

The Impact of Crumbs on Trademark Licenses in Bankruptcy

Written by:

Beverly A. Berneman

Golan & Christie LLP: Chicago, Illinois

www.golanchristie.com

Introduction

This article will address how the decision in *In re Crumbs Bake Shop, Inc.*¹ continues the evolution of trademark licensing in bankruptcy and contributes to an understanding of the fate of Intellectual Property (“IP”) during a §363 asset sale.

The treatment of IP assets and specifically trademark licenses in bankruptcy has textures and nuances. IP assets can be hypothecated in ways that tangible assets cannot. IP can be licensed, in whole or in part, exclusively and non-exclusively, world-wide or by territory, with or without license fees or royalties. Thus, when dealing with IP assets in a bankruptcy, all facets of the IP should be taken into account.

Brief Background of Trademark Licenses in Bankruptcy

Section 365(a) of the Bankruptcy Code permits a debtor to reject an executory contract leaving the non-debtor with a pre-petition claim for rejection damages. The original version of §365 treated all executory contracts the same, including IP licenses.

The *Lubrizol Enterprises v. Richmond Metal Finishers, Inc.*² decision prompted a change. In *Lubrizol*, the debtor rejected a patent license. The non-debtor licensee opposed rejection. The Fourth Circuit affirmed the bankruptcy court’s decision to allow rejection. The court upheld the general rule that rejection deprived the non-debtor licensee of its rights under the license and left it with the sole remedy of rejection damages.³

In reaction to the *Lubrizol* decision, Congress amended the Bankruptcy Code in 1988 adding §365(n).⁴ Section 365(n) gives the non-debtor IP licensee two choices upon rejection. The licensee can treat the IP license as being terminated thus entitling it to rejection damages.⁵ Or, the IP licensee can choose to retain its rights for the balance of the license.⁶

Trademarks were omitted from the definition of IP for the purposes of §365(n).⁷ The omission left non-debtor trademark licensees in the same unfortunate position as the patent licensee in the *Lubrizol* case. The omission has been subject of much discussion but little action for many years.

¹ 522 B.R. 766 (Bankr. D.N.J. 2014).

² 756 F.2d 1043 (4th Cir. 1985).

³ 756 F.2d 1047-1048.

⁴ 11 U.S.C. §365(n).

⁵ 11 U.S.C.A. § 365(n)(1)(A) and §365(h)(1)(A); *In re Storm Technology, Inc.*, 260 B.R. 152 (Bankr. N.D. Calif. 2001); *In re Prize Frize, Inc.*, 150 B.R. 456 (Bk.App. 9th Cir. 1993).

⁶ 11 U.S.C.A. § 365(n)(1)(b).

⁷ 11 U.S.C. §101(35A).

Recent cases have remediated the exclusion of non-debtor trademark licensees from §365(n). In *In re Exide Technologies*,⁸ and *In re Interstate Bakeries Corp.*,⁹ the Third and the Eight Circuits, respectively, held that a trademark license resulting from the sale of a business was non-executory. Therefore, the debtor could not reject the license. In *Sunbeam Products, Inc. v. Chicago Manuf., LLC*,¹⁰ the Seventh Circuit held that a non-debtor trademark licensee's rights survived rejection because Congress did not intend the omission of trademark licenses from §365(n) to mean that the *Lubrizol* decision applied to the rejection of trademark licenses. The Seventh Circuit focused on the fact that §365(g) treats rejection as a breach. Under non-bankruptcy law, a breach by a licensor does not deprive a licensee of its rights to the IP.¹¹

These decisions set the stage for the next step in the development of the treatment of trademark licenses.

*In re Crumbs Bake Shop, Inc.*¹²

Crumbs Bake Shop, Inc. and its affiliates ("Crumbs") specialized in the retail sale of cupcakes, baked goods and beverages. Crumb's trademarks and trade secrets were its most valuable assets. Using a licensing representative, Crumbs entered into a series of pre-petition trademark and trade secret license agreements with third parties (the "IP Licenses"). Crumbs obtained a bankruptcy court order permitting it to sell all of its assets, including its IP assets free and clear of all liens. However, the IP Licenses were excluded from the sale.¹³ The purchaser was Crumbs' sole secured creditor, Lemonis Fischer Acquisition Company LLC ("LFAC"). The day after the bankruptcy court approved the sale, Crumbs filed a motion to reject the IP Licenses. The licensing representative filed a notice that the licensees were electing to retain their rights under their respective IP Licenses. The licensing representative also sought an order allowing it to retain the royalties paid by the licensees. Crumbs withdrew its motion to reject to the extent that it related to rejection of the IP licenses. LFAC demanded the royalties from the trademark licenses because it had purchased all of Crumbs' IP. The bankruptcy court, Judge Michael B. Kaplan, presiding, had to decide the fate of the trademark licenses and the royalties. Judge Kaplan addressed three issues.

