

# The Transactional Lawyer

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## Protecting Distributors and Trademark Licensees in Bankruptcy

*Stephen L. Sepinuck*

In January, the U.S. Court of Appeals for the First Circuit issued a decision that allows both an exclusive distributorship and a trademark license to be wiped out in bankruptcy.<sup>1</sup> The decision therefore creates substantial risk for those entities that pay up front for, or otherwise build their business around, such contractual rights. This article briefly explains the court's decision and then discusses the strategies that transactional lawyers can use to mitigate the risk the decision creates.

### *The Court's Decision*

Tempnology LLC manufactured clothing designed to remain at low temperatures when used during exercise. A number of patents and trademarks supported this enterprise. In 2012, Tempnology entered into a Co-Marketing and Distribution Agreement with Mission Product Holdings, Inc., which granted Mission: (i) the exclusive right to distribute specified Tempnology products in the United States; and (ii) a nonexclusive right to use Tempnology's trademarks. In 2014, Mission exercised its contractual right to terminate the agreement, which meant that its distribution rights and trademark license would expire on July 1, 2016. Ten months before expiration, Tempnology filed a Chapter 11 bankruptcy petition and immediately moved to reject its agreement with Mission.

Section 365 of the Bankruptcy Code allows a bankruptcy debtor to reject an executory contract that, in the debtor's business judgment, is not beneficial to the

debtor. The bankruptcy court granted Tempnology's motion. The court then had to determine what effect rejection had on Mission's distribution rights and trademark license.

Unfortunately, the effect of rejecting an executory contract is one of the enduring enigmas of bankruptcy law. The Bankruptcy Code specifies that rejection constitutes a breach,<sup>2</sup> but beyond that is rather unclear about what this means for the debtor and the debtor's counter-party, particularly with respect to rights that have already been transferred pursuant to the rejected contract.

In 1985, the Fourth Circuit held that the debtor's rejection of a patent license terminated the license.<sup>3</sup> Congress responded by enacting § 365(n), which gives a licensee of intellectual property a choice between treating the license as terminated and asserting a claim for damages or retaining its intellectual property rights under the license. However, Congress defined "intellectual property" to include patents and copyrights, but not trademarks.<sup>4</sup> The negative implication of this amendment is that a licensee of a trademark does not have the right to retain the trademark license if the debtor rejects the license agreement. However, the legislative history indicates rather clearly that Congress did not intend by its enactment of § 365(n) to imply anything about how trademark licenses should be treated.<sup>5</sup>

Six years ago, believing itself unencumbered by the negative implication in the statute's language, the Seventh Circuit ruled that the debtor's rejection of a trademark license does not deprive the licensee of its license rights, and thus the licensee could still sell products branded with the debtor's trademark.<sup>6</sup> The court expressly rejected the Fourth Circuit's reasoning from 1985.<sup>7</sup>

The First Circuit's decision earlier this year in the *Tempnology* case sided with the Fourth Circuit and widened the split among the circuits with respect to trademark licenses. To some extent, the issue reflects disagreement about whether a license of a trademark is a present transfer of property rights (which remains effective even if the agreement is rejected) or merely an executory promise not to sue for infringement (which does not survive rejection of the contract in which the promise is made). The First Circuit implicitly viewed it as the latter. In so doing, it expressly noted that effective trademark licensing requires the trademark owner to monitor and exercise control over the quality of the goods sold to the public under cover of the trademark, and thus

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substantial postpetition services are necessarily involved and relief from the burden of these services is precisely what rejection is designed to achieve.<sup>8</sup>

With respect to Mission's *distributorship* rights, the First Circuit's decision is almost assuredly correct. The whole point of allowing a bankruptcy debtor to reject executory contracts is to relieve the debtor of the burden of continued performance. Tempnology would have had significant duties remaining if Mission retained the exclusive right to distribute Tempnology products in the United States. Regardless of the merits, however, the decision creates a significant problem for companies that contract for trademark licenses or distributorships: those contractual rights might disappear if the grantor of those rights seeks bankruptcy protection.

