MAY 2017

DEVOTED TO LEADERS IN THE INTELLECTUAL PROPERTY AND ENTERTAINMENT COMMUNITY

VOLUME 37 • NUMBER 5

THE Licensing Journal

Edited by Gregory J. Battersby and Charles W. Grimes

Wolters Kluwer

First Circuit Bankruptcy Appellate Panel Weighs in on Effect of Grantor/Licensor's Bankruptcy on Exclusive Distribution Rights of Distributor/Licensee

Alfred Lurey, Michael Pavento, Kandace Watson, and Jennifer Giordano-Coltart

Alfred Lurey is Senior Counsel at Kilpatrick Townsend and concentrates his practice on bankruptcy and insolvency matters.

Kandace Watson is a partner at Kilpatrick Townsend. She heads the firm's Mergers & Acquisitions, Securities, and Corporate Team in Southern California and leads the Corporate Department's Southern California Chemical & Life Sciences and Medical Devices Teams.

Michael Pavento is a partner at Kilpatrick Townsend, where he advises established companies and start-up ventures in a wide range of intellectual property matters, including the procurement and exploitation of intellectual property rights and the management of intellectual assets.

Dr. Jennifer Giordano-Coltart is an associate at Kilpatrick Townsend where she advises businesses on patent matters in the areas of biotechnology, life sciences, pharmaceuticals, and medical devices.

Preserving rights, including exclusivity rights and rights to use licensed trademarks, granted under a contract, when the party that granted the rights becomes a debtor in a case under the Bankruptcy Code can be a problematic endeavor for the counterparty to whom the rights were granted. When the contract involves a grant of exclusive distribution rights as well as a license or licenses to use intellectual property, the effect on the distributor/licensee of the grantor/licensor's bankruptcy may depend on how the contract was structured. This point is illustrated by a case decided last November by the Bankruptcy Appellate Panel for the First Circuit (BAP)—*In re Tempnology LLC.*[1]

In addition to discussing the issues presented in the *Tempnology* case, this article suggests some structuring techniques that could be employed in an effort to protect a distributor/licensee's *exclusive* distribution rights and licensed trademark rights from certain adverse consequences that otherwise might result from rejection of the operative contract (under Section 365 of the Bankruptcy Code), in a subsequent bankruptcy of the grantor/licensor. In particular, the likelihood of preserving exclusive distribution rights in such a scenario may be increased if the rights are conveyed indisputably through an intellectual property license, rather than in a separate agreement or granting clause. Suggestions also are offered on the separate subject of protection of a licensee's rights to continue to use licensed trademarks in the event of a licensor's bankruptcy, though the relative negotiating strength of the licensee and licensor may be a factor bearing on the ability to incorporate the suggested techniques into the deal.

The Co-Marketing and Distribution Agreement

At the core of the *Tempnology* case is a Co-Marketing and Distribution Agreement that had an initial term of two years and was subject to automatic one-year renewals (Agreement). The parties to the Agreement were (i) a company (Grantor) that produced and sold certain branded products (Cooling Accessories) covered by patents and copyrights held by the Grantor and (ii) a company (Distributor) that, under the Agreement, was granted exclusive distribution rights for the Cooling Accessories within a defined territory and certain non-exclusive licenses to use the Grantor's intellectual property in connection with the distribution and sale of Cooling Accessories (and, to some extent, other products). In the Agreement, the provisions granting the exclusive distribution rights were separate from the provisions granting the IP licenses.

The Agreement was terminable by either party at any time without cause by giving written notice to the other party. Upon such a termination, a two-year wind-down period would ensue, during which the Distributor would continue to have rights to purchase, distribute, and sell Cooling Accessories with the same exclusivity rights that existed pre-termination. Though not confirmed explicitly in either the bankruptcy court or BAP's opinion, it is reasonable to assume, for reasons discussed later in this article, that the Agreement also provided for termination for cause and elimination of the wind-down period if the Agreement was terminated by the Grantor for cause in accordance with its terms.

