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# Protecting Trademark Licensees in Bankruptcy Proceedings: Extending Section 365(n) Protections to Licensees on Equitable Grounds

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If there were doubts before about the protections afforded trademark licensees in bankruptcy filings, a recent case decided by the District Court of New Jersey seems to have erased them. The trend of courts finding ways to protect trademark licensees from the harsh effects of losing their trademark license rights in bankruptcy is in full swing. The latest example of protecting trademark licensees comes in the Crumbs Bake Shop, Inc. Chapter 11 bankruptcy case in New Jersey.<sup>1</sup> On October 31, 2014, Judge Michael B. Kaplan of the US Bankruptcy Court for the District of New Jersey rejected a motion by the buyer of the assets of Crumbs to clarify, among other things, that it purchased the Crumbs trademarks free of trademark licenses previously entered into by Crumbs. In a 22-page revised decision dated November 3, 2014, Judge Kaplan identified three issues facing the court:

I. Whether trademark licensees to rejected intellectual property licenses fall under the protective scope of 11 U.S.C. § 365(n), notwithstanding that “trademarks” are not explicitly

included in the Bankruptcy Code definition of “intellectual property”;

II. Whether a sale of Debtors’ assets pursuant to 11 U.S.C. §§ 363(b) and (f) trumps and extinguishes the rights of third-party licensees under § 365(n); and

III. To the extent there are continuing obligations under the license agreements, which party is entitled to the collection of royalties generated as a result of third party licensees’ use of licensed intellectual property.

This article examines how the court addressed these three issues, one by one. As discussed below, the court’s Section 365(n) analysis raises the most questions.

## Another *Lubrizol* Rejection

Before turning to the Section 365(n) question, the court first looked at the impact of rejection on an intellectual property license. The court examined the 1985 Fourth Circuit decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,<sup>2</sup> which held that, upon rejection of a license agreement by a debtor-licensor, the licensee loses its rights to the intellectual property. The *Crumbs* bankruptcy court stated that it “is not persuaded by the decision.” It cited the Seventh Circuit’s decision in the *Sunbeam Products* case (which disagreed with *Lubrizol*’s interpretation of the effect of rejection under Section 365(g)), and noted that it is “not alone in finding that its reasoning has been discredited.” The *Crumbs* court decided not to follow *Lubrizol* but did not adopt the Seventh Circuit’s approach to the issue. Instead, it turned to Section 365(n) and equitable considerations.

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## Section 365(n) and Trademarks

The court reviewed the language and legislative history of Section 365(n) of the Bankruptcy Code and its companion definition of “intellectual property” in Bankruptcy Code § 101(35A). Looking at Third Circuit precedent, it examined Judge Ambro’s concurrence in the Third Circuit’s 2010 decision in *In re Exide Technologies*. The *Crumbs* court then considered the consequences of the congressional decision not to include trademarks in the definition of intellectual property in Section 101(35A).

- As did Judge Ambro in *Exide Technologies*, the bankruptcy court pointed to the passage in the legislative history of Section 365(n) and Section 101(35A) about postponing congressional action on trademark licenses “to allow the development of equitable treatment of this situation by bankruptcy courts.”
- The *Crumbs* court stated that reasoning by negative inference—and thereby to hold that Congress’s omission of trademarks from the definition of intellectual property in Section 101(35A) means that the protections of Section 365(n) do not extend to trademarks and trademark licensees lose their rights—would be improper.
- The court concluded 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)” and found “it would be inequitable to strip” the trademark licensees “of their rights in the event of a rejection, as those rights had been bargained away by Debtors.”
- The *Crumbs* court also commented on the passage of the Innovation Act by the House of Representatives, which if enacted would add trademarks to the definition of intellectual property in Section 101(35A). While not dispositive, the court noted that the legislation showed that Congress was aware of the prejudice to trademark licensees that would result from the position advanced by the buyer.
- Without explicitly holding that Section 365(n) itself applies to all trademark licenses, the *Crumbs* court granted the trademark licensees the protections of Section 365(n) on equitable grounds.

## A Closer Look at the Court’s Section 365(n) Analysis

The *Crumbs* decision appears to be the first holding that allows the protections of Section 365(n) to

be extended to trademark licensees, despite the intentional omission of trademarks in Section 101(35A). The other courts protecting trademark licensees, including the Third and Eighth Circuits, found the trademark licenses at issue no longer executory, while the Seventh Circuit in *Sunbeam Products* held that rejecting a trademark license does not terminate the licensee’s IP rights. Although the *Crumbs* court did not expressly hold that Section 365(n) applies to trademark licenses in all cases, the court held it could invoke the specific protections of Section 365(n) (and that section’s royalty requirements) for trademark licensees on equitable grounds.

## Does “Means” Mean Anything?

Although the *Crumbs* court’s result is consistent with the recent trend, its analysis is questionable. Extending Section 365(n) rights to trademark licenses, even on an equitable basis, appears to conflict with the statute’s language. Section 101(35A), the definition of intellectual property on which Section 365(n) is based, begins with “The term ‘intellectual property’ means” and then lists six specific categories of intellectual property. As we know, trademarks, service marks, and trade names are not among them. The use of the word “means” in Section 101(35A) is significant, notwithstanding the legislative history about the development of equitable treatment, a subject on which the statute itself is silent. The bankruptcy court’s decision in *Crumbs* did not discuss the use of the term “means” in Section 101(35A), but that term and its significance has been construed by the US Supreme Court in another context.

