Reinhart

Trademarks in Bankruptcy Sales: One Court Provides Guidance

POSTED:

Jan 5, 2015

RELATED SERVICES:

[Business Reorganization](https://www.reinhartlaw.com/services/business-reorganization)

https://www.reinhartlaw.com/services/business-reorganization

RELATED PEOPLE:

[Peter C. Blain](https://www.reinhartlaw.com/people/peter-blain)

https://www.reinhartlaw.com/people/peter-blain

Trademarks today are the poor cousins of other forms of intellectual property under the United States Bankruptcy Code (the "Code"). 11 U.S.C. §§ 101-1532. Trademarks are not included in the definition of "intellectual property" found in Code section 101(35A), and consequently are not explicitly treated in the same fashion as other forms of intellectual property under Code section 365(n), which provides that licensees of patents and other intellectual property may continue to use the licensed property after rejection of the license agreements.

Congress's omission of trademarks was intentional. Congress observed that to enforce a trademark the licensor must monitor the quality of the licensee's goods associated with the trademark, which makes trademarks different than other forms of intellectual property. Regarding the omission of trademarks from Code section 365(n), the legislative history provides:

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors... [S]uch contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, **it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts**.

S. Rep. No. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204 (citations omitted) (emphasis added).

The uncertainty and resultant litigation arising from the omission of trademarks from the ambit of Code section 365(n) has recently prompted a reconsideration of this issue. The House passed the Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (2013), which would add trademarks to the Code definition of intellectual property. In addition, the report of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11, released in December 2014, makes a similar recommendation at page 126. However, today the uncertainty continues.

The Background of the Crumbs Bake Shop Decision

In re Crumbs Bake Shop, Inc., No. 14-24287, 2014 WL 5508177 (Bankr. D.N.J. (2014), decided on October 31, 2014, is a thoughtful, well-reasoned opinion from the United States Bankruptcy Court for the District of New Jersey which provides some guidance regarding the rights of trademark licensees in connection with the sale of substantially all of the assets by a Chapter 11 debtor. Crumbs Bake Shop, Inc. (the "Debtor") was in the business of selling cupcakes, baked goods and beverages through retail stores, catering services, at wholesale and through an e-commerce division. In connection with its business, it licensed the "Crumbs" trademark and the right to sell its products to various third parties. The Debtor also entered into a brand licensing representation agreement with Brand Squared Licensing ("BSL"), which obtained for the Debtor six additional licensees.

The Debtor experienced severe liquidity issues and, after ceasing operations, filed a petition for relief under Code Chapter 11 on July 11, 2014. On the same day, the Debtor entered into a credit bid Asset Purchase Agreement with Lemonis Fischer Acquisition Company, LLC ("LFAC"). On July 14, 2014, the Debtor filed a motion to sell substantially all of its assets to LFAC and, after an unsuccessful attempt to solicit a higher or better offer, on August 27, 2014 the court approved the sale of the Debtor's assets to LFAC free and clear of liens, claims, encumbrances and interests. On August 28, 2014, the Debtor filed a motion to reject certain executory contracts, including the trademark license agreements. BSL filed an objection asserting that Code section 365(n) permitted the licensees to elect to retain the right to use the trademarks, and that BSL was entitled to the royalty stream due upon the continued use of the marks. On September 19, 2014, the Debtor withdrew the rejection motion with respect to the trademark licenses and LFAC filed a motion requesting that the court clarify the rights of the parties.

Issues to Be Addressed

LFCA asked the court to determine the following issues:

1. Whether trademark licensees to rejected intellectual property licenses fall under the protective scope of Code section 365(n), notwithstanding that "trademarks" are not explicitly included in the Code definition of "intellectual property";
2. Whether a sale of the Debtor's assets under Code sections 363(b) and (f)

trumps and extinguishes the rights of third party licensees under Code section 365(n); and

3. To the extent there are continuing obligations under the license agreements, which party is entitled to the royalties generated as a result of the licensee's continued use of the intellectual property. In re Crumbs Bake Shop, Inc., 2014 WL 5508177, at *1.