As interpreted by the BAP, the Agreement granted the Distributor (i) the exclusive right to sell Cooling Accessories to *sporting goods retailers* in the defined territory (Exclusive Territory) during the term of the Agreement and the wind-down period (together, Term), (ii) the exclusive right to sell a particular subset of the Cooling Accessories to *anyone* in the Exclusive Territory during the Term, (iii) a non-exclusive, fully-paid, irrevocable, perpetual, worldwide, fully-transferable license to use the Grantor's intellectual property other than trademarks (IP License),[2] and (iv) a limited, non-exclusive license to use the trademarks associated with the Cooling Accessories during the Term (Trademark License).

The Parties' Dispute

Less than two years after the parties entered into the Agreement, the Distributor notified the Grantor of the exercise of its right to terminate the Agreement without cause, purportedly triggering the commencement of the two-year wind-down period. The Grantor, in turn, notified the Distributor that it was terminating the Agreement for cause based on the alleged breach of the Agreement by the Distributor. The dueling notices precipitated an arbitration proceeding, in the first phase of which the arbitrator determined that the Agreement remained in full force and effect.[3] Before the arbitration could be completed, however, the Grantor filed a petition for relief under Chapter 11 of the Bankruptcy Code. That filing stayed the arbitration proceeding.

Almost immediately after filing its Chapter 11 petition, the Grantor (henceforth, Debtor) filed a motion to reject the Agreement under Section 365 of the Bankruptcy Code and a motion for approval by the bankruptcy court of a sale of substantially all of its assets free and clear of all liens, claims, encumbrances, and other interests. The Distributor objected to the motions, giving notice that it was exercising its rights under Section 365(n) of the Bankruptcy Code with respect to the Agreement. It asserted that its exercise of its Section 365(n) rights preserved, for the duration of the wind-down period, its *exclusive* distribution rights and its rights under the limited, non-exclusive Trademark License, notwithstanding the Debtor's rejection of the Agreement. Therefore, according to the Distributor, the Debtor's assets could not be sold free and clear of the Distributor's exclusive distribution rights and non-exclusive Trademark License, which would continue in effect until the expiration of the wind-down period. The Debtor disputed these assertions, arguing that the only rights of the Distributor with respect to the Grantor's products and intellectual property that would survive rejection of the Agreement under Section 365 of the Bankruptcy Code were its rights under the non-exclusive IP License, which did not apply to trademarks.

Section 365 of the Bankruptcy Code

To put these conflicting positions in perspective, a brief discussion of Section 365 and the enactment in 1988 of Section 365(n) may be helpful.

Generally speaking, under Section 365 of the Bankruptcy Code, a debtor, with bankruptcy court approval, can reject an executory contract to which it is a party. Rejection generally relieves the debtor of its obligations to continue to perform under an executory contract after rejection. The rejection is deemed to be a pre-petition breach of contract that, in most instances, leaves the non-debtor party to the contract with only an unsecured pre-petition claim for damages against the bankruptcy estate. With a few exceptions, after rejection, the non-debtor party to the contract cannot obtain specific performance of any of the debtor's obligations under the contract. Typically, distribution agreements and license agreements constitute executory contracts for purposes of the Bankruptcy Code.

In 1985, in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*,[4] the Court of Appeals held that the rejection of an IP license by a debtor-licensor divested the licensee of the right to further use of the intellectual property that was the subject of the license. In response to that decision, three years later, Congress enacted Section 365(n) of the Bankruptcy Code. That section applies to licenses of intellectual property other than trademarks. By and large, it affords licensees of IP other than trademarks the right to continue to use the IP after rejection of the license by a debtor-licensor, "including a right to enforce any exclusivity provision of such contract."[5]

Though Section 365(n), as a consequence of the omission of trademarks from the definition of "intellectual property" in the Bankruptcy Code, does not apply to trademark licenses,[6] the law (as discussed later in this article) seems, nevertheless, to be trending in a direction that permits a trademark licensee to continue to use a licensed trademark for the period provided in the license agreement, even though the license has been rejected in a bankruptcy of the licensor.