- In *Burgess v. United States*,<sup>3</sup> the Supreme Court held, in the context of a criminal statute: “As a rule, [a] definition which declares what a term ‘means’...excludes any meaning that is not stated.’ *Colautti v. Franklin*, 439 U.S. 379, 392-393, n. 10, 99 S.Ct. 675, 58 L.Ed.2d 596 (1979) (some internal quotation marks omitted).”
- In footnote 3 of the *Burgess* decision the Court actually examined several Bankruptcy Code definitions, two of which used the term “means,” in support of its statutory construction that “means” is exclusive.
- Although the *Crumbs* decision did not hold that Section 101(35A) and Section 365(n) apply to trademarks in all cases, it extended Section 365(n) rights, expressly by name, to trademark licensees on equitable grounds. Given Congress’s use of the restrictive term “means” in the statutory definition, and its intentional omission of

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trademarks, service marks, and trade names from Section 101(35A), extending the statutory protections of Section 365(n) to trademark licensees seems to create an unnecessary conflict with the language of the statute.

- Instead of invoking Section 365(n), the *Crumbs* court could have used alternatives approaches to protect the trademark licensees and avoided a conflict with the language of Section 101(35A). It could have ruled, as Judge Ambro suggested in his *Exide Technologies* concurrence, that on equitable grounds rejection of a trademark license does not deprive the licensee of its rights. Likewise, it could have held, as the Seventh Circuit did in *Sunbeam Products*, that rejection does not terminate a counterparty's license rights at all.

## Was the Sale Free and Clear of the Trademark Licenses?

Having concluded that the protections of Section 365(n) should apply to the trademark licensees in this case, the *Crumbs* court addressed whether the asset sale under Section 363(b) and Section 363(f), which included the trademarks, was “free and clear” of the licensees’ interests. The buyer argued that the licensees were given notice of the proposed “free and clear” sale but failed to object, thereby impliedly consenting to the extinguishment of their Section 365(n) rights. However, after examining the notice given in the case, the *Crumbs* court concluded that the licensees were not provided with adequate notice that the sale put their rights at risk.

- The court observed how a party had to “traverse a labyrinth of cross-referenced definitions and a complicated network of corresponding paragraphs with annexed schedules” to determine what was being sold. The court admitted that it had difficulty following the “definitional maze” and observed that “there is no clear discussion as to what rights were purported to be taken away as a result of the sale,” meaning that the trademark licensees had no apparent reason to believe that an objection was needed to retain their rights under Section 365(n).
- The court acknowledged that a proposed order was part of the Debtors’ moving papers, and “addressed that the sale was to be clear of licensees’ rights.” However, the court noted that this reference was “a mere ten words, buried within a single twenty-nine page document, which itself

was affixed to a CM/ECF filing totaling one hundred twenty-nine pages.”

- Under these circumstances—with no other express reference to the licensees, Section 365(n) rights, or the stripping of those rights—the *Crumbs* court held it would be inequitable to find that the licensees consented to the termination of their rights.
- The *Crumbs* court also held, as a matter of statutory construction, that Section 365(n), a more specific provision, is not overcome by the broad text of Section 363(f) and its free and clear language. “Nothing in § 363(f) trumps, supercedes, or otherwise overrides the rights granted to Licensees under § 365(n).” This ruling again raises the issue whether Section 365(n) can be applied to trademark licenses in the first place.

## Which Party Is Entitled to Royalties under the License Agreements?

The court also addressed whether the buyer, as the new owner of the trademarks, or the debtor, as the party to the trademark licenses that were not assigned to the buyer, was entitled to payment of ongoing royalties under those agreements. The court cited the Third Circuit’s decision in *In re CellNet Data Sys., Inc.*,<sup>4</sup> and its ruling that Section 365(n) links royalties to the license agreement rather than the intellectual property. The *Crumbs* court concluded that because the license agreements had not been assigned, the buyer did not obtain royalty rights under the licenses going forward (although it did purchase any unpaid pre-closing royalties through its acquisition of accounts receivable). However, because the Debtors no longer owned the trademarks, the court questioned how anyone other than the buyer could perform under the trademark license agreements and, accordingly, concluded that rejection likely is necessary.

## Conclusion

Over the past four years, one of the most significant developments at the intersection of IP and bankruptcy law has been how courts have used factual, legal, and equitable approaches to protect trademark licensees from the harsh effects of rejection. The *Crumbs* case—pending in New Jersey in the Third Circuit—built on Judge Ambro’s concurring opinion in *Exide Technologies*, and extended, on an equitable basis, the protections of Section 365(n) to trademark licensees. However, the *Crumbs* court



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seems to have gone too far in applying Section 365(n) itself to trademark licenses—despite the fact that the definition of intellectual property in Section 101(35A) does not include trademarks. Given the use of the restrictive term “means” in Section 101(35A), the *Crumbs* court’s statutory interpretation and

its reliance on legislative history, is questionable. Although the *Crumbs* decision is further evidence of the continuing trend of courts protecting trademark licensees in bankruptcy, courts would be on stronger ground if they did so without applying Section 365(n) itself to trademark licenses.

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1. *In re Crumbs Bake Shop, Inc.*, No. 14-24287 (Bankr. D.N.J., Oct. 31, 2014).
2. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).

3. *Burgess v. United States*, 128 S.Ct. 1572 (2008), *citing* 2A N. Singer & J. Singer, *Statutes and Statutory Construction* § 47:7, at 298-299, and nn. 2-3 (7th ed. 2007).
4. *In re Cell Net Data Sys., Inc.*, 327 F.3d. 242 (3d Cir. 2003).

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