Lubrizol and Section 365(n)

The court began its analysis by discussing *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), a case holding that the rights of intellectual property licensees are cut off upon rejection of the license agreements under Code section 365. The outcry from the commercial community resulting from the *Lubrizol* decision, said the court, prompted the enactment of Code section 365(n). *In re Crumbs Bake Shop, Inc.*, 2014 WL 5508177, at *3. The court also noted that the reasoning of *Lubrizol* has been substantially discredited, citing *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010) and *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012). *Id*.

Nonetheless, LFCA argued that because trademarks were excluded from the ambit of Code section 365(n), the holding of Lubrizol still governed the effect of the rejection of a trademark license agreement. Id. The court rejected this negative inference, relying instead upon the legislative history of Code section 365(n) (set forth above) which in the highlighted portion provides that the impact of rejection of trademark license agreements was to be developed by the bankruptcy courts. *Id*. at *4.

The court found that, in this instance, it would be inequitable to strip the licensees of the rights for which they had they bargained. Moreover, as the Sunbeam court observed, outside of bankruptcy, a licensor's breach does not terminate the licensee's right to use the intellectual property. *Id*. The court also dismissed LFCA's contention that allowing the licensees to continue to use the trademarks placed LFCA in a licensor/licensee relationship that it never intended to assume. The court said that LFCA approached the transaction with eyes wide open and had the ability after due diligence to adjust its price to account for the existing license agreements. The rights of licensees should not be vitiated to aid LFCA's recovery under its credit bid. *Id*.

Additionally, the court rejected LFCA's argument that allowing the use of the trademarks would leave LFCA with little ability to control the quality of the products. Warranties given by the licensees to their customers relating to the quality of the products sold, among other things, is a sufficient incentive for licensees to maintain the quality of the goods. *Id*. at *4-5. The court noted that the Innovation Act pending in Congress, while not dispositive of the issue, was evidence that Congress was cognizant of the prejudice to licensees caused by courts adopting the position advanced by LFCA and that Congress desired to remedy this inequitable result. *Id*. at *5.

The Licensees Did Not Consent to the Sale

The court then discussed the impact of the sale order authorizing the transfer of assets free and clear of liens, claims, encumbrances and interests upon the rights of the licensees to continue to use the trademarks in the absence of the licensees' consent to the sale. LFCA argued that the licensees impliedly consented to the sale by failing to object. The court scoffed at this assertion, observing that the sale motion and the attached asset purchase agreement were so confusing and had so many cross-references that it was unreasonable to conclude that the licensees had notice that their rights were going to be adversely affected. *Id*. at *5-6.

The court noted that while the sale order did reference that the sale was free and clear of license rights in favor of a third party, this reference comprised 10 words in a 29-page order, which in turn was attached to a 129-page pleading. *Id*. at *7. The court discussed at length *In re Lower Bucks Hospital*, 571 F. App'x. 139 (3d Cir. 2014) in which the Third Circuit, considering the enforceability of a third party release included in a plan of reorganization, held that clear notice of the impact of releases was a prerequisite to the release's enforceability. *Id*. at *6. Had the licensees in this case received adequate notice, the court concluded, they would have certainly objected and the court would have found that their rights under Code section 365(n) would remain intact. *Id*. at *7.

