ALERT MEMORANDUM

Recent Case Underscores Growing Divide on Treatment of Trademark Licenses in Bankruptcy Proceedings, an Issue Ripe for Supreme Court Review

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The U.S. Supreme Court will soon likely be asked to clarify the extent to which trademark license rights survive rejection in bankruptcy proceedings, as the lower courts are growing increasingly divided.

On May 17, 2018, the U.S. Bankruptcy Court for the District of Connecticut held that a trademark licensee retains the right to use licensed trademarks following a debtor-licensor's rejection of the license. *See In re SIMA Int'l, Inc Debtor*, No. 17-21761, 2018 WL 2293705 (Bankr. D. Conn. May 17, 2018) ("*SIMA*"). This decision, the most recent in a series of cases addressing the treatment of trademark licenses in bankruptcy proceedings, is consistent (in result though not necessarily in reasoning) with court decisions in the Third[1] and Seventh[2] Circuits, but directly conflicts with case law from the Fourth Circuit[3] and with a recent First Circuit decision[4], which will likely be appealed to the Supreme Court on Monday, June 11, 2018.

Until the high court decides the issue, or Congress weighs in via statutory amendment, trademark licensees will face continued uncertainty on their ability to use licensed trademarks following rejection in bankruptcy. In the meantime, in cases where the trademarks make up a material portion of the licensor-debtor's assets, the divide in authorities could also drive a debtor's determination on the most advantageous venue in which to file Chapter 11.

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[1] *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).
[2] *Sunbeam Prods. Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012).
[3] *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985) ("*Lubrizol*").
[4] *Mission Prod. Holdings, Inc. v. Tempnology LLC (In re Tempnology, LLC)*, 879 F.3d 389 (1st Cir. 2018) ("*Tempnology*").

Background

Under Section 365 of the Bankruptcy Code, a debtor can assume or reject any executory contract, including a trademark license. Once the contract or license is rejected, it is deemed to have been breached by the rejecting party immediately prior to the petition date, giving rise to a pre-petition claim for damages.

Despite rejection, Section 365(n) of the Bankruptcy Code preserves the rights of a licensee only with respect to "intellectual property," as defined in 11 U.S.C. § 101. Notably, such definition includes patents, copyrights and trade secrets but excludes trademarks; accordingly, the scope of protection that Section 365(n) affords to trademark licensees is subject to ongoing debate.

Legislative history indicates that Congress intended to exclude trademarks from the scope of Section 365(n)'s protection.[5] Congress passed Section 365(n) as a direct response to *Lubrizol*[6], a case which held that the rejection of a patent license terminated the licensee's rights in the licensed patents. Following *Lubrizol*, courts held that after a license was rejected, the licensee had no ability to continue to use the licensed marks. Congress intended that Section 365(n) would preserve certain licensee rights in order to balance the competing interests of licensor and licensee. However, Congress intentionally omitted trademarks from Section 365(n), in order "to allow the development of equitable treatment of this situation by bankruptcy courts."[7] This has generated significant uncertainty around a trademark licensee's rights following rejection of the license.

Overview of Circuit Court Split

Some courts have avoided the issue of the consequences of rejection and the protections afforded to trademark licensees altogether by finding that a trademark license is not executory and thus cannot be rejected.[8] The Third and Eighth Circuits, setting a high bar in the mergers and acquisitions context for an agreement to be deemed executory, held, in the particular circumstances of the cases before them, that trademark licenses, when considered as part of a set of related transaction agreements, were not executory contracts subject to rejection.[9]

Other courts hold that trademark licenses are executory, as each party has material unperformed obligations.[10] Even among these latter courts, there is a further split.

Many of such courts have taken the position that a licensee's rights to licensed trademarks are preserved following rejection of the applicable license. These courts reason that rejection does not constitute termination[11], and/or adopt an interpretation of Section

[5] *See* S. Rep. No. 100-505, at 5 *as reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.

[6] *See In re Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).

