the harsh result in *Lubrizol* would adversely impact the technology industry as a whole.

Section 365(n), however, only applies to certain types of "intellectual property." *See* 11 U.S.C. § 101(35A). Trademarks are not among the enumerated categories of protected intellectual property and the legislative history indicates that their absence was intentional. *See In re Exide Techs*., 607 F.3d 957, 966-7 (3d Cir. 2010), citing S. Rep. No. 100-505, at 5. Thus, the legal consequences of trademark license rejection for trademark licensees remain unclear. Some courts impose the *Lubrizol* result— the debtor's rejection of a trademark license extinguishes the licensee's rights. *See e.g. In re HQ Global Holdings, Inc*., 290 B.R. 507, 513 (Bankr. D. Del. 2003). Others have declined to apply *Lubrizol*, reasoning that rejection is nothing more than a breach of the agreement and that breach alone does not terminate a licensee's rights. *See Sunbeam Prods., Inc. v. Chicago Mfg., LLC,* 686 F.3d 372, 277-8 (7th Cir. 2012) (rejection did not terminate counterparty's right to continue to manufacture and sell trademarked fans); *see also In re Exide Techs*., 607 F.3d 957, 964-8 (3d Cir. 2010) (Judge Ambro, concurring).[1]

In *Crumbs*, Judge Kaplan held that section 365(n) applies to Crumbs' trademark licenses, notwithstanding that the Bankruptcy Code's definition of protected "intellectual property" does not expressly include trademarks. He maintained that "Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case, whether trademark licensees may retain the rights listed under §365(n)," (2014 WL 5508177 at *4), and that, given the facts at hand, it would be inequitable to strip the licensees of their rights for the benefit of the purchaser. *Id*., citing favorably to Judge Ambro's concurrence in *Exide*, 607 F.3d at 967-8 ("Courts may use 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not… use it to let a licensor take back trademark rights it bargained away."). Separate and apart from equitable considerations, he agreed with *Sunbeam* that rejection of a trademark license should not eliminate the counterparty's rights. *Id*. at *4-5. He also noted that legislation is currently pending that would remedy the omission of trademarks from the definition of "intellectual property" covered by section 365(n). *Id*. at *5.

Section 365(n) in a Sale Context

Having determined that section 365(n) applies to and protects trademark licenses, Judge Kaplan next addressed section 365(n)'s operation in the context of a 363 sale.

First, the court considered whether section 363(f) trumps licensees' rights under section 365(n). Under specified circumstances, section 363(f) allows a purchaser to take assets "free and clear" of any other property interest. Would that include section 365(n) rights? Judge Kaplan said "no," that section 363(f) does not extinguish section 365(n)'s protections, absent the informed consent of the counterparty. 2014

[1] Additionally, some courts have been able to avoid reaching this issue, by concluding that the agreements at issue before them are not executory and, thus, are not subject to rejection. In those instances, the licensee's rights to use the trademarks under the license agreements continue. *See In re Interstate Bakeries Corp*., 751F.3d 955 (8th Cir. 2014); *Exide*, 607 F.3d 957 (3d Cir. 2010).

WL 5508177 at *8. As a matter of statutory construction, the specific protections provided by section 365(n) trump the general "free and clear" language of section 363(f). *Id.* at *9. In so holding, the court declined to follow a Seventh Circuit ruling to the contrary regarding a similar provision, section 365(h). *Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003). There, the Court of Appeals concluded that a sale under section 363(f) stripped a lessee of its rights under section 365(h).

Judge Kaplan also rejected the purchaser's argument that the licensees had "impliedly consented" to the termination of their section 365(n) rights by failing to object to the sale motion. He found that the notice provided to Crumbs' licensees—one which neither identified clearly the assets being sold, nor informed the licensees that their rights might be extinguished—was inadequate. Given that, Judge Kaplan decided that the counterparties' failure to object to the sale could not be construed as informed consent. *Id.* at *6-7.

Second, Judge Kaplan considered an additional consequence of his decision arising from the fact that the underlying trademarks, but not the license agreements, had been transferred to the purchaser. Because the agreements remained with the debtors, Judge Kaplan concluded that post-closing royalties under the agreements were owed to the debtors, not the purchaser of the trademarks. *Id.* at *11.

Consequence for Purchaser

The *Crumbs* decision places the burdens of trademark license issues squarely on the purchaser. Judge Kaplan acknowledged that the continuation of trademark licenses under section 365(n) that are not assumed by the debtor and acquired by the purchaser resulted in the purchaser – now, owner of the trademarks – never becoming party to the rejected agreements and, thus, unable to enforce their terms (such as quality control standards). *Id.* at *5. He suggested that existing infringement and anti-fraud laws constituted sufficient incentives for the counterparties to maintain the quality of the trademarks (*id.*), but these are incentives for the licensee to comply with quality control standards, and not remedies available to a trademark owner. Such incentives do not address circumstances that arise during the course of a licensing arrangement, including how to apply and enforce quality control standards in the face of emerging technologies and media available to a licensee, such as social media. This separation of ownership of the trademarks from the ability to enforce and police their use could diminish the value of the trademarks purchased in a sale transaction as a result of potential "naked licensing." Perhaps recognizing this, Judge Kaplan ventured that purchase price adjustments might be necessary to compensate the purchaser. *Id.* at *5.

Conclusion

The ultimate impact of the decision—particularly Judge Kaplan's application of section 365(n) to trademark licenses—remains to be seen. However, given the evolving case law regarding section 365(n) and the legal effect of rejecting a trademark license, buyers should understand that a debtor may not be

able to deliver intellectual property—including trademarks—"free and clear" of the burdens of existing licenses. Thus, buyers should consider including language in purchase agreements to protect against adverse intellectual property decisions (*e.g.*, providing for a purchase price adjustment, the transfer of all royalties or section 365(n) payments associated with purchased assets, an assignment of enforcement rights, a license "back" from the purchaser to the debtor to permit the debtor to sublicense the trademarks to the licensees and enforce purchaser's rights, and the like).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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