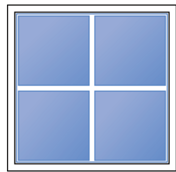

INDUSTRY *OUTLOOK*

Handling Trademark Licensees in Bankruptcy

by Oliver Herzfeld and Richard R. Bergovoy

An envelope arrives from bankruptcy court. You open it and realize with shock that one of your trademark licensees has filed a bankruptcy petition and listed you as a creditor. Over the past two years, this has become an increasingly common occurance. But from a trademark licensor's point of view, a licensee entering bankruptcy is not always the disaster it might appear to be.

This two-part article—the next article will be in the August issue—will provide an overview of the main issues faced and decisions to be made by a trademark licensor whose licensee has filed for bankruptcy.

Bankruptcy and Trademark Law

First, some background on bankruptcy and trademark law in the United States. Bankruptcy is a process for adjusting the debts and adjudicating the property of a bankrupt debtor's estate. Trademarks are distinctive names, logos, designs, symbols, or other indicators to identify to consumers that the products or services on which the trademark appears originate from a unique source, and to distinguish the trademark owner's products or services from those of other entities. Interestingly, the Lanham Act, which codifies U.S. trademark law, does not address or even mention bankruptcy, and the Bankruptcy Code, which codifies U.S. bankruptcy law, does not address or even mention trademarks. Nonetheless, it is well understood that valid trademark license agreements are considered assets of the debtor subject to the provisions of the Bankruptcy Code.

The two main categories of business bankruptcy in the U.S. are Chapter 7 and Chapter 11. Chapter 7 is a so-called "liquidation" bankruptcy, in which a trustee carves up the debtor, liquidates its assets, and then distributes the proceeds to creditors according to a priority scheme contained in the Bankruptcy Code. Chapter 11 is a so-called "reorganization" bankruptcy, in which the debtor itself restructures its affairs and pays off creditors a portion of what it owes them, usually from a combination of loans, selected asset sales, stock issuance, and current revenues. Chapter 11 bankruptcies are carried out according to a plan that must be voted on by creditors and holders of equity interests, and approved by the bankruptcy court. Reorganizations under Chapter 11 sometimes fail and convert to Chapter 7 liquidations, or sometimes are intentionally utilized by the debtor to liquidate its assets, similar to a Chapter 7 trustee.

Executory Contracts

The Bankruptcy Code treats a valid licensing agreement as a special kind of asset called an "executory contract." There is no definition of executory or executory contracts in the Bankruptcy Code, but the most commonly accepted definition in the case law is an agreement where substantial performance remains due by both parties. Most unexpired trademark licenses will meet the definition of executory contract, because typically the licensee is required to observe the quality specifications of the licensor and pay royalties to the licensor, while the licensor is required to maintain quality control of the licensed product and refrain from suing the licensee for trademark infringement.

Automatic Stay

Most executory contracts are subject to the automatic stay provisions of the Bankruptcy Code. That means, once a licensee files for bankruptcy, the licensor is prohibited from taking any action to collect a debt from the licensee without the express approval of the bankruptcy court.

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors, stopping all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

As part of the automatic stay, the licensor is forbidden to make any attempt to terminate the license agreement. Boilerplate provisions that state the license agreement is automatically terminated if the licensee files for bankruptcy are so-called "ipso facto" clauses that are automatically invalid in bankruptcy. Therefore, a licensor should definitely refrain from the impulse to send its bankrupt licensee a termination notice with a demand for immediate payment of all royal-

ties due since such an action could be a violation of the automatic stay and put the licensor in contempt of the bankruptcy court.

Licensee Must Assume or Reject

Another consequence of a license agreement being executory is that the Bankruptcy Code requires the licensee to choose whether to "assume" the license agreement (*i.e.*, accept it in full, both benefits and responsibilities, and render performance according to its original terms) or "reject" it (*i.e.*, terminate the agreement and excuse itself from any further performance obligations). The rationale behind this goes right to the heart of bankruptcy law, namely, to maximize the value of the bankruptcy estate by allowing the debtor to retain useful, profitable, and advantageous agreements, and reject unprofitable and disadvantageous ones. The license agreement may be a revenue producer that is critical to the licensee's Chapter 11 reorganization efforts, or the licensee may wish to sell (assume and assign) the license agreement to a third party as part of either a Chapter 11 or Chapter 7 asset sale.

A Chapter 7 licensee (or, more precisely, the trustee of its bankruptcy estate) must elect to assume an executory license agreement within 60 days of the bankruptcy filing unless it obtains an extension from the bankruptcy court, otherwise the licensee is deemed to have automatically rejected the agreement. The Chapter 7 licensee (or the trustee) would typically notify the licensor by serving notice of a motion to assume executory agreements. A Chapter 11 licensee has until confirmation of its plan of reorganization (which is usually at least six months after the bankruptcy filing but could be longer—sometimes more than a year) to elect to assume or reject the license agreement. However, many Chapter 11 licensees make that decision much earlier—often as part of a pre-confirmation asset sale—and send their licensor a notice of intention to assume as part of the sale.

So what can a trademark licensor do when a licensee makes its election to assume or reject? Trademark licensors would normally want their licensees to assume license agreements, especially if the licensees are in default of their agreements, which bankrupt licensees almost always are. The reason is that in order for a licensee in default to assume, the Bankruptcy Code requires it to:

(A) cure, or provide adequate assurance that it (or the trustee) will promptly cure, such default;

(B) compensate, or provide adequate assurance that it will promptly compensate, a party other than the debtor to the license, for any actual pecuniary loss to such party resulting from such default; and

(C) provide adequate assurance of future performance under such license.

Among other things, this means that the licensor must receive 100 cents on the dollar of what it is owed, as well as assurances that the licensee will meet payment and all other contractual obligations in the future.

But even if the licensor is prepared to accept the assumption of the license agreement, it should carefully review the notice of intention to assume and file an objection in bankruptcy court if it believes the licensee has not met its burden under any of these factors. Most obviously, under (A) above, the licensor should determine whether the licensee has listed the correct cure amount for any arrears, both pre- and post-petition. Under

Oliver Herzfeld is shown on the right and Richard R. Bergovoy is shown on the left.

(C), the licensor should determine whether the licensee has shown that it or any proposed assignee has the resources available to continue performing all contractual obligations. And the good news for licensors is that under (B), if the license contains an attorneys' fees provision that applies to bankruptcy proceedings and is valid under state law, the licensor can request to be compensated for its reasonable attorneys' fees arising out of its filing of such objection (although whether as an unsecured creditor it can actually collect will depend on the law of that judicial district).

Three Other Scenarios

In the next printed issue of ***Royaltie$***, we will conclude this two-part article with an exploration of the other three possible scenarios, namely, what happens if (i) the licensee seeks to assume the license agreement and the licensor objects, (ii) the licensee seeks to reject the license agreement and the licensor consents, and (iii) the licensee seeks to reject the license agreement and the licensor objects.

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