



Whether Rejection of a Trademark License Agreement Terminates the Licensee's Rights to
Use the Trademark

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Introduction

Section 365(a) of the Bankruptcy Code sets forth the basic power of a trustee in bankruptcy or a debtor in possession to assume or reject an executory contract.¹ A debtor's ability to assume or reject an executory contract allows a debtor to keep favorable contracts and to discard burdensome contracts,² subject to the bankruptcy court's approval.³ The bankruptcy court will apply a two-part test to determine whether assumption or rejection should be allowed.⁴ First the court will determine whether the contract is executory.⁵ If the court determines that the contract is executory, the court will then determine whether assumption or rejection is advantageous to the bankruptcy estate.⁶ In determining whether assumption or rejection is advantageous to the bankruptcy estate, the court will typically defer to the debtor's business

¹ Michelle Morgan Harner, Carl E. Black & Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 190 (2005) (internal citations omitted).

² *Id.* at 187.

³ 11 U.S.C. § 365(a) (2012).

⁴ *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985).

⁵ *Id.*; see Harner, *supra* note 1, at 190.

⁶ *Lubrizol*, 756 F.2d at 1045; see Harner, *supra* note 1, at 194.

judgment.⁷ The court will generally approve the debtor's request to assume or reject an executory contract if the debtor satisfies both parts of the test.⁸

Courts have long struggled when determining whether the rejection of a trademark license agreement under section 365 acts to terminate such an agreement.⁹ Section 365(n) provides that rejection of an executory contract under which the debtor is a licensor of a right to intellectual property does not act to terminate the contract unless the licensee elects to treat the contract as terminated.¹⁰ Although section 365(n) addresses the rejection of a copyright, patent, or trade secret license agreement,¹¹ it does not address the rejection of a trademark license agreement¹² because the definition of "intellectual property" in the Bankruptcy Code excludes trademarks.¹³ Consequently, court decisions are split as to whether the rejection of a trademark license agreement acts to terminate such an agreement.

This Article discusses the current state of the law regarding whether the rejection of a trademark license agreement operates to terminate the licensee's rights in the mark. Part I discusses section 365 generally. Part II discusses *Lubrizol Enterprises v. Richmond Metal Finishers, Inc.*¹⁴ and section 365(n) which specifically treats the rejection of intellectual property licenses. Part III discusses the current split over whether the rejection of a trademark license

⁷ See Harner, *supra* note 1, at 194 – 95.

⁸ *Id.*

⁹ Lewis Bros. Bakeries Inc. v. Interstate Brands Corp. (*In re Interstate Bakeries Corp.*), 751 F.3d 955, 964 n.2 (8th Cir. 2014).

¹⁰ See 11 U.S.C. § 365(n) (2012).

¹¹ See 11 U.S.C. § 365(n) (2012).

¹² Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 34-35 (2013).

¹³ 11 U.S.C. § 101(35A); Gilhuly, *supra* note 12, at 35.

¹⁴ *Lubrizol*, 756 F.2d 1043 (4th Cir. 1985).

agreement terminates such agreement. Part IV will analyze the implications of the current split of authority.

I. Section 365 Generally

A goal of section 365 is to “allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations.”¹⁵ Section 365 also allows a debtor to assume executory contracts as a means to “force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.”¹⁶ A debtor that assumes an executory contract will continue to receive the benefits of the contract and will have a duty to perform all obligations under the contract.¹⁷ A debtor is permitted to assume a contract only in its entirety, and the debtor cannot rewrite the terms of the contract.¹⁸ Alternatively, a debtor that rejects an executory contract will be deemed to have made a prepetition breach of contract.¹⁹ Therefore, if a debtor rejects a contract, the counter party will be entitled to an unsecured claim for its damages, and the debtor will generally be freed from having to continue to perform its obligations under the rejected contract.²⁰ Before a contract can be rejected or assumed, (1) the contract must be executory and (2) the rejection or assumption of the contract must be advantageous to the bankruptcy estate.²¹

a. Whether a Contract is Executory

i. Most Courts Adopt the Countryman Definition of an Executory Contract.

¹⁵ *Chateaugay Corp. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 954-955 (internal quotations, citation, and emphasis omitted).

¹⁶ *Id.*

¹⁷ *See In re Interstate Bakeries*, 751 F.3d at 961.