The Bankruptcy Court's Decision

Against this backdrop, the bankruptcy court in the *Tempnology* case ruled squarely in favor of the Debtor. It held that the protections triggered by the Distributor's election to exercise its Section 365(n) rights extended only to the non-exclusive, perpetual IP License. In reaching that decision, the bankruptcy court concluded that the protections of Section 365(n) are limited to licenses of intellectual property rights other than trademark rights and do not extend to exclusive distribution rights such as those granted in the Agreement, which it concluded were unrelated to the non-exclusive IP License in the Agreement. The court rejected the Distributor's argument that the inclusion in Section 365(n) of the language, "including a right to enforce any exclusivity provision of such contract," extended to the exclusive distribution provisions in the Agreement, which the court considered to be extraneous to the IP license.

Turning to the effect of the Debtor's rejection of the Agreement on the separate, non-exclusive Trademark License, the bankruptcy court found that trademarks are excluded from Section 365(n) and therefore trademark licensees derive no protection from it. The bankruptcy court declined to adopt what appears to be the emerging trend in the case law, at least at the Circuit Court of Appeals level,[7] that holds that rejection by a debtor-licensor of a license of intellectual property (*including trademarks)* simply relieves the debtor of any obligation to specifically perform its affirmative obligations under the license agreement and does not deprive the licensee of the use of any and all such intellectual property for the time set forth in the agreement.[8]

Unconvinced and not bound by the appellate level decisions cited in note 7 of this article, the bankruptcy court followed the *Lubrizol* approach and held that rejection deprived the Distributor of any further use of the Debtor's trademarks. In sum, under the bankruptcy court's rationale, the purchaser of the Debtor's assets in a bankruptcy sale would take them free and clear of both the Distributor's exclusive distribution rights and its non-exclusive right to use the trademarks.

The Bankruptcy Appellate Panel's Decision

The Distributor appealed the bankruptcy court's ruling to the First Circuit Bankruptcy Appellate Panel, an intermediate appellate tribunal to which, with the consent of all parties, appeals from orders of bankruptcy courts in the First Circuit may be taken, in lieu of appealing to a US District Court. The BAP affirmed the decision of the bankruptcy court in part and reversed it in part. It agreed with the bankruptcy court that the Distributor's exclusive distribution rights did not survive the rejection of the Agreement, notwithstanding the provisions of Section 365(n) of the Bankruptcy Code. The BAP concluded that the parties to the Agreement had two independent goals: (1) to grant the Distributor the right to distribute certain of the Debtor's products on an exclusive basis in a defined territory during a limited time period; and (2) to grant the Distributor a non-exclusive license to use some of the Debtor's intellectual property in perpetuity. It rejected the argument that the Debtor actually had granted the Distributor an implied exclusive IP license for defined products in the Exclusive Territory by virtue of the exclusive distribution provisions and licensing provisions of the Agreement.

The BAP parted ways with the bankruptcy court on the effect of rejection of the Agreement on the Distributor's rights under the non-exclusive, limited Trademark License, concluding that the reasoning underlying the *Sunbeam* case was persuasive, namely, that rejection by a licensor does not deprive a licensee of intellectual property of the right to continue to use it, subject to compliance with the terms of the license (such as quality maintenance). Thus, under the BAP's decision, the Distributor retained the non-exclusive right to use the trademark in accordance with the terms of the Agreement.

As the arbitration was interrupted by the bankruptcy case, the practical effect of the BAP's decision regarding the trademark issue on the parties to the *Tempnology* case is not apparent. We do not know (i) whether the wind-down period ever began to run, (ii) whether it was deemed to have been tolled during the ongoing litigation, or (iii) if not tolled, whether any of the wind-down period remained at the time of the BAP's ruling. In any event, unless reversed on appeal, the BAP's decision on the trademark issue serves as additional authority for future cases supporting the position that, notwithstanding the inapplicability of Section 365(n) to trademark licenses, rejection in bankruptcy by a debtor-licensor or its trustee of a trademark license does not deprive the licensee of continued use of the licensed mark(s) in accordance with the terms of the license agreement.[9]