### *Strategies for Mitigating the Risk*

Some possible strategies for mitigating the risk of vanishing distributorship rights or trademark licenses are unlikely to work. For example, a transactional lawyer might try to protect the distributor or licensee by including in the applicable contract a clause choosing a state within the Seventh Circuit as the state whose law governs and the place for all litigation. However, such a clause will not affect where venue lies for bankruptcy,<sup>9</sup> and thus will have no bearing on the law applicable to the issue.<sup>10</sup>

The transactional lawyer could try to get the debtor to contribute its trademarks and other relevant rights to a special-purpose entity that is unlikely to have creditors, so as to make a bankruptcy filing unlikely. However, few distributors or licensees are likely to have the bargaining power to insist on such a structure. Moreover, under federal law, a registered trademark symbolizes the goodwill of the business to which it relates. Because of this, the owner is permitted to transfer a registered trademark only if the transfer also includes the associated goodwill.<sup>11</sup> While it is possible to make an effective transfer of a trademark without transferring physical assets, this rule would hamper the ability of a trademark owner to put only the trademark in a special-purpose entity, and the trademark owner might have many reasons for not wanting to spin off the line of business to which the trademark relates.

Another possible strategy is to structure the transaction so that it will not be an executory contract, and thus not subject to rejection in bankruptcy. For example, several courts have held that a trademark licensing agreement executed in connection with a sale of a business is not an executory contract because the essence of the transaction is the business sale, and therefore a breach of the licensing agreement would not

be a material breach of the entire transaction that excuses performance by the other party.<sup>12</sup> However, this approach would likely require that the licensee pay in full up front, thereby increasing the risk if a court later determines that the contract is executory and can be rejected. Moreover, it would be very difficult to structure a distributorship agreement so that no material duties remained by both parties.

Perhaps the best strategy is to insist that the licensor grant the license (or manufacturer grant the distributor) a security interest to secure the licensor's obligations under the contract. For example, a trademark licensor could grant the licensee a security interest in the trademark and associated goodwill to secure the licensor's obligation to allow the licensee to use the license for the duration of the license agreement.<sup>13</sup> Given that it is usually the *licensee*, rather than the *licensor*, that owes a payment obligation in connection with a trademark license, it might seem strange for a security interest to be granted by the licensor. However, nothing in Article 9 of the UCC requires that the obligation secured by a security interest be a monetary one.<sup>14</sup> There is therefore no legal impediment to having the security interest secure the licensor's obligations. If the licensee had an unavoidable security interest in the trademark license, it would be far more expensive for the licensor to reject the license agreement, thereby making rejection far less likely.<sup>15</sup>

Getting a security interest might require the consent of the debtor's existing secured lender, if there is one. To facilitate that, the licensee could agree to subordinate its security interest to the lender's, in return for a non-disturbance agreement in which the lender promises, in the event of default by the debtor, not to interfere with the licensee's rights under the license. As long as the value of the collateral exceeds the sum of the monetary and non-monetary obligations to the lender and the licensee, so that the licensee is not undersecured, this approach would both make it less likely that the licensor would reject the license and provide more sure recompense if licensor did reject the license.

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### *Notes:*

1. In re Tempnology LLC, [879 F.3d 389](#) (1st Cir. 2018).
2. [11 U.S.C. § 365\(g\)](#).
3. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., [756 F.2d 1043](#) (4th Cir. 1985).

4. See [11 U.S.C. § 101\(35A\)](#).
5. See S. Rep. No. 100-505, at 5 (indicating that Congress “postpone[d]” action on trademark licenses “to allow the development of equitable treatment of this situation by bankruptcy courts”). See also *In re Exide Techs.*, [607 F.3d 957](#), 966-67 (3d Cir. 2010) (Ambro, J., concurring) (crediting this legislative history).
6. *Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, [686 F.3d 372](#) (7th Cir. 2012).
7. See also *Exide Techs.*, [607 F.3d at 965-68](#) (Ambro, J., concurring) (expressing disagreement with the Fourth Circuit on this issue).
8. [879 F.3d at 402](#). Although the court did not so indicate, it might matter if the license is exclusive or nonexclusive. A nonexclusive license looks more like a promise not to sue whereas an exclusive license seems to more closely resemble a present transfer of property rights.
9. See [28 U.S.C. § 1408](#).
10. Moreover, even though the Court of Appeals for the Seventh Circuit ruled that a trademark licensee’s rights survive rejection by the bankrupt licensor of the trademark license agreement, that does not mean the court would rule that distribution rights would also survive rejection of the executory contract that granted them. Consequently, even within that circuit, bankruptcy courts might well conclude that such distribution rights can be lost.
11. See [15 U.S.C. § 1060](#).
12. See, e.g., *In re Interstate Bakeries Corp.*, [751 F.3d 955](#) (8th Cir. 2014); *In re Exide Techs.*, [607 F.3d 957](#) (3d Cir. 2010).
13. The licensee should, of course, perfect that security interest. Perfection of a security interest in a trademark is accomplished by filing a financing statement in accordance with Article 9, not by filing in the Patent and Trademark Office. See *Trimarchi v. Together Dev. Corp.*, [255 B.R. 606](#) (D. Mass. 2000).
14. The term “secured obligation” is used in several provision of Article 9. See §§ 9-102(a)(4), (67)(C), 9-109(b), 9-207(c)(2), 9-208(a), 9-209(a)(1), 9-618(a)(1), 9-616(a)(3), (4), 9-628(c)(2), (e). Although most of these uses seem to presume that the obligation is a monetary one, nothing in the UCC so limits it and the term itself is undefined. Indeed, the term “obligor” is defined sufficiently broadly to include a person with no monetary obligation at all. See § 9-102(a)(59). Moreover, the drafters did expressly limit some types of collateral to a “monetary obligation,” see § 9-102(a)(2), (11), (46), (47),