[7] *Id.*

[8] *See Lewis Bros. Bakeries Corp. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 751 F.3d 955 (8th Cir. 2014); *See also In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).

[9] *See In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014) (holding that, under Chapter 11 of the Bankruptcy Code, the trademark licensee had substantially performed its obligations under an integrated asset-sale agreement, and that the agreement was, therefore, not executory; the Court held the trademark license and the purchase agreement, which were executed by the same contracting parties in the course of the same transaction on the same date, were a singular instrument and assessed the extent of continuing obligations of the integrated asset-sale agreement rather than the license agreement alone, making it easier for the court to hold the parties had substantially performed their obligations than if it had considered the license in isolation); *See also In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (holding the same).

[10] *See e.g., In re HQ Glob. Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) (holding an exclusive trademark license is an executory contract, as licensor's agreement not to use trademarks in certain territories is an ongoing material obligation). *See also Richard Royce Collection Ltd. v. New York City Shoes, Inc. (In re New York City Shoes, Inc.)*, 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (holding "[the trademark license] certainly appears to fit . . . the classic 'executory contract' definition of a contract that has not been fully performed on both sides").

[11] *See Sunbeam Prods., Inc., v. Chicago Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012); *See also In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (Ambro, J., concurring).

365(n) that does not preclude a finding in favor of the licensee's trademark rights.[12]

Other courts[13] have instead held that a debtor-licensor's rejection of an executory trademark license terminates a licensee's right to use the licensed trademarks (and none of the protections available under Section 365(n) apply).

A. First, Courts Are Divided on Whether Rejection Terminates the License.

— The **Seventh Circuit** has held that a licensee retains its rights to trademark use post-rejection under a "plain reading" of Section 365(g). The Court reasoned that rejection is a breach by the debtor-licensor rather than a termination, and the licensee's rights under such contract continue unaffected.[14]

— The **First Circuit**[15], on the other hand, effectively revived the **Fourth Circuit's** *Lubrizol* rationale and held that rejection of a trademark license terminates the license.

B. Second, Courts Are Divided on Whether Licensees Have Continued Rights to Use Trademarks Under Section 365(n) Post-Rejection.

— The **District of New Jersey** held that Section 365(n) left open the opportunity for bankruptcy courts to exercise their equitable powers to decide whether a trademark licensee retains rights to use the licensed trademarks post-rejection.[16]

— The **First Circuit**[17], and bankruptcy courts in **New York**[18] and the **Delaware**,[19] relying upon the omission of trademarks from the Bankruptcy Code's definition of intellectual property, held that following rejection, the licensee cannot continue use of the licensed marks.

Potential Appeal to the Second Circuit

A recent Connecticut case presents a novel opportunity for the **Second Circuit** to weigh in on this issue.

In *SIMA*, a trustee sought to reject a royalty-bearing license agreement under which the debtor-licensor licensed all of its intellectual property associated with a motivated ability identification system, including associated copyrights and trademarks. The licensee conceded that the license agreement was executory, but argued it could elect to continue use of the trademarks under Section 365(n). The Connecticut court's decision presents a novel opportunity for the Second Circuit to weigh in on the divide.

— *SIMA*, like the Seventh Circuit, holds that rejection merely frees a licensor from performing its obligations under the agreement, but does not completely terminate the agreement. Instead, *SIMA* looks to state law, and reasons that because the rejection was not a material breach, there was no justification to extinguish the licensee's use of the trademarks.

