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Keeping It **Personal**

Seventh Circuit restricts trademark licensee's right of assignment.

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INTELLECTUAL PROPERTY licensors are perpetually concerned about whether their licensees can use the bankruptcy process to assign their license rights to third parties, especially to third parties to whom the licensor would not want to grant a license, or at least not on the existing license terms. This concern can be particularly acute for trademark licensors, who want to protect their trademarks against undesired uses and keep the trademark license rights "personal" to their licensees.

The U.S. Court of Appeals for the Seventh Circuit recently provided some comfort for trademark licensors when it concluded in *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011), that a licensee under a non-exclusive trademark license cannot assign its license in bankruptcy under §365 of the Bankruptcy Code without consent from the licensor. While the Seventh Circuit's pronouncements with respect to the assignability of the license were ultimately dicta, this case is noteworthy for several reasons.

First, in contrast to the fairly well-established body of case law prohibiting a licensee from assigning its non-exclusive patent and copyright licenses without the consent of the licensor,[1] the ability of a trademark licensee to assign its license has been relatively unclear. The Seventh Circuit's decision provides welcome clarity on the issue. Second, the Seventh Circuit essentially ignored the usual predicate for a finding that a license is not assignable by a licensee in bankruptcy; that is, whether "applicable law"—federal, state, or otherwise—would prohibit assignment of the license without the consent of the licensor outside of bankruptcy. Instead, the Seventh Circuit summarily characterized its conclusion that a trademark license cannot be assigned without consent as the "universal rule."

Finally, the Seventh Circuit's statement that "if the contract still included a trademark sublicense when [the debtor] attempted to assign the contract to the purchasers, [the contract] was not assignable," highlights an important issue: that a party to a contract containing a trademark (or other intellectual property) license to the debtor, regardless of how minor a part the license may play, could prevent assignment of the entire agreement by the debtor on the grounds that the "licensor" does not consent to assignment of the license contained within the agreement.

This issue raises the possibility that a contracting party will try to use minor aspects of a contract containing a trademark license to prevent assignment of the contract by the debtor in the event of the debtor's bankruptcy. A licensee, for its part, may try to negotiate a license agreement as a stand-alone contract, separate from other rights in its contractual relationship, to preserve the potential assignability of its other contractual rights in bankruptcy to the maximum extent possible.

Contracts and Section 365

Section 365 of the Bankruptcy Code permits a debtor to assume and assign its executory contracts.[2] Courts have generally deemed intellectual property licenses to be "executory" within the meaning of §365.[3] A debtor's right to assume and assign its executory contracts is subject to certain exceptions. One such exception is found in §365(c)(1) of the Bankruptcy Code, which prevents a debtor from assuming or assigning an executory contract without the consent of the other party to the contract, when applicable law excuses that party from accepting performance from someone other than the debtor. In jurisdictions applying the so-called "hypothetical test," §365(c)(1) will also generally prevent a debtor from *assuming* the contract, even if the debtor is planning to restructure itself within its existing corporate entity and does not contemplate *assigning* the contract to a third party.[4]

Assignment Before 'XMH'

With regard to the treatment of trademark licenses in bankruptcy, the primary question under §365(c)(1) is whether applicable trademark law excuses the non-debtor party from accepting performance from someone other than the debtor. Until recently, relatively little case law has addressed this issue. Of the cases that have considered it, the approaches and conclusions vary, resulting in uncertainty for licensors of trademarks, and for licensees of trademarks who may find themselves in bankruptcy (and, indeed, for potential acquirors of assets from licensees in bankruptcy).

A case often cited for the proposition that trademark licenses may be assigned by licensees in bankruptcy without regard to the licensor's consent is *In re Rooster Inc.*, 100 B.R. 228 (Bankr. E.D. Pa. 1989). The debtor in *Rooster* was the licensee under a trademark sublicense giving it the right to use the "Bill Blass" name to manufacture and sell men's ties. The licensor moved for relief from the automatic stay for permission to terminate its sublicense with the debtor on the grounds that (i) the debtor conceded that it could no longer perform under the agreement and (ii) the license was not assignable to a third party because it was a personal services contract.

The court evaluated whether the contract was a contract for personal services under Pennsylvania law. Under Pennsylvania law, a contract for personal services "contemplates performance of contracted-for duties involving the exercise of special knowledge, judgment, taste, skill or ability." Rooster, 100 B.R. at 232. The court concluded that the debtor retained little discretion over the creation or design of the trademarked neckwear. Instead, the licensor retained the right to control the final design. Accordingly, the court held that the "actual control over [the debtor's] performance removes [the debtor's] duties from the sphere of personal service and from the ambit of §365(c)(1)(A)." Id. at 234.