Structuring Considerations

As the Distributor filed an appeal of the BAP's decision to the First Circuit Court of Appeals, the last word on the issues raised in the *Tempnology* case may not yet have been articulated. Regardless of its ultimate disposition on appeal, the case raises questions about whether transactions involving the grant of exclusive distribution rights in conjunction with licenses to use intellectual property of a grantor can be structured in ways that improve the chances of preservation of exclusivity for the term of the agreement, in the event the grantor bankrupts and rejects the operative agreement. The case also raises questions about possible structuring techniques for protecting licensees' rights under trademark licenses, given the fact that trademarks are omitted from the definition of "intellectual property" under the Bankruptcy Code, undercutting any argument that the protections of Section 365(n) extend to trademark licensees.

Exclusive Distribution Rights

With respect to protecting exclusive distribution rights in a grantor bankruptcy scenario, neither the grantor, nor a purchaser of substantially all of the grantor's assets in a bankruptcy sale, could be compelled to continue to sell products to the distributor. To mitigate that fact, an agreement could be structured to grant to the distributor a non-exclusive license with respect to the grantor's intellectual property to manufacture, or have manufactured elsewhere, the subject products in the event the grantor declines or is unable to continue to supply the products. The agreement also should include an exclusive license to use the grantor's intellectual property (which, hopefully, includes not just trademarks) in connection with the distribution and sale of licensed products to the trade in a defined exclusive territory and/or field for the term of the agreement. Such a structure should improve the prospects for preserving distributor exclusivity for the term, in the event of rejection of the agreement.

Trademark Rights

Insofar as trademark rights are concerned, given (i) the unpromising prospects for obtaining any protection for trademark licensees under Section 365(n) of the Bankruptcy Code, (ii) the possibility that a trademark licensor might be able to file bankruptcy in a bankruptcy court in the Fourth Circuit, where *Lubrizol* represents the current state of the law, and (iii) the fact that there is no certainty that the *Sunbeam* rationale will be followed in a bankruptcy case filed anywhere outside the Seventh Circuit, the question presented is whether any feasible structuring techniques exist that might protect a trademark licensee from loss of the right to use licensed trademarks and/or any exclusivity rights in connection therewith, if the licensor files bankruptcy in a jurisdiction that follows the *Lubrizol* approach.

One means to address this predicament would be for the trademark licensor to grant the licensee a security interest (which the licensee would perfect) in the licensed trademarks and the goodwill associated therewith as security for the damages that will be suffered by the licensee if the license is rejected in a bankruptcy of the licensor and the rejection is held to deprive the licensee of continued use of the licensed trademarks and/or any rights of exclusivity with respect to the use of the trademarks. However, this scenario would require the licensee to have relatively strong negotiating leverage and the licensor not to be contractually constrained from encumbering its intellectual property, for example, by covenants in loan documents regarding which a waiver is unobtainable from the lender. On a best case basis, this technique would be coupled with an enforceable liquidated damages provision in the agreement that prescribes how the damages will be calculated if the licensee is deprived of the use of the trademarks and/or any exclusivity rights. If such a structure can be implemented, it may eliminate any incentive for the licensor or its trustee to attempt to deprive the licensee of the use of the licensed trademarks and/or any exclusivity rights by rejecting the license agreement in a bankruptcy of the licensor.

Another possible, and perhaps more feasible, technique for protecting against the rejection of a trademark license would be for the licensor to grant the licensee a covenant not to sue the licensee for infringement of the licensed trademarks during the stated term of the license, any renewals to which the licensee is entitled, and any sell-off or wind-down period. The covenant not to sue should state that it is binding on the licensor and any and all of its successors and assigns. The potential utility of this technique likely depends on establishing that the covenant not to sue is not an executory contract because it requires no affirmative performance on the part of the licensor and, therefore, is not subject to rejection. To our knowledge, this technique has not yet been tested in court. If it ultimately is proven to be effective to preserve a licensee's ability to continue to use licensed trademarks after rejection of the license in a jurisdiction that follows the *Lubrizol* approach, its inclusion in the deal will have been worthwhile, even though it is far from clear that it also would preserve any exclusivity rights with respect to the trademarks.