¹⁸ *See Harner, supra* note 1, at 193.

¹⁹ 11 U.S.C. § 365(g); Gilhuly, *supra* note 12, at 45.

²⁰ *See Gilhuly, supra* note 12, at 45.

²¹ *Lubrizol*, 756 F.2d at 1045.

As a threshold issue, a contract must be “executory” in order to be rejected or assumed under section 365.²² While the Bankruptcy Code does not define the term “executory contract,” most courts adopt the Countryman definition.²³ Under the Countryman definition, an executory contract is “a contract under which the obligation[s] of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”²⁴ Accordingly, under this approach, a contract would be executory if “the lack of performance by either party would constitute a material breach” of the agreement.²⁵

Some courts find the Countryman definition too restrictive²⁶ and therefore, adopt the “functional analysis approach” to determine whether a contract is executory.²⁷ Under the functional analysis approach, a court will inquire as to “whether the debtor has unperformed duties that the trustee may elect to perform or breach.”²⁸ In doing so, a court will consider “the nature of the parties, the goals of the reorganization, and whether the acceptance or rejection of a contract will ultimately benefit the bankruptcy estate.”²⁹ The holistic considerations of the functional analysis approach make for a broader and more flexible definition of an “executory

²² See 11 U.S.C. § 365(a) (2012).

²³ Gilhuly, *supra* note 12, at 3.

²⁴ Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); See *In re Interstate Bakeries*, 751 F.3d at 962.

²⁵ Gilhuly, *supra* note 12, at 3; See *In re Interstate Bakeries*, 751 F.3d at 962.

²⁶ See 3 COLLIER ON BANKRUPTCY, ¶ 365.02 [2] [a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014); see also Gilhuly, *supra* note 12, at 3.

²⁷ Gilhuly, *supra* note 12, at 3 (quotations omitted); See 3 COLLIER ON BANKRUPTCY, ¶ 365.02 [2] [a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014).

²⁸ 3 COLLIER ON BANKRUPTCY, ¶ 365.02 [2] [a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014).

²⁹ Gilhuly, *supra* note 12, at 3.

contract” than under the Countryman definition.³⁰ Although no circuit has rejected one approach in favor of the other,³¹ the Countryman definition remains widely used.³²

ii. Trademark License Agreements are Generally Executory.

Generally, intellectual property licenses are considered as executory contracts under both the Countryman definition and the functional analysis approach because the licensor and the licensee typically owe continuing material obligations to one another.³³ Courts have held that “the duty to pay royalties, provide updates, adhere to confidentiality provisions and indemnify the licensor” are all ongoing material obligations of a licensee that if unperformed would constitute material breaches of contract.³⁴ However, the determinative factor in finding an executory contract is whether the licensor has ongoing obligations.³⁵

On the one hand, courts generally adopt a broad definition of the licensor’s “ongoing obligations”.³⁶ Under the broadest interpretation of “ongoing obligations,” the licensor’s grant of a license is a continuing obligation not to sue the licensee, thus, making any license executory.³⁷ On the other hand, some courts have refused such an expansive view and have found that “licenses are not executory contracts when one party has fully performed its material obligations.”³⁸ Ultimately, intellectual property licenses are “almost always viewed as executory

³⁰ *Id.*

³¹ 3 COLLIER ON BANKRUPTCY, ¶ 365.02 [2] [a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014).

³² Gilhuly, *supra* note 12, at 3.

³³ *Id.* at 3-4.

³⁴ *Id.* at 4.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

contracts, unless the license constitutes an assignment or one side has completely performed its obligations.”³⁹

Trademarks license agreements are “typically viewed as executory contracts because both parties to the license agreement have ongoing obligations.”⁴⁰ However, this analysis may change if the license is part of a larger, integrated contract for the sale of a business. For example, in *In re Interstate Bakeries Corp.*,⁴¹ the Eighth Circuit held that a trademark license agreement was not an executory contract because it was part of a larger, integrated sales agreement that had been substantially performed by both parties.⁴² The trademark license agreement was entered into by both parties in connection with an asset purchase agreement under which the purchaser bought two of the debtor’s brands.⁴³ When determining whether the debtor could reject the agreement, the court found that the trademark license agreement was part of a larger, integrated sales agreement because, among other things, both agreements were entered into on the same date and both agreements referred to each other.⁴⁴ As a result, the trademark license agreement was not executory for purposes of rejection under section 365 because the parties had substantially performed the sales agreement to the extent that the lack of performance by either party would not have been a material breach of the contract.⁴⁵

b. Whether the Assumption or Rejection of a Contract will be Advantageous to the Bankruptcy Estate

³⁹ *Id.*

⁴⁰ *Id.* at 9.

