INDUSTRY OUTLOOK

Handling Trademark Licensees in Bankruptcy: Part Two

by Oliver Herzfeld and Richard R. Bergovoy

In the June 2011 issue of *Royaltie$*, we commenced our overview of the main issues faced and decisions to be made by a trademark licensor whose licensee has filed for bankruptcy. In particular, we explained 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), and described what happens if the licensee seeks to assume the license agreement and the licensor consents. In this second article, we will complete our review of the remaining three possible scenarios.

If Licensee Seeks to Assume and the Licensor Objects

The licensor may believe that the licensee or its proposed assignee are incapable of properly performing the license agreement. One of the fundamental principles of U.S. trademark law is that a licensor must control the quality of the goods and services provided by the licensee under the licensed mark. This rule is designed to fulfill the public policy objective of consumer protection, in that trademark laws help prevent the public from being misled as to the quality of branded products and services. A prohibited "assignment in gross of a mark" or other failure to maintain quality control standards could give rise to a so-called "naked license" claim. The consequences of such a claim can be quite severe. In particular, "a court may find that the trademark owner has abandoned the trademark, in which case the owner would be estopped from asserting rights to the trademark."

To prevent such damage from occurring, the licensor may object to a licensee's assumption or assumption and assignment of a license agreement on the following four grounds:

1) The license agreement was terminated prior to the bankruptcy filing. A license agreement that has been terminated prior to the licensee entering bankruptcy is no longer executory, and therefore not subject to assumption, provided that all the conditions for termination have occurred prior to the bankruptcy filing (including, in the event of a material breach, the expiration of any permitted remedy or cure periods);

2) The license agreement is not executory. If either party to a license agreement has substantially performed its material obligations under the agreement, the license may no longer be considered executory. For example, the Third Circuit recently held a perpetual, exclusive, and royalty-free trademark license entered into in connection with an asset purchase agreement to be nonexecutory, because the licensee had no royalty payment obligations, and none of its other obligations could be considered material;

3) The licensee cannot possibly fulfill its requirements for assumption, in case of a defaulted contract. In other words, the licensee cannot satisfy its burden of proof that it is capable of promptly curing all defaults, compensating third parties for their pecuniary losses, and providing adequate assurances of future performance by the licensee or its assignee; or

4) The license agreement is not assumable and/or assignable. By its literal language, the Bankruptcy Code prohibits a debtor from assuming an agreement without the consent of the other party when the debtor does not have the explicit right to assign the agreement under "applicable law" in the absence of a bankruptcy. "Applicable law" is often, but not always, interpreted to mean state law and federal common law prohibitions on assignments of agreements that are "personal" in nature. The two courts that have directly considered the issue of when a trademark license is assignable under non-bankruptcy law concluded that non-exclusive trademark licenses are unassignable without the licensor's consent. The first court reasoned that "the grant of a non-exclusive license is an 'assignment in gross' pursuant to the Lanham Act, that is, one that is personal to the assignee and thus not freely assignable to a third party." And the second court reasoned that "copyright and trademark licensors share a common retained interest in the ownership of their intellectual property—an interest that would be severely diminished if a licensee were allowed to sublicense without the licensor's express permission." Other courts have permitted the transfer of trademark licenses without the licensors'

consent, but usually without full analysis of precisely what is "applicable law" as required by the Bankruptcy Code. Furthermore, as may be inferred from the statutory language above, the non-assignability of the license may impact not only the licensee's ability to assume it and assign it to a third party but also just to assume it and continue performance itself as prior to the bankruptcy.

If Licensee Seeks to Reject and Licensor Consents

On the other hand, what happens if the licensee decides not to accept but rather to reject an executory license agreement? As mentioned above, an executory agreement in a Chapter 7 bankruptcy is deemed automatically rejected if the licensee does not announce its intent to assume within 60 days of the bankruptcy filing. In a Chapter 11 bankruptcy, the motion to assume will normally state that any agreements not listed as being assumed will be deemed rejected.

A rejected license agreement is treated as a breach of contract effective as of the date of the bankruptcy filing, and the licensor would normally file a claim for damages on that basis. Usually, the claim will be an unsecured one, meaning that the licensor will have to stand in line with all the other general unsecured creditors and probably receive no more than the proverbial "10 cents on the dollar," at least as to amounts due as of the bankruptcy filing date (but see below regarding post-petition amounts).

If Licensee Seeks to Reject and Licensor Objects

If the licensor is opposed to the licensee's rejection, it can in theory file an objection, but judges will usually not overturn the licensee's decision to reject if it was made in good faith and with reasonable business judgment as to what is most beneficial to the bankruptcy estate.

License Agreement Performance After the Bankruptcy Filing

As mentioned above, absent a court order, usually by way of a licensor's motion to lift the automatic stay or to compel the licensee's assumption or rejection of an executory agreement, the licensee is permitted to exercise its rights under the license agreement after the bankruptcy filing, unless and until the agreement is rejected. An important clarification is necessary: the licensor's prospect, as described above, between receiving 100 cents on the dollar if the licensee assumes versus only cents on the dollar if the licensee rejects, applies only to amounts owing as of the bankruptcy filing date. A different set of rules applies as to amounts due during the limbo period after the filing date, but before assumption/rejection goes into effect.

Specifically, the Bankruptcy Code requires the debtor to reimburse creditors for the benefits that they provide to the bankruptcy estate during such limbo period. In the license context, this is commonly interpreted to mean that the licensee must pay all post-filing running royalties. The debtor in a Chapter 11 bankruptcy will sometimes pay post-filing royalties voluntarily, especially for a license agreement that it is planning to assume, but more often, the licensor in both Chapter 7 and Chapter 11 bankruptcies is required to file a so-called administrative expense claim for post-filing royalties.

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

Sometimes courts allow such claims to be filed on the same pre-printed form as an unsecured claim with no motion required, but more frequently, they require a separate motion to be filed. Since the administrative expense claim is treated as one of the most preferred of "priority" claims in business bankruptcies, the licensor will usually (but not always) receive 100 cents on the dollar, or something close to it, rather than the general unsecured claimant's cents on the dollar.

After the initial shock of the licensee's bankruptcy wears off, licensors may realize that such an event puts them in an even better position than they were previously. But trademark licensors should retain an attorney knowledgeable about the intersection of bankruptcy and trademark law to help guide them through an arcane and specialized process and assist them in maximizing the likelihood of a positive outcome.

Oliver Herzfeld is senior vice-president and chief legal officer of Beanstalk, a brand licensing consultancy that's part of Omnicom Group. Richard R. Bergovoy is an attorney in private practice working with companies that own, sell, or license intellectual property and information technology, as well as acting as counsel in hundreds of bankruptcy cases.