— The *SIMA* court explicitly rejected the First Circuit's *Tempnology* decision, holding it "plainly contrary to Congress' explicit efforts."[20] Instead, *SIMA* upheld the licensee's right to continue its use of the licensed trademarks post-rejection, particularly where the rights to use of the

[12] *See In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014).
[13] *See In re Tempnology, LLC*, 876 F.3d 389 (1st Cir. 2018); *See also In re Old Carco LLC,* 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); *See also In re HQ Glob. Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003).
[14] *See Sunbeam Prods. Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012); *See also In re Exide Techs.*, 607 F.3d 957 (3d. Cir. 2010) (Ambro, J., concurring) (holding that more than a negative inference is necessary to conclude that the rejection of a trademark license results in a termination of such license).
[15] *In re Tempnology, LLC*, 876 F.3d 389 (1st Cir. 2018).
[16] *See In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014); *See also In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (Ambro, J., concurring).
[17] *See In re Tempnology, LLC*, 876 F.3d 389 (1st Cir. 2018).
[18] *See In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009).
[19] *See In re HQ Glob. Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003).
[20] *In re SIMA Int'l, Inc Debtor*, No. 17-21761, 2018 WL 2293705, at *8 (Bankr. D. Conn. May 17, 2018).

copyrights and trademarks were ancillary to the use of other IP.

Second Circuit Appeal May be Preempted by SCOTUS Review

As the lower courts continue to take opposing sides on this issue, the licensee in *Tempnology* has requested an extension to file a writ of certiorari petitioning the Supreme Court to resolve the split. The certiorari petition is due on June 11, 2018.

Implications of the Ongoing Circuit Split

Until the Supreme Court decides the issue, or Congress weighs in via statutory amendment,[21] lower courts will continue to grapple with the effect of a rejection of an executory contract.

This split will continue to result in debtor-licensors carefully choosing the venues in which they file for bankruptcy to ensure that their licensees' rights to use trademarks terminate upon the rejection of the underlying licenses. In these debtor-friendly jurisdictions, even a perpetual, irrevocable trademark licensee may lose its trademark rights if a licensor files for bankruptcy.

On the other hand, the circuits in which licensees are permitted to retain their trademark rights post-rejection, on the basis that rejection merely frees the licensor from performing its obligations under the agreement but does not completely terminate the license, can be criticized for presenting debtor-licensors with two bad options that effectively nullify rejection of a trademark license:

— (i) accept third parties' usage of the licensed trademarks without such debtors-licensors' approval or control, and risk invalidating the licensed trademarks, as a lack of control is inconsistent with the function of a trademark as an indicator of source and can result in naked licensing; or

— (ii) continue to operate under the license and monitor/approve the quality of licensees' goods that are subject to the license to avoid the serious risks of naked licensing.

Furthermore, if the justification for licensees' retention of their trademark rights is that rejection does not result in termination, then this reasoning would also necessarily apply in the context of patent, copyright and trade secret licenses, which calls into question the significance of Section 365(n) generally, other than perhaps in safeguarding the licensee's exclusivity following rejection.[22]

In light of the current uncertainty, some licensees may attempt to build contractual protections into trademark licenses, such as provisions stating that licensed trademarks shall be deemed to be "intellectual property" under Section 365(n) or that the license shall continue despite any rejection by the licensor. However, such language is not binding on the courts and is unlikely to have any meaningful effect otherwise. By contrast, sophisticated licensees can explore with counsel other ways to protect their trademark rights through creative arrangements and bespoke contract drafting.

For additional information, click here for our prior memorandum on the Eight Circuit's position and here for our prior memorandum on the Seventh Circuit's position.

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[21] The Innovation Act, H.R. 3309, 113th Cong. (2013), a proposed statutory amendment, extends the protections under Section 365(n) by expanding the definition of "intellectual property" in the Bankruptcy Code to include trademarks, service marks and trade names. This legislation also fails to relieve a trustee of the debtor-licensor's contractual obligations to monitor or control the quality of a licensed product or service. The bill was passed by the House of Representatives on December 5, 2013, but not the Senate, who instead responded with several bills, including the Patent Transparency and Improvements Act of 2013, S. 1720, 113th Cong. (2013), which were never enacted. The Innovation Act was reintroduced in February of 2015, but has yet to be passed.

[22] *See In re SIMA Int'l, Inc Debtor*, No. 17-21761, 2018 WL 2293705, at *8 (Bankr. D. Conn. May 17, 2018) (holding that Section 365(n) preserves a licensee's exclusivity rights under an executory license).