⁴¹ *In re Interstate Bakeries*, 751 F.3d 955 (8th Cir. 2014).

⁴² *Id.* at 963.

⁴³ *Id.* at 958.

⁴⁴ *Id.* at 962.

⁴⁵ *Id.* at 963.

A second issue a court will consider in determining whether to approve rejection or assumption of an executory contract is whether the result will be advantageous to the bankruptcy estate.⁴⁶ In considering this issue, courts generally apply the business judgment rule, which accords deference to the decisions of corporate directors.⁴⁷ Courts are reluctant to interfere with a debtor's decision under the business judgment rule,⁴⁸ unless there is a showing that the debtor made the request in bad faith or in gross negligence.⁴⁹ Consequently, if a court finds that a contract is executory, it will presume that assumption or rejection is advantageous to the debtor and will grant the debtor's request.⁵⁰

II. *Lubrizol* and Section 365 (n): the Rejection of Intellectual Property Licenses

When a court finds that a trademark license agreement is executory for purposes of section 365, the question remains as to whether the rejection of the agreement “terminates the licensee's rights to use the trademark.”⁵¹ Under section 365(g), the rejection of an executory contract constitutes a breach of contract.⁵² The breach of contract will be deemed to have occurred prepetition, and therefore, the counter party will be entitled to an unsecured claim for its damages.⁵³

a. *Lubrizol Enterprises v. Richmond Metal Finishers, Inc.*

In *Lubrizol Enterprises v. Richmond Metal Finishers, Inc.*⁵⁴ the Fourth Circuit held that under section 365(g), the rejection of a patent license agreement operated to terminate the

⁴⁶ *Lubrizol*, 756 F.2d at 1045.

⁴⁷ *Id.* at 1046.

⁴⁸ Harner, *supra* note 1, at 194.

⁴⁹ *Id.* at 194 – 195; *Lubrizol*, 756 F.2d at 1047.

⁵⁰ Harner, *supra* note 1, at 194 – 195.

⁵¹ *In re Interstate Bakeries*, 751 F.3d at 964 n.2.

⁵² 11 U.S.C. § 365(g) (2012); *see In re Interstate Bakeries*, 751 F.3d at 961.

⁵³ 11 U.S.C. § 365(g) (2012).

⁵⁴ *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).

agreement.⁵⁵ The court further held that the licensee of the rejected patent license only had a right to damages.⁵⁶ In so holding, the Fourth Circuit relied on the legislative history of section 365(g), concluding that Congress intended damages to be the exclusive remedy for a licensee in the event that the licensor rejects the agreement.⁵⁷ Particularly, the Fourth Circuit concluded that allowing the licensee's rights in the patent to continue beyond the termination of the contract would run contrary to section 365(g) because the legislative history of the statute did not mention specific performance as a remedy for the licensee.⁵⁸

b. Section 365(n)

In response to the *Lubrizol* decision and other similar court rulings,⁵⁹ Congress swiftly enacted section 365(n) in 1988.⁶⁰ According to the legislative history of section 365(n), the bankruptcy court decisions that terminated licensee rights upon the rejection of intellectual property license agreements “imposed a burden on American technological development that was never intend by Congress”.⁶¹ Consequently, Congress enacted section 365(n) to protect licensees from being “stripped” of the right to continue to use licensed intellectual property as a result of the rejection of intellectual property license agreements under section 365.⁶²

Under section 365(n), the rejection of an intellectual property license does not necessarily terminate all of the licensee's rights.⁶³ Section 365(n) applies only in the context of a debtor-licensor, and it allows a licensee to retain certain intellectual property rights even after a debtor-

⁵⁵ *Id.* at 1048.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ S. REP. NO. 100-505, at 2 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3201.

⁶⁰ Intellectual Property Bankruptcy Protection Act of 1987, Pub. L. No. 100-506, ----- (1988)

⁶¹ S. REP. NO. 100-505, at 2 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3201.

