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The authors give advice on how to navigate the wake of a recent Delaware bankruptcy case in which trademark licenses were held non-assignable—and therefore non-assumable—by licensee debtors without the licensor's consent.

Federal Trademark Law Trumps Bankrupt Licensee's Right to Assumption and Continued Use of License

By Alfred S. Lurey and Paul M. Rosenblatt

Earlier this year, the United States Bankruptcy Court for the District of Delaware issued a noteworthy decision about the treatment of licenses of intellectual property, specifically trademarks, in a licensee's bankruptcy case. The decision is potentially quite significant because a great number of companies are organized under Delaware law and therefore are permitted to seek bankruptcy relief in the Delaware bankruptcy court, even though their principal places of business or principal assets are in other jurisdictions. Thus, if an owner of intellectual property licenses the intellectual property to a licensee that is organized under Delaware law, in the event the licensee later winds up in bankruptcy, there is a good chance the bankruptcy case will have been filed in Delaware.

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The decision referred to above is *In re Trump Entm't Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015) . In a nutshell, the court held in that case that—unlike generally with respect to executory contracts in bankruptcy—trademark licenses, whether exclusive or non-exclusive, are not assignable by a debtor licensee without the consent of the licensor. The court reached this conclusion because it interpreted applicable non-bankruptcy law—federal trademark law—as precluding assignment by a licensee without licensor consent, even if the license agreement does not prohibit expressly such an assignment. The decision has potentially far-reaching implications because (1) unlike the law with respect to patent and copyright licenses, it applies not just to non-exclusive trademark licenses, but also to exclusive trademark licenses, and (2) it signifies that, in a Delaware bankruptcy case, a debtor licensee will be precluded from assuming a trademark license agreement and continuing to use the licensed marks without licensor consent, even if it has no intention of attempting to assign the agreement to a third-party.

The latter consequence stems from the fact that the Third Circuit has adopted the so-called ''hypothetical test'' for determining whether an executory contract can be assumed without the consent of the non-debtor party, and that test therefore applies in a Delaware bankruptcy case. Because the court in *Trump Entertainment* concluded that the debtor licensee could not assign the trademark license agreement without licensor consent and therefore was precluded, under the ''hypothetical test,'' from assuming it (even though it had no intention of assigning it to a third-party), the court granted the licensor's motion for relief from the automatic stay, permitting the licensor to move forward with the process set forth in the license agreement for terminating the agreement. This outcome gave the licensor considerable leverage in negotiating the terms under which it eventually consented to the assumption of the license agreement by the debtors.

The trademark license agreement involved in the *Trump Entertainment* case was exclusive for a six-state territory. Under the agreement, Trump Entertainment Resorts, Inc. and certain of its affiliates (collectively, the ''Debtors'') were granted a royalty-free license to use the names and likenesses of Donald and Ivanka Trump and certain other designated marks in connection with the operation of three casinos in Atlantic City. The license was perpetual, subject to certain termination rights provided for in the license agreement. In that regard, if the Debtors failed a quality assurance review and did not cure the deficiencies within a specified period of time, the licensor, under the terms of the license agreement, had the right to institute proceedings to terminate the license in the Superior Court of New Jersey.

The Debtors allegedly failed a quality assurance review and failed to cure the deficiencies within the specified period. They allegedly also committed other breaches of the license agreement. As a result, the licensor sued in New Jersey state court seeking to terminate the agreement in accordance with the procedure set forth in the agreement. Thereafter, the Debtors filed petitions for relief under chapter 11 and filed a plan of reorganization that contemplated the curing of any defaults and the assumption of the license agreement by the reorganized Debtors, a normal course of action when a debtor desires to assume an executory contract in a chapter 11 case, even if the non-debtor party to the contract wants the contract to be terminated. The state court action was stayed automatically by the filing of the chapter 11 petitions. The licensor filed a motion in the bankruptcy court seeking to have the stay lifted to permit it to proceed with the state court termination action.

In the process of ruling on the licensor's motion, the court found that the trademark license agreement was an executory contract. With respect to executory contracts generally, bankruptcy termination clauses are unenforceable, and debtors are permitted to cure defaults and assume the contracts over the objection of the non-debtor party to the contract. Thus, the benefits of an executory contract generally can be preserved for a debtor through the assumption process, notwithstanding the filing of a bankruptcy petition by or against the debtor. But there are exceptions to this general rule, and the court found an exception to apply in this case. The court first determined that, even though a license agreement is not a traditional personal services contract that is non-assignable as a matter of state law, *federal trademark law*, as interpreted by the court, renders a trademark license agreement non-assignable by the licensee without the licensor's consent.

That determination triggered an exception to the rule that normally permits a debtor to assume an executory contract. In that regard, applying a strictly literal interpretation of section 365(c) of the Bankruptcy Code pursuant to the so-called ''hypothetical test,'' which has been adopted by the Third, Sixth, Ninth, and Eleventh Circuits, the court concluded that because the agreement was not assignable as a matter of applicable non-bankruptcy law, it could not be assumed by the Debtors.[1] Because it concluded that the agreement could not be assumed by the Debtors, the court granted the licensor's motion for relief from the stay to continue the process of terminating the agreement. Thus, under the court's rationale, a determination that a licensee's rights under a license agreement are non-assignable under applicable non-bankruptcy law without the licensor's consent means that the licensee will be deprived of continued use of the licensed property if it becomes a debtor in a bankruptcy case, unless the licensor consents to the licensee's assumption of the license agreement.