Code Section 365(n) Versus Code Section 363(f)

The court then turned to the interplay of Code sections 365(n) and 363(f), which authorizes sales free and clear of interests in the debtor's property. The court noted with approval the reasoning of *In re Churchill Properties III, Limited Partnership*, 197 B.R. 283 (Bankr. N.D. Ill. 1996), where that court rejected the claim that a sale under Code section 363(f) extinguishes the right of a tenant to remain in possession of real property after a lease rejection under Code section 365(h), as this would negate the specific rights given in that section. In re Crumbs

Reinhart

Bake Shop, Inc. 2014 WL 5508177, at *8. The court noted that this position is specifically supported by the legislative history of Code section 365(h):

> Subsection (h) protects real property lessees of the debtor if the trustee rejects an unexpired lease under which the debtor is the lessor (or sublessor). The subsection permits the lessee to remain in possession of the leased property or to treat the lease as terminated by the rejection... Thus, the tenant will not be deprived of his estate for the term for which he bargained.

S. Rep. No. 95-989, at 60 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5846.

The court said that, as with real property leases in Code section 365(h), specific rights are granted to licensees under Code section 365(n) permitting them to continue using intellectual property. In this case, said the court, Code section 363(f) does not wipe away the rights of the licensees to continue to use the trademarks under Code section 365(n) after sale of the trademarks. *In re Crumbs Bake Shop, Inc.* 2014 WL 5508177, at *8. In reaching its conclusion, the court specifically rejected the holding of the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), wherein the court concluded that Code section 365(h) is limited to rejection and that unless a lessee seeks adequate protection prior to a sale under Code section 363(f), its rights can be extinguished in a Code section 363 sale. *Id*.

Who Gets the Royalties?

Finally, the court addressed the issue of who is entitled to the post-sale royalty payments for the continued use of the trademarks by the licensees. While the court said there was no question that the trademarks were among the assets sold to LFCA, the license agreements between the debtor and the licensees were not assumed and assigned to LFCA and remained assets of the bankruptcy estate. *Id*. at *8-9. The court relied upon the Third Circuit's decision in *In re CellNet Data Systems., Inc.*, 327 F.3d 242 (3d Cir. 2003), wherein intellectual property was sold to a buyer but the underlying license agreements were excluded from the sale and subsequently rejected. The Third Circuit concluded that under Code section 365(n)(2)(B), the obligation to pay post-rejection royalties is directly linked to the rejected contract and not to the intellectual property conveyed. The contract, therefore, determines where the royalties flow. *In re Crumbs Bake Shop, Inc.* 2014 WL 5508177, at *9.

Under this analysis, the court found that the post-sale royalties belonged to the Debtor but that the pre-sale royalties, which constituted accounts receivable, belonged to LFCA. Although BSL had proposed taking an assignment of the license agreements, BSL did hold the trademarks, and the court noted that it would be unable to perform under the agreements, and therefore would not be entitled to the royalties. *Id*. Based upon the foregoing, the court denied LFCA's motion.

Conclusion

The decision is noteworthy for several reasons. First, it makes clear that although trademarks are excluded from the provisions of the Bankruptcy Code dealing with intellectual property, under the appropriate circumstances, licensees should not be deprived of the ability to use the trademark after a sale or rejection of the executory license agreement. This may be crucial to the economic viability of licensees which have invested significant amounts to promote and sell a debtor licensor's products. Second, the court's insistence upon adequate notice to the affected licensees and its scathing criticism of the notice in this case stands as a stark warning to drafters of pleadings in connection with asset sales, particularly because the style, structure and complexity of the pleadings in this case typify the pleadings drafted in connection with many asset sales in bankruptcy.

Third, the court clarified that Code section 363(f) authorizing sales free and clear of interests does not trump Code section 365(n), which allows a licensee to continue to use the trademark post-sale or post-rejection. While in the Seventh Circuit, the *Qualitech* decision presumably still requires a trademark licensee faced with a sale of the trademarks to request adequate protection or risk losing its rights, the Crumbs Bake Shop decision may persuade a court in that jurisdiction that continued use of the trademark would constitute an acceptable form of adequate protection. Finally, the court clearly tied the entitlement to the royalty payments due for continued use to the contract and not to the ownership of the trademark. Asset purchasers should insist that trademark licenses are assumed and assigned to them; otherwise, they risk losing all of the benefits associated with the trademark(s).

represent you.