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Crumbs Decision Protects TM Licensees' 365(n) IP Rights

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A decision recently issued by the United States Bankruptcy Court for the District of New Jersey — In re Crumbs Bake Shop Inc., Case No. 14-24287 (Bankr. D.N.J. Oct. 31, 2014) (ECF No. 288) — underscores issues of critical importance to parties to licenses of intellectual property in instances where the intellectual property and related licenses are at issue in bankruptcy cases.

The Crumbs decision adds important clarifications regarding continuing disputes between intellectual property licensees and their bankrupt licensors. Crumbs held that trademark licensees are entitled to protection under Section 365(n) of the Bankruptcy Code, which allows licensees to continue using the subject intellectual property following the rejection of their licenses. In addition, Crumbs ruled that a sale under Section 363(f) "does not trump" such licensees' rights.

Accordingly, the debtors were not permitted to sell their assets "free and clear" of licensees' Section 365(n) rights without the licensees' informed consent. The court found that the licensees did not impliedly consent to forfeit their Section 365(n) rights simply by failing to object to that asset sale, because notice was insufficient.

Background

The debtors, Crumbs Bake Shop Inc. et al., sold baked goods in various channels and licensed to third parties the rights to sell products utilizing the Crumbs brand, trademark and trade secrets. In an effort to maximize licensing revenues, the debtors engaged an agent to provide licensing services, procuring several licensing agreements on the debtors' behalf.

After the debtors filed bankruptcy in July 2014, they filed a motion to sell substantially all of their assets pursuant to an asset purchase agreement with Lemonis Fischer Acquisition Company LLC ("buyer"). Certain of the debtors' secured debt had previously been assigned to the buyer and the buyer had also furnished debtor-in-possession financing to the debtors. The consideration to be paid by the buyer consisted of a credit bid and the assumption of certain liabilities. In August 2014, the court approved the sale of substantially all of the debtors' assets to the buyer, free and clear of liens, claims, encumbrances and interests pursuant to Section 363(f) of the Bankruptcy Code.

Following the approval of the sale, the debtors moved to reject certain executory contracts, including the license agreements. The debtors' licensing agent filed a response to the motion to reject. In it, the agent asserted that licensees could elect to retain their rights under Section 365(n). Further, the agent claimed it was entitled to payment of royalties under the licenses, to the extent the licensees elected to retain their Section 365(n) rights.

Key Rulings In re Crumbs Bake Shop, Inc.

Trademark Licensees <u>are</u> Protected Under 11 U.S.C. 365(n)

In Crumbs, Judge Michael Kaplan held that licensees under rejected trademark licenses are entitled to Section 365(n) protection (effectively meaning that licensees may continue using the trademark), notwithstanding the fact that trademarks are not expressly included in the definition of "intellectual property" in Bankruptcy Code Section 101.

By way of background, Section 365 of the Bankruptcy Code allows debtors to reject executory contracts in bankruptcy, often freeing the debtor from burdensome contractual obligations. Subsection (n) of 365 provides special protections for licensees of "intellectual property" whose licenses have been rejected in bankruptcy. Section 365(n) was enacted as a congressional response to a controversial decision from the Fourth Circuit: Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc., 756 F.2d 1043, 1048 (4th Cir. 1985).

Lubrizol held that rejection of an intellectual property license in bankruptcy deprived the licensee of all rights under the license. The draconian result of the Lubrizol holding has engendered widespread criticism of this decision.[1] Crumbs at 5-6 ("Scholars uniformly criticize Lubrizol, concluding that it confuses rejection with the use of an avoiding power.").

While Section 365(n) largely protects licensees' right post-rejection, the problem facing trademark licensees in the Crumbs case is that "intellectual property" as defined in the Bankruptcy Code does not expressly include trademarks.[2] As a result, certain courts have reasoned by negative inference that the omission of trademarks from the definition of intellectual property signaled congressional intent to exclude trademark licensees from Section 365(n). Such courts have applied the Lubrizol holding to trademark licensees, that is, terminating the licensee's rights to use the trademarks upon rejection and not permitting the licensee to elect to retain rights under Section 365(n) or otherwise preserve their rights to the trademark.

In Crumbs, the court was unpersuaded by the "negative inference" rationale for denying trademark licensees' Section 365(n) rights. Instead, Crumbs relied on the legislative history of Section 365(n), as well as Judge Thomas Ambro's concurrence in In re Exide Technologies, to conclude that "Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under § 365(n)." Crumbs at 9.

Applying an equitable analysis to the facts in Crumbs, the court found that it would be inequitable to strip the trademark licensees of their rights upon the debtors' rejection because the debtors had "bargained away" those rights. Id. Allowing a "licensor [to] take back trademark rights it bargained away ... makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve." Id. (quoting Exide).

The debtors' buyer, who had purchased the trademark as part of an asset sale under Section 363(f), argued that such equitable considerations are not relevant where debtors have sold their assets to a bona fide purchaser. The court found this distinction unpersuasive, observing that the proposed result would benefit lenders at the expense of licensees and posited that Congress likely did not intend "to sacrifice the rights of licensees for the benefit of the lending community." Id.

The buyer also argued that licensees' continued enjoyment of their licensee rights would undermine the buyer's ability — as the new trademark owner — to control the quality of products or services sold under the Crumbs trademark. While the court recognized the importance of quality control relating to the brand, the court noted that existing trademark protections outside of bankruptcy incentivize licensees to "maintain a certain standard of quality in using the licensor's trademark." Id. at 11 (citing causes of action for trademark infringement and unfair competition as examples of nonbankruptcy incentives for licensees to comply with quality standards).