Rooster is often cited for the proposition that trademark licenses should be evaluated through the lens of whether they are personal services contacts under state law—which turns on the particular license at issue, rather than a bright-line rule. *Rooster*, however, has also been criticized as being of limited utility, because the parties to the dispute had stipulated that Pennsylvania law was "applicable law" for the purposes of §365(c)(1) and had narrowly framed the issue before the court as whether the contract was one for personal services. Moreover, the *Rooster* court itself noted that it is generally accepted that §365(c) prohibits the assignment of more than just personal services contracts; instead, it applies to any contract that is subject to a law restricting assignment.

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A case dealing with the assignability of franchise agreements, which generally contain within them trademark licenses, is also cited in support of the application of a personal services contract analysis to determine whether a debtor may assign trademark licenses without the consent of the licensor. In *In re Sunrise Restaurants Inc.*, 135 B.R. 149 (Bankr. M.D. Fla. 1991), the debtor moved to assume and assign a fast food franchise agreement in connection with a sale of its assets.

The court examined the franchise agreement in the context of whether it was a personal services contract, which under applicable law would excuse the licensor from accepting performance from a party other than the debtor. The court concluded that the relationship between the parties was strictly a business relationship, and that the running of the fast food establishment did not require special knowledge, taste, skill or ability, in part because the franchise agreement imposed strict rules and conditions on the licensee. Notably, the court did not directly address the assignability of the trademark license contained within the franchise agreement, instead permitting assignment of the entire agreement, without consent, on the grounds that it was not a personal services contract.

The court in *In re Travelot Company*, 286 B.R. 447 (Bankr. S.D. Ga. 2002), reached the opposite conclusion of the courts in *Rooster* and *Sunrise Restaurants*, stating that a trademark license is not assignable by a debtor-licensee without consent of the licensor. Although the court in *Travelot* ultimately concluded that the agreement at issue did not contain a trademark license at all, it stated in dicta that federal trademark law constitutes "applicable law" under §365(c) and that, under federal trademark law, the grant of a non-exclusive trademark license is "an assignment in gross" that is personal to the assignee and thus not freely assignable to a third party.

In 2005, the U.S. District Court for the District of Nevada squarely addressed the issue of whether trademark licenses may be assigned by a licensee in bankruptcy in *N.C.P. Marketing Group Inc. v. Billy Blanks (In re N.C.P. Marketing Group Inc.)*, 337 B.R. 230 (D. Nev. 2005). In *N.C.P.*, the debtor was the licensee under an agreement permitting it to use the "Tae Bo" trademark in marketing and selling products. The owner of the trademark moved to compel the debtor to reject the agreement on the grounds that, under federal law, the trademark license could neither be assigned nor assumed by the debtor.

The court applied federal trademark law to conclude that trademarks are personal and non-assignable without the consent of the licensor. As a result, a licensee cannot assume and assign a trademark license without the licensor's consent. The court noted that copyrights and patents had frequently been held assignable only with the consent of the licensor. The court rejected an argument by the debtor that, unlike copyrights and patents, the purpose of which is to encourage authorship and invention by protecting the rights of the creator of the work, the sole value of a trademark is to protect consumers from deception and confusion.

While the court acknowledged that trademarks do protect the public from confusion, it stated that they are also used by trademark owners to preserve the value of their business name and products by protecting them from unauthorized use. The court reasoned that the owner of a trademark "has an interest in the party to whom the trademark is assigned so that it can maintain the good will, quality, and value of its products and thereby its trademark." Id. at 236. The U.S. Court of Appeals for the Ninth Circuit affirmed the district court's decision.

Despite the *N.C.P.* court's clear articulation of the standard for evaluating whether trademark licenses can be assigned by a debtor, there remained uncertainty after its decision for several reasons. First, it remained unclear whether other courts would agree with the selection of the federal trademark law as "applicable law" within the meaning of §365(c)(1). Second, even if courts agreed that federal trademark law was "applicable law," it was uncertain whether other courts would agree with the *N.C.P.* court's analysis of the result under that law. This is due in part to the fundamental differences in copyright and patent law, on the one hand, and trademark law, on the other hand-the differences that the *N.C.P.* debtor highlighted in its argument in the district court.

'In re XMH Corp.'

