

In re Crumbs Bake Shop – Trademark Licensees May Be Able to Have Their (Cup)Cake And Eat It, Too

New Jersey Bankruptcy Court Extends Section 365(n) Protection to Trademark Licensees on Equitable Grounds

November 18, 2014

Following a recent line of high profile and notable decisions that have sought to protect the rights of trademark licensees in a trademark licensor's bankruptcy, the U.S. Bankruptcy Court for the District of New Jersey has issued a significant decision that, for the first time, extends the protections of Section 365(n) of the U.S. Bankruptcy Code to trademark licensees on equitable grounds (*In re Crumbs Bake Shop, Inc.*, No. 14-24287 (Bankr. D.N.J. Oct. 31, 2014)).

Section 365(n) generally serves to mitigate an intellectual property licensee's exposure to the risk of the licensor's bankruptcy by allowing the licensee to treat the license as terminated or to elect to retain certain of its rights under the license. If the licensee accepts termination of its license, it can file a claim in the bankruptcy case, which would typically be treated as a pre-petition general unsecured claim. If the licensee makes an election under Section 365(n) to retain its rights, the debtor must comply with the confidentiality and exclusivity provisions of the license agreement and continue to provide access to the licensed intellectual property as it existed immediately before the bankruptcy filing. However, because Congress excluded trademarks from the definition of "intellectual property" under the Bankruptcy Code for the purposes of Section 365(n), courts have traditionally reasoned by negative inference that a trademark licensee's rights to licensed trademarks are vulnerable if a trademark licensor in bankruptcy elects to reject the trademark license under Section 365(a).

Recently, courts within the Third and Seventh Circuits have provided trademark licensees with protections against this vulnerability and the court's decision in *Crumbs* extends this trend. Relying on the reasoning articulated by Judge Ambro in his concurring opinion in *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010) (Ambro, J., concurring) and citing the legislative history of Section 365(n), the court concluded that even if Section 365(n) does not expressly apply to trademarks, the court has the equitable power to apply Section 365(n) to trademark licenses. In addition, the court concluded that the trademark licensees' Section 365(n) rights were not vitiated by a Section 363 "free and clear" sale of the licensed trademark because it did not have the consent of the trademark licensees. Finally, because the applicable licenses were excluded from the Section 363 sale, the debtors were entitled to collect future royalties from the licensees.

Background

Crumbs Bake Shop, Inc. ("**Crumbs**") specialized in the retail sale of cupcakes as well as other baked goods and beverages. As part of its business, Crumbs entered into licensing agreements with third parties, which allowed them to use the Crumbs trademark and trade secrets and sell products under the Crumbs brand. In July 2014, due to severe liquidity constraints, Crumbs ceased operations and filed a voluntary petition for bankruptcy under Chapter 11 of the Bankruptcy Code.

On the same date that Crumbs filed for bankruptcy, Crumbs (as debtors-in-possession) entered into a credit bid Asset Purchase Agreement (the "**APA**") for the sale of substantially all of its assets to Lemonis Fischer Acquisition Company ("**LFAC**") and after LFAC emerged from a sale auction process as the successful stalking horse bidder, the court subsequently entered a sale order that approved the sale of Crumbs' assets to LFAC free and clear of all liens, claims, encumbrances and interests.

Subsequently, the debtors filed a motion to reject certain executory contracts, including the trademark licenses granted to Crumbs' licensees. A representative of the licensees filed a response arguing that the trademark licensees could elect to maintain their licensed rights under Section 365(n). The debtors withdrew their rejection motion to the extent that it related to the trademark licenses and LFAC filed a motion seeking clarification on the parties' rights under the license agreements.

Bankruptcy Court Opinion

In evaluating LFAC's motion, the court considered three issues: (1) whether trademark licenses fall under the protective scope of Section 365(n), notwithstanding that "trademarks" are not explicitly included in the definition of "intellectual property" under the Bankruptcy Code; (2) whether a sale of the debtors' assets pursuant to Section 363(b) and (f) trumps and extinguishes the rights of third party licensees under Section 365(n); and (3) which party is entitled to the collection of any ongoing royalties generated as a result of third party licensees' use of licensed intellectual property.

