In re Exide Technologies: A Ray of Hope for Trademark Licensees When Licensors File for Bankruptcy?

In a notable recent decision (*In re Exide Technologies*, Docket Number 08-1872 (3d Cir. Jun. 1, 2010)), the Third Circuit, in reversing a decision by the District of Delaware, held that a trademark license agreement, when considered as part of a set of related transaction agreements executed in connection with the sale of a business, was not an executory contract subject to rejection under Section 365(a) of Chapter 11 of the U.S. Bankruptcy Code because the purchaser/licensee had already substantially performed under the transaction agreements taken as a single "integrated agreement". In a concurring opinion, Judge Ambro argued that, even if a trademark license can be rejected under Section 365(a), bankruptcy courts can, and often should, use their equitable powers to preserve a trademark licensee's rights to the licensed marks. The Third Circuit's decision, if it stands, and the concurring opinion, if it is adopted by courts in future decisions, are significant in that they may provide practitioners with strong new tools with which to protect the interests of trademark licensees and, potentially, the hope of significantly reducing or eliminating, in certain contexts, the risk posed by a trademark licensor's bankruptcy.

Background

In 1991, Exide Technologies ("**Exide**") sold its industrial battery business to EnerSys Delaware, Inc. ("**EnerSys**"). In connection with the sale, Exide granted a perpetual exclusive license to EnerSys to use the "Exide" trademark in the industrial battery business, but retained the right to use the Exide mark outside of that business. The transaction was governed by a series of agreements, which included an Asset Purchase Agreement, a Trademark and Trade Name License Agreement, an Administrative Services Agreement, and a Letter Agreement (collectively, the "**Transaction Agreements**").

Almost ten years later, Exide desired to return to the industrial battery business and regain the right to use the Exide mark in that business. However, EnerSys refused to relinquish its exclusive rights to the Exide mark, forcing Exide to compete against EnerSys, which was selling batteries under the Exide name.

In 2002, Exide filed for Chapter 11 bankruptcy protection. Shortly thereafter, Exide sought to regain the right to use the Exide mark in the industrial battery business by requesting court approval to reject the Transaction Agreements as executory contracts under Section 365(a). In 2006, the bankruptcy court held that the four Transaction Agreements constituted a single "integrated agreement", a ruling that neither party challenged. The bankruptcy court then held that the integrated agreement was an executory contract that was subject to rejection under Section 365(a) and that rejection of the integrated agreement terminated Exide's obligations and EnerSys's rights under it, including EnerSys's exclusive right to use the Exide mark in the industrial battery business. The bankruptcy court ultimately approved Exide's transition plan and the district court affirmed the bankruptcy court's ruling. EnerSys appealed the district court's order to the Third Circuit, arguing that the integrated agreement was not an executory contract subject to rejection and, in the alternative, that rejection of it did not terminate EnerSys's rights.

Third Circuit Opinion

On the question of whether the integrated agreement constituted an executory contract, the Third Circuit applied its version of the widely used "Countryman Definition" (proposed by the notable bankruptcy scholar, Vern Countryman): "An executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing performance of the other." In determining whether both parties had such material unperformed obligations under the integrated agreement, the court applied relevant non-bankruptcy law, which in this case was New York law. According to the court, under New York law, a material breach is one that occurs prior to the rendering of substantial performance and that is so substantial as to defeat the purpose of the entire transaction. Therefore, the focus of the court's inquiry was to determine whether, at the time of Exide's proposed rejection of the integrated agreement, each party had any unperformed material obligation remaining under the integrated agreement. If not, then the integrated agreement would not constitute an executory contract.

Applying this standard, the court concluded that the integrated agreement was not an executory contract and accordingly, Exide could not reject it under Section 365(a). Based on the factual record, the court concluded that EnerSys had substantially performed under the integrated agreement because, among other factors, it had paid the full purchase price for Exide's battery business and had been operating under the integrated agreement and using the assets purchased under the transaction, including the Exide mark, to produce batteries since 1991.

Exide argued that EnerSys had material unperformed obligations that outweighed EnerSys's performance, including (1) an obligation to adhere to quality standards for the batteries bearing the Exide mark, (2) a restriction prohibiting EnerSys from using the Exide mark outside of the industrial battery business, and (3) indemnity and further assurance obligations under the Asset Purchase Agreement. The court rejected each of these arguments, finding that (i) the quality standards obligation was "minor" because it related to the standards of each battery produced under the Exide mark, not the transfer of the industrial battery business and there was no evidence that Exide had provided EnerSys with any such quality standards, (ii) the trademark use restriction imposed on EnerSys was not a material obligation because it was a condition subsequent that required EnerSys to use the mark in accordance with the terms of the Trademark and Trade Name License Agreement and did not relate to the transfer of the industrial battery business, and (iii) EnerSys's indemnity and further assurance obligations had expired.

Concurring Opinion

In a concurring opinion, Judge Ambro wrote separately to express the view that a licensor's rejection of a trademark license under Section 365(a) does not necessarily deprive the licensee of its rights in the licensed mark. Judge Ambro argued that Congress's omission of trademarks from the definition of "intellectual property" in the Bankruptcy Code should not be used to infer that Congress intended to exclude trademark licenses from Section 365(n) protection.

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. In the event that 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 bankruptcy trustee 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, trademarks are noticeably absent from the definition of intellectual property that is used in Section 365(n). Accordingly, courts have 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).

Citing the legislative history of Section 365(n), Judge Ambro argued that, because trademark licenses raise additional issues (such as quality control) which required further study by Congress at the time Section 365(n) was enacted, Congress left the "equitable treatment" of the rejection or quarantine of trademark licenses to the bankruptcy courts. With respect to the Exide case, Judge Ambro argued that the bankruptcy court should have used its "equitable powers to give Exide a fresh start without stripping EnerSys of its fairly procured trademark rights." Judge Ambro suggested that the bankruptcy court could have allowed Exide to reject the integrated agreement to avoid its future obligations under the agreement while leaving EnerSys's rights to the Exide mark unaffected. Put more generally, Judge Ambro's view of Section 365 is that, while it should operate as a shield to free the bankrupt trademark licensor from burdensome ongoing duties that would hinder its reorganization, it should not serve as a sword to put the debtor-licensor in a position that it does not deserve.

Conclusions and Implications for Practice

Prior to *Exide*, courts have generally treated intellectual property licenses, including trademark licenses, as executory contracts and, because Section 365(n) does not apply to trademark licenses, the rights of trademark licensees have generally been viewed as vulnerable in the event of the licensor's bankruptcy. The only way to completely protect a would-be licensee's interest is to acquire the trademarks outright rather than licensing them, but this is quite often not a plausible solution for various business or legal reasons. Barring acquisition, practitioners representing licensees can employ a variety of other strategies, alone or in combination, which may somewhat mitigate, but not remove, the bankruptcy risk, including:

- *Taking a security interest.* The licensee may seek to take a security interest in the licensed trademarks or other assets of the licensor in order to secure any damage claims and create a disincentive for the trustee to reject the trademark license.
- *Allocating royalties/payments.* Where the trademark license is part of a larger intellectual property license agreement or other commercial transaction, the licensee may seek to allocate separate ongoing royalties or milestone or other payments to the trademark license in order to create a disincentive for the trustee to reject the trademark license or to at least recognize some savings in the event of a rejection.
- *Employing a bankruptcy remote vehicle.* The licensee may seek to have the licensor place the licensed marks in a special purpose entity which would be isolated from any bankruptcy filing affecting the rest of the licensor's estate. However, recent legal developments have cast some doubt on the efficacy of this strategy.

However, in light of *Exide* (assuming the decision stands and is adopted by other courts), in the event the trademark license is granted as part of a larger transaction (*e.g.*, a sale of business), the licensee might also consider including the trademark license grant and the related quality control provisions in the general transaction agreement itself or include an acknowledgement in any standalone trademark license agreement that the trademark license agreement and the other applicable transaction agreements should be read as a "single integrated agreement". In either case, the licensee should consider including an acknowledgement that each party's obligations shall be considered to be "substantially performed" upon the closing of transaction. While the pre-*Exide* strategies seek to create a disincentive for the trustee to reject the trademark licenses (or attempt to keep the trademarks out of the bankruptcy filing altogether), *Exide* provides trademark licensees with the hope that their licenses may survive rejection as a matter of law even if they are subject to the debtor-licensor's bankruptcy filing.

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