⁶² S. REP. NO. 100-505, at 1-2 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3200-01.

⁶³ *See* 11 U.S.C. § 365 (n); *In re Interstate Bakeries*, 751 F.3d at 964 n.2.

licensor has rejected the license agreement.⁶⁴ Upon rejection, the licensee has two options.⁶⁵ The licensee can “treat the debtor’s rejection as termination of the license and assert a claim for rejection damages,”⁶⁶ or the licensee can “retain its rights to use the intellectual property as they existed as of the filing of the bankruptcy petition.”⁶⁷

As mentioned above, because the Bankruptcy Code’s definition of “intellectual property” excludes trademarks, section 365(n) only addresses the rejection of a copyright, patent, or trade secret license agreement.⁶⁸ Furthermore, Congress intentionally excluded trademarks from section 365(n)’s protection.⁶⁹ Because trademark license agreements depend on the licensor’s ability to control the quality of the products or services sold by the licensee, Congress believed that rejected trademark license agreements invoked issues that went beyond the scope of the legislative intent of enacting 365(n).⁷⁰ Consequently, Congress tasked the bankruptcy courts with developing “equitable treatment” in determining the legal effect of a rejected trademark license agreement.⁷¹

III. The Split over Whether Rejection Terminates a Trademark Licensee’s Rights

There is a split of authority over whether a trademark licensee loses rights in the trademark upon rejection of a license agreement by a debtor.⁷² On the one hand, some courts

⁶⁴ Gilhuly, *supra* note 12, at 34; *see* 11 U.S.C. § 365(n).

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *See* 11 U.S.C. § 365(n); *see also* Gilhuly, *supra* note 12, at 34-35.

⁶⁹ S. REP. NO. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *See In re Interstate Bakeries*, 751 F.3d at 964 n.2.; *see also* Gilhuly, *supra* note 12, at 44-47.

have found that a licensee cannot retain trademark rights upon rejection of the trademark agreement by the licensor.⁷³

For example, in *In re Gucci*,⁷⁴ the Second Circuit concluded that it was not against public policy for trademark rights to cease upon the rejection of a trademark agreement.⁷⁵ The Second Circuit noted that section 365(n)'s "protection is limited to the Bankruptcy Code's definition of 'intellectual property' -- which does not include trademarks."⁷⁶ "Consequently, it may be seen that Congress specifically excluded trademark licensees from this protection accorded other intellectual property licensees."⁷⁷

More recently, in *In re Old Carco*,⁷⁸ the Southern District of New York held that the debtor's rejected trademark license agreements precluded the licensees from retaining their rights in the trademarks because "[t]rademarks are not 'intellectual property' under the Bankruptcy Code."⁷⁹ The court relied on *In re Chipwich, Inc.*, where the Southern District concluded that a debtor's rejection of trademark license agreements deprived the licensee of the right to use the trademark.⁸⁰ The *Chipwich* court held that the licensee was only entitled to an allowable claim for damages for breach of contract.⁸¹

⁷³ *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)*, 281 B.R. 660, 674 (Bankr. N.D. Cal. 2002) ("§ 365(n) plainly excludes trademarks"); *In re Blackstone Potato Chip Co.*, 109 B.R. 557, 562 (Bankr. D.R.I. 1990) (approving rejection and ordering return of trademarks and trade names to debtor).

⁷⁴ *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380 (2d Cir. 1997).

⁷⁵ *See id.* at 394.

⁷⁶ *Id.* (internal citation omitted.)

⁷⁷ *Id.* (internal citation omitted.)

⁷⁸ *In re Old Carco L.L.C.*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009).

⁷⁹ *Id.* at 211.

⁸⁰ *Id.* (citing *In re Chipwich, Inc.*, 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985)).

⁸¹ *In re Chipwich*, 54 B.R. at 431.