(61), (65) (defining “account,” “chattel paper,” “health-care insurance receivable,” “instrument,” “payment intangible,” and “promissory note,” respectively), so they knew how to be restrictive in this manner when they thought it desirable to do so.

15. Instead of having an unsecured claim for damages, the licensee would have a secured claim for damages.



## Recent Cases

### SECURED TRANSACTIONS

#### *Attachment Issues*

*ARA Incorporated v. City of Glendale*,  
[2018 WL 1411787](#) (D. Ariz. 2018)

Because Minnesota law does not require an explicit after-acquired clause when the collateral is rotating collateral such as accounts, a factoring agreement that granted the factor a security interest in “all accounts” of the debtor and which defined “Accounts Receivable” to include accounts “arising . . . from time to time” was sufficient to cover accounts acquired after execution of the agreement.

#### *Perfection Issues*

*In re The Feed Store, LLC*,  
[2018 WL 1320168](#) (Bankr. N.D.W. Va. 2018)

A secured party whose filed financing statement was erroneously assigned the same instrument number as another filing, and hence was not properly indexed, was nevertheless perfected. The rule treating a mis-indexed financing statement as effective to perfect does not deprive searchers of constitutionally required notice.

*In re Community Home Financial Services, Inc.*,  
[2018 WL 1146271](#) (Bankr. S.D. Miss. 2018)

A secured party that obtained an assignment of mortgage loans represented by instruments that were in the possession of a law firm acting as custodian for the assignor was not perfected by possession because the Custodial Agreement identified the law firm as the agent of only the assignor, not the assignee/secured party. The secured party was not perfected through possession of a bailee because the law firm never acknowledged that it held the instruments for the secured party. Although a perfected security interest that is assigned normally remains perfected under § 9-310(c), that rule can be and was varied by agreement because the secured party’s

principal stated the name on the lockbox, custodial agreement, and all other documents should be amended, but he not follow through.

### **Priority Issues**

*S & H Packing & Sales Co. v. Tanimura Distrib., Inc.*,  
[883 F.3d 797](#) (9th Cir. 2018) (en banc)

Contrary to a prior ruling of a panel, a commercially reasonable factoring agreement by a buyer of produce removes accounts receivable from the PACA trust without breaching the trust only if the factoring transaction is a true sale; a security interest in accounts that is granted to secure a loan is, even if perfected, inferior to the rights of the PACA trust beneficiary. In distinguishing a true sale of accounts from a loan secured by accounts, the threshold question is whether the seller retained the risk of loss. If so, the transaction is not a sale.

### **Enforcement Issues**

*Melrose Credit Union v. Soyferman*,  
[2018 WL 1004988](#) (N.Y. Sup. Ct. 2018)

Because the debtor failed to pay a balloon note when due, the secured party was entitled to summary judgment on the issue of default despite the debtor's affidavit describing his efforts to refinance the debt. The debtor's defense of waiver, based on the secured party's acceptance of partial payment after default, did not create a triable issue because the note expressly provided that, even if the holder did not require full payment upon default, the holder "will still have the right to do so if I am in default at a later time."

*Missouri Credit Union v. Diaz*,  
[2018 WL 707445](#) (Mo. