

**Trademark Licensees May Be Able to Have Their (Cup)Cake and Eat It, Too***NJ Bankruptcy Court Extends Section 365(n) Protection to Trademark Licensees on Equitable Grounds*By **Frank J. Azzopardi, Timothy Graulich, Brian Resnick and David R. Bauer**

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 United States 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 Bankruptcy Code, 11 U.S.C. § 365(n), to trademark licensees on equitable grounds. *In re Crumbs Bake Shop, Inc.*, No. 14-24287 (Bankr. D.N.J. Oct. 31, 2014) (*Crumbs*).

Given that intellectual property licenses are generally considered to be executory contracts that may be rejected pursuant to Section 365(a) of the Bankruptcy Code, Section 365(n) serves to mitigate an intellectual property licensee's exposure to the risk of the licensor's bankruptcy by allowing the licensee to treat a rejected 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-licensor 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, when Congress enacted Section 365(n), it excluded trademarks from the

definition of "intellectual property" under the Bankruptcy Code for the purposes of Section 365(n) (*see* 11 U.S.C. § 101(35A)), and consequently, 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). *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003).

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 Thomas L. Ambro in his concurring opinion in *In re Exide Technologies*, 607 F.3d 957, 964–68 (3d Cir. 2010) (Ambro, J., concurring) and citing the legislative history of Section 365(n), the court in *Crumbs* 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. *Crumbs*, No. 14-24284 at 8-9. 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. *Id.* at 12. Finally, because the applicable licenses were excluded from the Section 363 sale, the debtors were entitled to collect future royalties from the licensees. *Id.* at 21.

**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 un-

der 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.

**EQUITABLE POWER TO APPLY SECTION 365(N)**

On the question of whether Crumbs' trademark licensees were eligible to retain their licensed rights pursuant to Section 365(n), the court was not convinced

**Frank Azzopardi** (frank.azzopardi@davispolk.com) is head of Davis Polk's Intellectual Property and Technology Group, and **David Bauer** (david.bauer@davispolk.com) is a senior associate in that group. **Timothy Graulich** (timothy.graulich@davispolk.com) and **Brian Resnick** (brian.resnick@davispolk.com) are partners in Davis Polk's Insolvency and Restructuring Group.

that Congress' omission of trademarks from the Bankruptcy Code's definition of "intellectual property" evidenced an intent by Congress for Section 365(n) not to apply when a debtor-licensor rejects a trademark license. *Id.* at 8. Instead, relying on Judge Ambro's concurring opinion in *In re Exide Technologies*, 607 F.3d at 964-68 (Ambro, J., concurring), and 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. *Crumbs*, No. 14-24284 at 8-10. In particular, the court pointed to the following discussion in the Senate committee report on the bill for Section 365(n) as persuasive authority for exercising the court's discretion and equity:

[T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others, see, e.g., *In re Chipwich, Inc.*, 54 [B.R.] 427 (Bankr. S.D.N.Y. 1985), such 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. ... Nor does the bill address or intend any inference to be drawn concerning the treatment of executory contracts which are unrelated to intellectual property.

*Id.* at 8 (quoting S. Rep. No. 100-505, at 5 (1988) (emphasis in the original)).

Noting that the debtors had bargained away rights for their licensees to use the licensed trademarks, the court concluded that it would be inequitable to strip the licensees of those rights in the event of a rejection of the license agreements by the debtors. The court agreed with Judge Ambro that Section 365 may be used by courts as a "shield" to "free a bankrupt trademark licensor from burdensome duties that hinder its reorganization," but that Section 365 should not be used as a "sword" to permit a "licensor [to] take back trademark rights it bargained away." *Crumbs*, No. 14-24284 at 9 (quoting *In re Exide Technologies*, 607 F.3d at 967-68 (internal quotations omitted)).

## SECTION 365(N) VS. SECTION 363

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 of the debtors' assets to LFAC because in the absence of any express or implied consent of the trademark licensees, the Section 363 sale did not trump the rights granted to the trademark licensees by Section 365(n). *Id.* at 12. LFAC, relying on a line of cases that included *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281 (7th Cir. 2002), argued that the trademark licensees had impliedly consented to the vitiation of their Section 365(n) rights by failing to object to the debtors' motion seeking approval of the sale of the debtors' assets to LFAC. *Crumbs*, No. 14-24284 at 12. However, the court distinguished the *FutureSource* line of cases as all involving non-objecting parties being provided with adequate notice of the relevant free and clear sale that would vitiate their rights. *Id.*

The court then found that the trademark licensees' failure to object to the Section 363 sale to LFAC 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. *Id.* at 12-17. 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 that it would be inequitable to hold otherwise. *Id.* at 17. The court also held that, in the absence of consent, nothing in the language of Section 363(f) expressly trumps the rights granted to licensees under Section 365(n), and that the legislative history of Section 365 supports such an interpretation. *Id.* at 17-20.

## RIGHTS TO ROYALTIES

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. *Id.* at 21. 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. *Id.* at 21-22.

## CONCLUSIONS AND IMPLICATIONS FOR PRACTICE

For approximately 25 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 of 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., *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012); *In re Exide Technologies*, 607 F.3d 957. The court's decision in *Crumbs* 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:

- acquire the licensed trademarks if possible;
- take a security interest in the licensed trademarks;
- allocate payments under the license in a manner that would create a disincentive for the trustee to reject the license; and
- request that the licensor place the licensed trademarks in a special purpose entity isolated from any bankruptcy filing.

The *Crumbs* 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.