On the question of whether Crumb's trademark licensees were eligible to retain their licensed rights pursuant to Section 365(n), the court was not convinced that Congress' omission of trademarks from the Bankruptcy Code's definition of "intellectual property" evidenced an intent by Congress for Section 365(n) to not apply when a debtor-licensor rejects a trademark license. Instead, relying on Judge Ambro's concurring opinion in *In re Exide Technologies* and references to "equitable" concerns in the legislative history of Section 365(n), the court concluded that Congress intended for bankruptcy courts to decide on a case-by-case basis whether a trademark licensee may rely upon Section 365(n) to repel attempted rejection of the license that it has obtained from a debtor-licensor.

On the second question considered, the court concluded that the Section 365(n) interests of the trademark licensees were not extinguished by the Section 363 sale because in the absence of consent of the trademark licensees, the Section 363 sale did not trump the rights granted to the trademark licensees by Section 365(n). The court found that the trademark licensees' failure to object to the sale was understandable given that the APA was unclear as to the specific assets being sold and neither the APA nor the sale motion put the trademark licensees on adequate notice to cause them to believe that an objection was necessary to retain their Section 365(n) rights. Confident that the licensees would have objected to the extinguishment of their Section 365(n) rights if they had notice of the sale of the licensed trademarks, the court concluded it would be inequitable to hold otherwise. The court also held that nothing in the language of Section 363(f) trumps the rights granted to licensees under Section 365(n), and that the legislative history of Section 365 supports such an interpretation.

Finally, on the third question considered, the court concluded that because the license agreements at issue were explicitly excluded from the sale to LFAC, LFAC was not a party to those agreements and thus had no rights under them. Accordingly, the associated post-closing royalty rights deriving from future use of the licensed intellectual property by the licensees remained with the debtors, while the actual intellectual property that was the subject of the license would be owned by LFAC.

Conclusions and Implications for Practice

For approximately twenty five years, it was widely understood under *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), that trademark licenses were vulnerable in the event of a licensor's bankruptcy, in part because trademark licensees could not avail themselves to the protections of Section 365(n) of the Bankruptcy Code. Within the last few years, there has been a growing trend among courts within the Third and Seventh Circuits to provide trademark licensees with protections against such risk (see, e.g., *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010); *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012)) and the *In re Crumbs Bake Shop* decision further extends this trend. Nevertheless, given that there remains a split in federal circuit court authority on this question, until such time as either the United States Supreme Court

elects to review the issue or Congress amends the Bankruptcy Code to expressly clarify whether trademark licenses are within the purview of Section 365(n), practitioners should continue to employ traditional strategies for mitigating the risks associated with licensors entering bankruptcy. Such strategies include having the licensee (1) acquire the licensed trademarks if possible, (2) take a security interest in the licensed trademarks, (3) allocate payments under the license in a manner that would create a disincentive for the trustee to reject the license and (4) request that the licensor place the licensed trademarks in a special purpose entity isolated from any bankruptcy filing.

The *In re Crumbs Bake Shop* decision also highlights the importance of placing intellectual property licensees on adequate notice of any proposal to effect a sale of the licensed intellectual property pursuant to Section 363, as the failure to do so may result in the purchaser of such licensed intellectual property taking such rights subject to the Section 365(n) rights of the licensee. In addition, purchasers of a debtor-licensor's assets should be careful to receive an assignment from the debtor-licensor of applicable licenses (including the right to receive royalties) to account for the possibility that the licenses survive the sale or are unable to be rejected under Section 365.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Intellectual Property

Frank J. Azzopardi	212 450 6277	frank.azzopardi@davispolk.com
David R. Bauer	212 450 4995	david.bauer@davispolk.com

Bankruptcy

Donald S. Bernstein	212 450 4092	donald.bernstein@davispolk.com
Timothy Graulich	212 450 4639	timothy.graulich@davispolk.com
Marshall S. Huebner	212 450 4099	marshall.huebner@davispolk.com
Brian M. Resnick	212 450 4213	brian.resnick@davispolk.com
Damian S. Schaible	212 450 4580	damian.schaible@davispolk.com

© 2014 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. Please refer to the firm's [privacy policy](#) for further details.