In analyzing the effect of applicable non-bankruptcy law on the issue before it, the court (relying principally on Judge Posner's decision in *In re XMH Corp.*, 647 F.3d 690, 99 U.S.P.Q.2d 1393 (7th Cir. 2011)) held that ''federal trademark law generally bans assignment of trademark licenses absent the licensor's consent because, in order to ensure that all products bearing its trademark are of uniform quality, the identity of the licensee is crucially important to the licensor.'' *Trump Entertainment*, 526 B.R. at 124. It reached this conclusion notwithstanding that the license agreement was exclusive for the licensed territory. In that regard, the court rejected the licensee's argument that because federal law renders only *non-exclusive* patent and copyright licenses non-assignable without licensor consent, only non-exclusive trademark licenses should be deemed non-assignable as a matter of law. In the court's view, trademark license agreements, whether exclusive or non-exclusive, are non-assignable as a matter of federal law for reasons different from the reasons that make non-exclusive patent and copyright licenses non-assignable. Quality assurance is at least as important to the trademark licensor in the case of an exclusive license as in the case of a non-exclusive license.

The court also rejected the argument of the Debtors and their asset-based lender that an agreement ancillary to the license agreement entered into by the Debtors, the lender, and the licensor constituted the licensor's consent to the transfer of the Debtors' rights under the license agreement, which the Debtors argued removed any impediment to the Debtors' assumption in bankruptcy of the license agreement. At the time the license agreement was entered into, the lender had a security interest in substantially all of the Debtors' assets. Contemporaneously with the Debtors and licensor's entry into the license agreement, the Debtors, the lender and the licensor entered into a Consent and Agreement providing, in essence, that the licensor consented to transfers of the Debtors' rights under the license agreement in connection with the enforcement of the lender's rights under its security agreement. The Consent and Agreement provided that following an enforcement ac-

[1] The ''hypothetical test,'' which appears to be the majority view, differs from the so-called ''actual test,'' which permits (assuming that the normal prerequisites to assumption of an executory contract are fulfilled) the assumption of a non-assignable executory contract, so long as the debtor is not attempting also to assign it.

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tion by the lender, the licensor would recognize the lender as a licensee under the license agreement in the place of the Debtors who were the subject of the enforcement action.

The court held that the proposed assumption of the license agreement by the Debtors under the plan of reorganization did not constitute an enforcement action by the lender within the meaning of the Consent and Agreement. Therefore, the licensor was not deemed to have consented to assignment of the license agreement by the Debtors in a way that would have validated assumption of the license agreement by the Debtors over the objection of the licensor.

The notion (endorsed by courts that apply the ''hypothetical test'') that applicable non-bankruptcy law prohibiting assignment without licensor consent can have the effect, in a licensee's bankruptcy case, of preventing the licensee—the very entity to whom the licensor granted the license—from even assuming the agreement, thereby forcing it to forfeit the license, may be counter-intuitive. Indeed, the American Bankruptcy Institute commission that is proposing an overhaul of chapter 11 is recommending that section 365 be amended in a manner that would permit the assumption of all IP licenses in licensee bankruptcy cases, assuming that the normal prerequisites to assumption of an executory contract are fulfilled. There is no assurance, however, that the commission's recommendation will ever be enacted, and attorneys representing licensors should be alert to the opportunity cases such as *Trump Entertainment* afford to extricate a licensor from a licensing relationship with a bankrupt.

In that regard, attorneys representing licensors in the negotiation of trademark license agreements, non-exclusive patent license agreements, or non-exclusive copyright license agreements may secure distinct advantages for their clients, in the event of a later licensee bankruptcy, if able to accomplish or avoid, as applicable, the following:

- Provide in the agreement that the licensee's rights cannot be assigned, sublicensed, pledged or otherwise encumbered without the written consent of the licensor.
- Avoid language that such consent shall not be unreasonably withheld or delayed.
- Avoid language that permits assignment of the licensee's rights in connection with a transfer of substantially all the assets of the licensee whether by merger, consolidation, sale of stock or assets, or otherwise.
- Avoid entering into agreements with the licensee's secured lenders that permit transfer of the licensee's rights in connection with the exercise by the lenders of their rights and remedies as secured parties.
- Include a bankruptcy termination provision in the agreement.

On a final note, the proposed plan of reorganization in *Trump Entertainment* provided that if the court determined that the Debtors could not assume the license agreement without the consent of the licensor, the automatic stay would be modified to permit the lender to enforce its remedies (as contemplated in the Consent and Agreement) with respect to the Debtors' rights under the license agreement and the lender would be deemed to have designated the reorganized debtors as transferees of such rights in connection with the lender's deemed enforcement of such remedies. The effectiveness of that gambit will not be tested because, after the court's decision to lift the automatic stay, the parties reached a settlement providing for amendment of the license agreement and the licensor's consent to the assumption of the license agreement. The successful prosecution of the motion for relief from stay no doubt afforded the licensor substantial leverage in the settlement negotiations.