The Seventh Circuit's decision in *In re XMH* arose out of the chapter 11 case of XMH Corp., a clothing company. XMH sought permission under §363 of the Bankruptcy Code to sell the assets of its subsidiary, Simply Blue. As part of the sale, Simply Blue would assume and assign an executory contract between it and Western Glove Works. The contract had two parts: For the initial period of the contract, Western granted to Simply Blue a trademark sublicense that allowed Simply Blue to design, manufacture, and sell certain apparel in exchange for the payment of royalties to Western. Following the initial period, the trademark sublicense was to expire, after which Western would sell the trademarked apparel on its own, and Simply Blue would provide a variety of marketing, sourcing, and other services in exchange for a fee.

Western objected to the proposed assignment of the contract on the grounds that the contract contained a trademark sublicense and therefore, under §365(c)(1) of the Bankruptcy Code, could not be assigned without Western's consent, which Western would not give. The debtor, on the other hand, argued that the trademark sublicense had expired long before its attempt to assume and assign the contract and that §365(c) posed no bar to assignment. The U.S. Bankruptcy Court for the Northern District of Illinois agreed with Western, ruling that the contract could not be assigned over Western's objection. Simply Blue appealed this ruling to the U.S. District Court for the Northern District of Illinois, which reversed the Bankruptcy Court on the grounds that the trademark sublicense contained within the contract had expired by the time of the proposed assignment. Western appealed to the Seventh Circuit.

Although the district court's ruling was based upon a conclusion that the trademark sublicense had expired, the Seventh Circuit began its analysis with a discussion of whether trademark licenses are, in fact, assignable without the consent of the licensor under §365(c)(1) of the Bankruptcy Code. The Seventh Circuit concluded that trademark law, as opposed to, for example, state law governing personal services contracts, constituted "applicable law" within the meaning of §365(c)(1). The Seventh Circuit did not reach the issue of whether the applicable trademark law was federal, state, or even that of another nation (Western was a Canadian company). Instead, the Seventh Circuit declared that it did not matter, because: "[T]he universal rule is that trademark licenses are not

assignable in the absence of a clause expressly authorizing assignment."[5] *In re XMH*, 647 F.3d at 695.

In reaching its conclusion, the Seventh Circuit reasoned that a trademark conveys information about a brand to a consumer. If the seller of the branded product reduces the quality of the brand, then the trademark becomes deceptive, because its assurance of quality is not accurate. Of critical importance, the owner of the trademark must be able to control the quality of the brand. If the trademark owner has licensed it to a third party, the owner will normally not want to allow that person to sublicense the trademark without the owner's consent because the owner may not have the same level of confidence in the sublicensee that it had in the licensee. Thus, the Seventh Circuit reasoned, it makes sense that the "default" rule in all circumstances is that a trademark license is not assignable without the owner's express permission.

Ultimately, after its analysis of whether the agreement would have been assignable if it contained a trademark license, the Seventh Circuit concluded that the license portion of the contract had expired before the attempted assignment. Therefore, at the time of the assignment, the agreement was merely a services agreement that was freely assignable by Simply Blue. Nevertheless, based on its analysis, the Seventh Circuit stated that: "[I]f the contract still included a trademark sublicense when [the debtor] attempted to assign the contract to the purchasers, [the contract] was not assignable." *In re XMH*, 647 F.3d at 695.

'XMH' Effects

The Seventh Circuit's decision in *XMH* is important not only for what it says about the assignability of trademark licenses in bankruptcy, but also because it leaves certain questions unanswered. Rather than definitely conclude whether federal, state, or some other law constitutes "applicable law" for the purposes of §365(c)(1), the Seventh Circuit stated that it is the universal rule that trademark licenses are not assignable without the consent of the licensor. In reaching this conclusion, the Seventh Circuit did not discuss decisions like *Rooster*, *Sunrise Restaurants*, and others, which at least call into question the universality of this rule.

Notwithstanding the "universal rule" announced by the Seventh Circuit, the determination of what constitutes "applicable law" for the purposes of §365(c)(1) could be extremely important if the application of different laws would lead to different results. While the trend after *N.C.P.* and *XMH* seems to be toward the application of federal trademark law as applicable law, it remains possible that a court will apply the state law analysis employed by the court in *Rooster* to conclude that a contract is (or is not) a personal services contract. Alternatively, a court may disagree with the courts in *N.C.P.* and *XMH* and adopt the debtor's argument in *N.C.P.* that federal trademark law, unlike federal patent or copyright law, permits a licensee to assign its license without the consent of the licensor.

