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# what a trademark licensee can do to improve its chances of retaining its trademark rights after the licensor files bankruptcy

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*MSK Client Alert*

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Fashion industry licensees invest substantial sums in reliance on their license rights. Bankrupt licensors have been able to convince courts they can "reject" licenses and, when so doing, thereby cause licensees' trademark rights to vaporize. Here we discuss why and what a licensee can do.

## **The Effect of Rejection on Trademark License Rights**

In the shocking 1985 "Lubrizol" decision, 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 was actually in substance a completed sale documented in the parlance of a license.

Reacting to the outrage that followed, in 1988 Congress enacted Section 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.

Unfortunately, the definition of "intellectual property," which includes patents, copyrights, and trade secrets, does not include trademarks. Some courts have ignored the omission of trademarks, noting the licensee of a trademark usually has the rights to the trademark in conjunction with its rights to the patent or

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copyright. More courts, including the Third Circuit Court of Appeals (DE, NJ, and PA), have followed the literal language of the definition, commenting it is unfortunate that "intellectual property" does not include trademarks in this bankruptcy definition.

### California and New York, the Hubs of the U.S. Fashion Industry

The Ninth Circuit Court of Appeals (CA and other western states) has not addressed the issue. A Northern California bankruptcy court, whose decision is not binding on other California courts, concluded 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. (For more details about the Northern California decision, read below.)

The Second Circuit Court of Appeals (NY, CT and VT) has also not really addressed the issue. In a case concerning the name of Paolo Gucci, 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 clearly provides no guidance. (For a further discussion about the Paolo Gucci decision, read below.)

### What to Do (If Possible) When Negotiating the Transaction

1. *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 if the rights granted to the licensee/purchaser are exclusive, 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. 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.

For example, suppose you are 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 April 2013, and the shoes in July 2013. This transaction can be structured as an exclusive license under which the designer delivers the prototype handbags in April and the shoes in July. Alternatively, it can be structured as a sale in April 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 July of the rights to the shoes (with the same ongoing buyer's duty to make payments under



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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 originally bargained for.

1. *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.

1. *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.

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. 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—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:

1. The transaction is a completed sale and not an executory contract.
1. 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.)



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1. Argue the reasoning of the 2012 Seventh Circuit Court of Appeals (IL, IN, and WI) "Sunbeam" decision, which held the licensee of patents and trademarks could keep both the patents and the trademarks. The Seventh Circuit concluded 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 Section 365(n), this court concluded that, when a licensor breaches its contract by rejecting it, the licensee has the option of treating the breach as either ending its own obligations under the license or allowing it to continue to sell product under the existing 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.

In December 2012, the Supreme Court declined to resolve the conflict between the Fourth Circuit's Lubrizol decision and the Seventh Circuit's Sunbeam decision.

### **The Second Circuit's Reasoning in the Paolo Gucci Case**

The Second Circuit considered in 1997 an appeal from an order approving the sale of debtor Paolo Gucci's assets, which were primarily his name, to his estranged cousin Guccio Gucci, a competitor, after a hotly contested auction that was undertaken twice because of the difficulty of comparing bids that weren't comparable. The case involved protracted trademark litigation, licenses and sublicenses covering various territories, sometimes conflicting, and a sale by trustee Frank Sinatra (not the singer), who tried to procure the best terms without the assistance of Paolo Gucci, who had died during the pendency of the case. The court held the appeal was moot because the sale had closed and the appealing parties (the other bidders, many of whom were creditors) had not obtained a stay of the closing pending appeal.

After affirming the sale order, the Second Circuit noted the following with regard to the protection afforded to licensees of trademarks: "[Section 365(n)] protection is limited to the Bankruptcy Code's definition of 'intellectual property' which does not include trademarks. . . . [I]t may be seen that Congress specifically excluded trademark licensees from this protection accorded other intellectual property licensees." But in a footnote it said, "The effects of a rejection of a trademark licensing agreement are a matter that remains to be litigated" and cited various articles arguing that trademark licenses should not be rescinded as a consequence of rejection.

### **The Northern California Bankruptcy Court's Reasoning**

The 2002 Centura Software decision by a bankruptcy court in Northern California characterizes itself as a question of first impression. The court decided that Section 365(n) does not include trademarks, and therefore, after rejection, a trademark licensee cannot continue to use the mark. It based its decision on the statute's plain language supported by the bulk of the scholarly writings. This decision was cited positively by the Third Circuit Court of Appeals, which includes Delaware, where many businesses are incorporated.

In an interesting twist, the Centura Software court noted that it *did* have flexibility before rejection was ordered. It said, "To shield its trademark rights, the licensee must intervene before the court approves of the debtor's efforts to reject the agreement," and it must argue the relatedness of the trademark to the protected property the licensee could retain. Although the usual test for whether a debtor can elect to reject an unperformed contract is



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the business judgment rule, the argument here would be that, with the licensee able to continue to use the patents, copyrights, and trade secrets under 365(n), what business judgment would support the debtor rejecting the license and reacquiring the trademark?

### **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, you at least stand a chance of reducing the risk of losing those rights.