The first issue was whether the rejected trademark licenses fell within the scope of §365(n). Judge Kaplan adopted the reasoning of the concurring opinion in *Exide Technologies*.¹⁴ The concurring opinion cited the Senate committee report on the bill for §365(n) which stated:

In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the

⁸ 607 F.3d 957 (3rd Cir. 2010).

⁹ 690 F.3d 1069 (8th Cir. 2012).

¹⁰ 686 F.3d 372 (7th Cir. 2012).

¹¹ 686 F.3d. 377.

¹² 522 B.R. 766 (Bankr. D.N.J. 2014).

¹³ In granting Crumbs' motion for leave to sell, the bankruptcy court entered an Order Under 11 U.S.C. §§ 105(A), 363 And 365 (i) Authorizing and Approving the Sale of Substantially all of the Debtors' Assets Free And Clear Of Liens, Claims, Encumbrances, and Interests, (ii) Authorizing and Approving the Assumption and Assignment of Certain Unexpired Leases of Non-Residential Real Property in Connection With the Sale, and (iii) Granting Related Relief. As the title suggests, the only executory contracts that Crumbs assumed were certain non-residential real estate leases. All other executory contracts, including the IP Licenses, were not assumed and assigned.

¹⁴ 607 F.3d 966.

products or services sold by the licensee.¹⁵ 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 (emphasis added) S. Rep. No. 100-505 at 5.¹⁶

Judge Kaplan held that Congress intended for bankruptcy courts to use equitable powers on a case by case basis to determine whether trademark licensees may retain the rights listed in §365(n). Otherwise, a debtor-licensor could use bankruptcy as a sword rather than a shield to take back trademark rights that were bargained away.¹⁷ This holding also adopted the reasoning of the Seventh Circuit in the *Sunbeam Products, Inc.*¹⁸ By doing so, Judge Kaplan added another voice to equitable treatment of trademark licenses in bankruptcy.¹⁹

The second issue was whether the sale of the debtor's assets free and clear of all liens trumped the rights of the non-debtor licensees. Judge Kaplan acknowledged that some courts had allowed that result. However, Judge Kaplan refused to follow those cases and held that the sale did affect the IP Licenses.²⁰ Otherwise, a bankruptcy liquidation sale would interfere with a licensing system that Congress sought to protect.²¹

LFAC argued that it was being forced into a licensing relationship that it did not intend to assume. Judge Kaplan pointed out that LFAC came to this transaction with its "eyes wide open", after engaging in due diligence. LFAC could have adjusted the price if it did not want to take the risk.²²

Judge Kaplan also rejected LFAC's argument that the non-debtor licensees consented to the sale because they failed to object. Judge Kaplan described the sale documents and motion for leave to sell as a "labyrinth of cross-referenced definitions and a complicated network of corresponding paragraphs with annexed schedules".²³ Since the documents and motion failed to clearly set forth the treatment of the licensees, the licensees could not have consented to the sale. Ultimately, 363(f) which permits sales free and clear of liens, must give way to the specific language of §365(n).²⁴

¹⁵ Trademark licenses differ from most IP licenses because trademark law springs from protecting the consuming public from confusion in the marketplace. The licensor's rights depend upon use. In keeping with the goals of trademark law, a trademark licensor must have the right to quality control of the product or service identified by the trademark.

¹⁶ 522 B.R. 772.

¹⁷ *Id.*

¹⁸ 522 B.R. 772-773.

¹⁹ Another voice is the ABI Commission to Study the Reform of Chapter 11. The Commission recommends that trademark licenses be added to 365(n) along with provisions that allow a debtor to monitor quality control without having to perform any other obligations. *ABI Commission to Study the Reform of Chapter 11: Final Report and Recommendations* (2014), at pages 128-129.

²⁰ 522 B.R. 772.

²¹ *Id.*

²² *Id.*

²³ 522 B.R. 773.

²⁴ 522 B.R. 778.

The third issue was the treatment of royalties from the licenses. Judge Kaplan held that Crumbs sold the IP; but the licenses were specifically excluded from the sale. The licenses were not assumed or assigned. Therefore, the licenses and their royalties remained with Crumbs.²⁵

Conclusion

Whether by design or accident, Crumbs and LFAC sought shed the existing IP Licenses to give LFAC the unfettered ability to license the IP in the future. The bankruptcy court's decision frustrated this result.

In re Crumbs is a welcome addition to the emerging trend to allow non-debtor trademark licensees to invoke equitable considerations in order to avoid the draconian effects of a weakness in the current version of §365(n).

²⁵ LFAC appealed this decision and then the matter was settled. LFAC paid \$40,000.00 in exchange for the right to receive the royalties.