On the other hand, some courts have treated the rejection of trademark license agreements similarly to the rejection of other intellectual property licenses.⁸² For example, in *Sunbeam Products v. Chicago American Manufacturing, LLC*,⁸³ the Seventh Circuit held that “a licensor’s breach does not terminate a licensee’s right to use intellectual property” based on the plain language of section 365.⁸⁴ The Seventh Circuit noted that a licensor’s breach of a trademark license agreement, outside of the bankruptcy context, does not terminate the licensee’s right to use the trademark.⁸⁵ Therefore, the Seventh Circuit concluded that the effect of classifying rejection of a trademark license agreement as a “breach” is that the nonbreaching party’s rights do not terminate as a matter of law.⁸⁶

IV. Implications of the Current Split of Authority

Given the current split of authority over whether the rejection of trademark license agreements terminate such agreements, it is difficult to predict which side a jurisdiction that has yet to rule on the issue would take.⁸⁷ Although the recent trend set by the Seventh Circuit is to allow the licensee’s rights in intellectual property to continue after a debtor rejects a trademark license agreement, a court in may still choose to follow the Second Circuit approach of terminating a licensee’s rights upon rejection. The Innovation Act, however, may bring

⁸² See generally *In re Interstate Bakeries*, 751 F.3d at 964 n.2.; and see *In re Exide Techs.*, 607 F.3d 957, 965-67 (3d Cir. 2010) (Ambro, J., concurring) (“[A] trademark licensor’s rejection of a trademark agreement under 11 U.S.C. § 365 does not necessarily deprive the trademark licensee of its rights in the licensed mark.”).

⁸³ *Sunbeam Prods. v. Chi. Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012).

⁸⁴ *Id.* at 376.

⁸⁵ *Id.*

⁸⁶ *Id.* at 377.

⁸⁷ See *In re Interstate Bakeries*, 751 F.3d at 964 n.2. (citing the current split of authority and declining to address the issue of whether rejection of a trademark license agreement would terminate such agreement).

trademark license agreements within the scope of section 365(n)'s protection.⁸⁸ The Innovation Act, passed in the House of Representatives on December 5, 2013, amends section 365 of the Bankruptcy Code to include trademarks within the definition of intellectual property.⁸⁹ Although the amendment still needs to be passed by the Senate and signed by the President, the Innovation Act may encourage courts to continue the recent trend of treating rejected trademark licenses in the same way as any other rejected intellectual property license under section 365(n).

This uncertainty in the bankruptcy context creates an unpredictable environment for a debtor and a trademark licensee. As such, the current split of authority may encourage a debtor to file in a jurisdiction that treats rejected trademark license agreements as being terminated, especially if the rejection of such agreements is central to the debtor's plan of reorganization. If a debtor chooses to engage in such forum shopping, the trademark licensee will be limited to an unsecured claim for its damages, and the debtor will be free to license the trademark to another party. Alternatively, if the debtor is unable to forum shop, the debtor may be unable to terminate the trademark license agreement, in which case the licensee will be able to continue using the trademark. Therefore, the law of the applicable jurisdiction will impact a debtor's ability to terminate a trademark license agreement, which in turn could significantly impair a debtor's ability to implement its plan of reorganization, especially, if such plan revolves around the sale of all or substantially all of the debtor's assets.

Conclusion

Section 365(a) of the Bankruptcy Code gives a debtor the power assume or reject executory contracts for the benefit of the bankruptcy estate.⁹⁰ Subject to a court's approval, a

⁸⁸ See H.R. REP. NO. 113-279, at 64 (2013).

⁸⁹ See H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013).

⁹⁰ 11 U.S.C. § 365(a) (2012).

debtor can keep favorable contracts by assumption, or discard burdensome contracts by rejection.⁹¹ Generally, a court will approve a debtor's request to assume or reject a contract if (1) the contract is executory, usually under the Countryman definition, and (2) the assumption or rejection of the contract is advantageous to the bankruptcy estate.⁹²

The legal authority is split as to whether the rejection of a trademark license agreement acts to terminate such an agreement. While section 365(n) provides that rejection of an executory contract under which the debtor is a licensor of a right to intellectual property does not terminate the contract by law,⁹³ Congress intentionally excluded trademark license agreements from section 365(n)'s protection.⁹⁴ As a result, the bankruptcy courts have split as to whether the rejection of a trademark license agreement operates to terminate such agreement. Thus, a debtor's ability to terminate a trademark license agreement will depend on the law of the applicable jurisdiction.

⁹¹ Harner, *supra* note 1, at 187.

⁹² *See id.*, at 194-95.

⁹³ *See* 11 U.S.C. § 365(n).

⁹⁴ S. REP. NO. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.