Judge Kaplan discussed, but did not follow, the Seventh Circuit's Sunbeam decision, which preserved trademark licensee rights in the rejection context based on Section 365(g) of the Bankruptcy Code (i.e., on the basis that rejection is a breach, creating defenses that cannot be rejected, and not a termination). Sunbeam Prods. Inc. v. Chi. Am. Mfg. LLC, 686 F.3d 372 (7th Cir. 2012).

Judge Kaplan noted that Sunbeam reached the same result as Judge Ambro's equity-based rationale in Exide, but instead favored the equity-based approach for extending Section 365(n) to trademark licensees. The court also cited pending legislation, which proposes to revise the definition of "intellectual property" in the Bankruptcy Code to include trademarks,[3] as evidence that the omission of trademarks from the definition did not indicate congressional intent to terminate trademark licensees' rights upon rejection.

Debtor Cannot Sell Free and Clear of Section 356(n) Rights Absent Informed Consent

Separately, the buyer argued that it purchased the trademark "free and clear" of whatever 365(n) rights the trademark licensees possessed by operation of Section 363(f) of the Bankruptcy Code. The court disagreed and found that the licensees' rights were not extinguished by the sale in the absence of informed consent by the licensees — "a sale under § 363(f) does not trump the rights granted to Licensees by § 365(n)." Crumbs at 12. Rather, the specific language of Section 365(n) trumped the general language of Section 363(f). Id. at 17-18.

The buyer contended that the licensees impliedly consented to a sale free and clear of their Section 363(n) rights when they failed to object to the asset sale. However, the court found that the licensees did not have sufficient notice to understand the intended impact of the sale on their licenses and rights. In effect, the court indicated that actual informed consent would be required to override Section 365(n) in the sale context, or at least that implied consent would be subject to exacting scrutiny.

The court similarly found that the debtors failed to give the licensees sufficient opportunity to request adequate protection under Section 363(e) of the Bankruptcy Code. Section 363(e) conditions the sale of property on the provision of adequate protection of an entity's interest in the property, if such adequate protection is requested. Here, because the licensees lacked requisite notice of the debtors' intent to sell the trademark free and clear of their interest in it, the licensees were denied an opportunity to request adequate protection of their interest in the trademark.[4]

Licensing Royalties Remain With the Debtors

The court concluded that the debtors — not the buyer or the licensing agent — were entitled to the royalties generated as a result of the licensees' Section 365(n) election. Consistent with the leading circuit court authority, the court held that the royalties would remain with the debtors because the sale expressly excluded the license agreements, even though the trademark itself had been sold to the buyer. See also Schlumberger Res. Mgmt. Servcs Inc. v. CellNet Data Sys. Inc. (In re CellNet Data Sys. Inc.), 327 F.3d 242 (3d Cir. 2003).

Conclusion and Comment

The Crumbs decision is significant, primarily because it further illuminates alternative solutions for key unresolved legal questions regarding the treatment of rejected trademark licenses in bankruptcy. The decision will likely have implications for other forms of intellectual property not expressly covered by Section 365(n).

Judge Kaplan's decision to extend Section 365(n) protections to trademark licensees based on equitable considerations, while well-reasoned, may not be followed by other courts. Rather, the Sunbeam rationale — which achieves the same practical result, but does so from a more Bankruptcy Code-based perspective — may be more likely to prevail overall. Nevertheless, Crumbs makes clear that there are now multiple theories for preserving licensee rights after rejection, as well as an increasing consensus that Lubrizol was wrongly decided.

Furthermore, Crumbs adds important clarifications to other continuing disputes between intellectual property licensees and their bankrupt licensors. In particular, Crumbs squarely rejects the proposition that assets can be sold "free and clear" of licensees' Section 365(n) protections without licensee consent. While Crumbs provides precedent that debtors must include "lucid and specific language that would place Licensees on notice" that a contemplated sale would vitiate licensee rights, licensees must continue to carefully monitor the bankruptcy cases of licensors to watch for such language. Crumbs at 15.

Crumbs also has practical implications for the sale of intellectual property portfolios in bankruptcy cases. Potential buyers need to be aware that the bundle of intellectual property rights offered by debtor-sellers may be limited by Section 365(n) rights. The holding of Crumbs and similar authority will need to be taken into consideration in connection with deal structuring and pricing.

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[1] Compare Lubrizol with e.g., Sunbeam Prods. Inc. v. Chi. Am. Mfg. LLC, 686 F.3d 372 (7th Cir. 2012), writ denied, 133 S. Ct. 790 (2012), Lewis Bros. Bakeries Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.), 751 F.3d 955 (8th Cir. 2014) and In re Exide Techs., 607 F.3d 957, 967 (3d Cir. 2010) (Ambro., J., concurring) (each using various theories for correcting the core error in the Lubrizol decision

that rejection terminates licenses, unlike other types of executory contracts, and licensee defenses, which cannot be rejected).

[2] See 11 U.S.C. § 101(35A) ("The term 'intellectual property' means — (A) trade secret; (B) invention, process, design, or plant protected under title 35 [35 U.S.C.S. §§ 1 et seq.]; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [17 U.S.C.S. §§ 101 et seq.]; or (F) mask work protected under chapter 9 of title 17 [17 U.S.C.S. §§ 901 et seq.]").

[3] Innovation Act of 2013, H.R. 3309, 113th Cong., § 6(d) (2013).

[4] Debtors seeking to sell assets under Section 363(f) increasingly attempt to satisfy the adequate protection obligations of Section 363(e) by asserting that parties' interests in the property attaches to the proceeds of the sale. However, such "adequate protection" is largely illusory because sale proceeds typically benefit the DIP lender, prepetition secured creditor and administrative creditors only.