XMH is more important, however, for what it says about agreements that contain trademark licenses. The Seventh Circuit's unequivocal statement that the debtor could not assign the contract if it contained a trademark license at the time that the debtor sought to assume and assign it has serious ramifications for debtors whose businesses may depend on agreements that contain within them trademark licenses, or licenses of other intellectual property.

It is possible, and perhaps likely, that under the Seventh Circuit's reasoning in *XMH*, a debtor seeking to assume and assign a contract containing a trademark license may be prohibited from doing so. In a "hypothetical test" jurisdiction, this may also mean that a debtor cannot even assume the agreement for its own use. Due to the adverse consequences that may result from a debtor's inability to assume and assign a particular contract, the characterization of a contract as a license, or as containing a license, could become extremely important. It is also possible, though perhaps less likely, that a court would permit a debtor to sever the license portion of the contract from the remainder of the agreement, thus permitting the debtor to assume and assign the non-license portion for the purposes of its reorganization. This analysis depends on whether the court applies the well-accepted general rule that an executory contract must be assumed in its entirety,[6] or whether a court would view the separate components of the contract as distinct agreements as courts have allowed in other contexts.[7]

While the Seventh Circuit's ruling in *XMH* may provide some comfort to licensors seeking to protect their trademarks in the event of a bankruptcy by their licensees, it may also result in licensees seeking to protect their rights at the contract negotiation and drafting stage. In particular, a licensee may try to negotiate a license agreement as an independent contract, so that even if it is ultimately unable to assume and assign the license in bankruptcy, it may be able preserve the potential assignability of its other contractual rights. On the other hand, a savvy party seeking to ensure that a contract is deemed "personal" and, therefore, nonassignable in bankruptcy by the other party to the contract, may try to include elements of a "license" in the contract, if it can colorably do so under the circumstances of the transaction.

1. Courts have consistently held that a debtor may not assign its non-exclusive patent and copyright licenses without the consent of the licensor. See, e.g., *In re Access Beyond Technologies Inc.*, 237 B.R. 32, 45-47 (Bankr. D. Del. 1999) (non-exclusive patent license); *In re Patient Education Media Inc.*, 210 B.R. 237, 242-43 (Bankr. S.D.N.Y. 1997) (non-exclusive copyright license).

2. The Bankruptcy Code does not define the phrase "executory contract," but courts have generally accepted the Countryman definition, that:

> [An executory contract is] a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

Sharon Steel Corp. v. National Fuel Gas Distribution Corp., 872 F.2d 36, 39 (3d Cir. 1989), quoting Vern Countryman, "Executory Contracts in Bankruptcy," Part 1, 57 Minn. L. Rev. 439, 460 (1973).

3. See, e.g., *In re Golden Books Family Entertainment Inc.*, 269 B.R. 300, 308 (Bankr. D. Del. 2001) ("Applying the Countryman definition of executory contracts, courts generally have found intellectual property licenses to be "executory" within the meaning of section 365(c)…").

4. Applying a strict interpretation of the phrase "may not assume or assign" as used in §365(c)(1), some courts apply a "hypothetical test" to hold that if a debtor may not assign an executory contract to a third party, then the debtor may not assume the contract for its own use, even if no assignment is contemplated. See, e.g., *In re W. Elec. Inc.*, 852 F.2d 79 (3d Cir. 1988). Other courts, applying the so-called "actual test" look to whether the debtor actually plans to assign the contract to a third party; if not, these courts will permit the debtor to assume the contract for its own use. See, e.g., *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997). Some bankruptcy judges, including some in the Southern District of New York, have adopted a third test, the *Footstar* test. See *In re Footstar Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005). The results are generally the same under the *Footstar* test as under the actual test, and the technical differences between the *Footstar* and actual tests are beyond the scope of this article.

5. The Seventh Circuit cited to the U.S. District Court for the District of Nevada's decision in *In re N.C.P. Marketing Group Inc.* in support of this absolute rule.

6. See, e.g., *In re Leslie Fay Companies Inc. v. Corporate Property Associates 3 (In re Leslie Fay Companies)*, 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994) (A debtor must assume or reject an executory contract in its entirety; contracts may not be assumed in part and rejected in part.).

7. See, e.g., *In re Adelphia Business Solutions Inc.*, 322 B.R. 51, 54 n.10 (Bankr. S.D.N.Y. 2005) (Recognizing that "many courts… allow a single contract to be separately assumed and rejected if the contract is 'divisible' or 'severable' under state law").