It will be interesting to see whether the law continues to evolve in this area in connection with the appeal to the First Circuit in the *Tempnology* case and, if so, what the implications will be for structuring intellectual property license agreements from the perspective of protecting the licensee against rejection in the event the licensor becomes the subject of a bankruptcy case.

---

1. In re Tempnology LLC, 559 B.R. 809 (1st Cir. B.A.P. 2016).
2. The IP License appears to have been quite expansive, entitling the Distributor to the non-exclusive, royalty-free use of the Grantor's intellectual property (other than trademarks) in perpetuity and not just in connection with Cooling Accessories or other products sourced from the Grantor. *See Tempnology*, 559 B.R. at 812.
3. As alluded to earlier, neither the bankruptcy court nor the BAP's opinion in the case discusses whether the Agreement provided that it was terminable for cause and, if so, whether, under the terms of the Agreement, an effective termination for cause by the Grantor would eliminate the Distributor's right to a two-year wind-down period. However, in a companion case, *Mission Product Holdings, Inc. v. Old Cold, LLC* (*In re Old Cold, LLC*), 558 B.R. 500 (1st Cir. B.A.P. 2016), the BAP described the arbitrator's first phase ruling in the arbitration proceeding between the Grantor and the Distributor as "determining the Debtor's termination for cause was ineffective and that the [ ] Agreement remained in full force and effect during a two-year, wind down period." *Id.* at 503-04. It is reasonable to infer from that description that, under the terms of the Agreement, an effective termination for cause by the Grantor would have eliminated the Distributor's right to a wind-down period.
4. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).
5. *See* 11 U.S.C. § 365(n).
6. Trademark licenses were excluded from Section 365(n) apparently because of concerns of trademark lawyers about the necessity that trademark licensors maintain quality control over branded products. *See* In re Crumbs Bake Shop, Inc., 522 B.R. 766, 771-772 (Bankr. D.N.J. 2014) (discussing legislative history of Section 365(n)).
7. *See* Sunbeam Prods., Inc. v. Chicago American Mfg., LLC, 686 F.3d 372 (7th Cir. 2012) (Easterbrook, J.) (concluding that *Lubrizol* was wrongly decided and holding that rejection of a trademark license by debtor-licensor's bankruptcy trustee did not deprive the licensee of continued use of the licensed trademarks); In re Exide Technologies, 607 F.3d 957, 967-968 (3d Cir. 2010) (Ambro, J., concurring) (expressing the view, in a case involving a trademark license, that rejection is not tantamount to rescission and does not have same result as termination of a contract); Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. 2007) (holding that purpose of Section 365 is not to be the functional equivalent of rescission and that rejection merely frees the bankruptcy estate from the obligation to perform and has no effect upon rejected contract's continued existence); *see also Crumbs Bake Shop*, 522 B.R. at 771-772 (holding courts may use Section 365 to free bankrupt licensor from burdensome duties that hinder its reorganization but should not use it to take back trademark rights it bargained away). Contra In re HQ Global Holdings, Inc., 290 B.R. 507 (Bankr. D.Del. 2003); In re Old Carco, LLC, 406 B.R. 180 (Bankr. S.D.N.Y. 2009); Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.), 281 B.R. 660 (Bankr. N.D. Cal. 2002); In re Chipwich, 54 B.R. 427 (Bankr. S.D.N.Y. 1985) (following *Lubrizol*).
8. In the *Sunbeam* case, after rejection by the licensor's bankruptcy trustee of a license that included trademarks and other intellectual property, the bankruptcy court permitted the non-debtor licensee to continue to use the licensed trademarks "on equitable grounds," even though Section 365(n) does not technically apply to trademarks. Szilagyi v. Chicago American Mfg., LLC (In re Lakewood Eng'g and Mfg. Co., Inc.), 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011). On appeal, in an opinion authored by Judge Easterbrook, the Seventh Circuit disagreed with the bankruptcy court's conclusion that it could permit a non-debtor trademark licensee to continue to use a licensed trademark "*on equitable grounds*" after rejection of the license in bankruptcy, whether or not the effect of rejection under Section 365(a) of the Bankruptcy Code otherwise would be termination of the licensee's right to use the trademarks. Despite rejecting the bankruptcy court's invocation of equity as a basis for preserving the licensee's rights to use the licensed trademarks, however, the court of appeals affirmed the bankruptcy court's judgment on different grounds. In that regard, turning to the issue of the effect of rejection of a trademark license by a debtor-licensor or its trustee, the court of appeals held that, under Section 365(g) of the Bankruptcy Code, rejection simply constitutes a breach of contract by the debtor party to an executory contract that does not abrogate the rights of the non-debtor party to the rejected contract, other than a right it may have had under applicable non-bankruptcy law to obtain specific performance of the debtor's affirmative obligations under the contract. Rejection, in other words, is not an avoidance mechanism that empowers a debtor or trustee to claw-back rights conveyed under a contract with a counter-party. Instead, rejection relieves a bankruptcy estate of having to specifically perform burdensome, affirmative obligations under the contract, converting such unfulfilled obligations to a pre-petition damages claim in favor of the non-debtor party. In the words of the court, "nothing about this process implies that any rights of the other contracting party [other than a right, if any, to specific performance] have been vaporized." *Sunbeam*, 686 F.3d at 377. The court of appeals noted that scholars uniformly have criticized *Lubrizol* as confusing rejection with the avoiding powers under the Bankruptcy Code, such as the powers to avoid preferences and fraudulent transfers. *Id.* It also rejected the position, adopted by some bankruptcy courts, that Congress had codified *Lubrizol* with respect to trademarks by excluding trademark licenses from section 365(n). *Id.* at 375 ("The limited definition [of 'intellectual property'] in § 101(35A) means that § 365(n) does not affect trademarks *one way or the other*.") (emphasis added).
9. The trademark license in the *Tempnology* case was a non-exclusive license, and the BAP had no occasion to address specifically whether the rights of a trademark licensee that are preserved under the *Sunbeam* rationale in the event of rejection of a trademark license include any exclusivity rights that are granted under the license. As alluded to earlier in this article, the protections afforded under Section 365(n) to licensees of intellectual property other than trademarks encompass any rights of exclusivity conferred under the license. 11 U.S.C. § 365(n)(1)(B). The question presented is whether the *Sunbeam* rationale leads to the same result with respect to any rights of exclusivity granted under a trademark license agreement. Neither the bankruptcy court opinion nor the court of appeals opinion in the *Sunbeam* case states specifically whether the trademark license involved in that case was exclusive or non-exclusive. Based on the context in which the license was granted, however, it seems likely that the trademark license involved in the *Sunbeam* case was non-exclusive. It therefore can be argued that neither the Seventh Circuit's decision in *Sunbeam* nor the

BAP's decision in *Tempnology* constitutes a clear holding that exclusivity rights granted under a trademark license agreement are preserved along with the licensee's other rights to use the licensed trademarks when a trademark license agreement is rejected. The *Sunbeam* rationale, as characterized by the BAP, however, would appear to extend to exclusivity rights granted in a license agreement. *See Tempnology*, 559 B.R. at 822-23 ("Applying *Sunbeam's* rationale, we conclude that … the Debtor's rejection of the Agreement did not vaporize [the licensee's] rights under the Agreement. Whatever post-rejection rights [the licensee] retained in the Debtor's trademark and logo are governed by the terms of the Agreement and applicable nonbankruptcy law."). Accordingly, under the *Sunbeam* rationale as articulated by the BAP, if a breach of a trademark license agreement by the licensor would not impair, under the terms of the agreement or under applicable non-bankruptcy law, the licensee's exclusivity rights with respect to the trademark license granted under the agreement, the exclusivity rights would survive rejection of the agreement in a bankruptcy of the licensor.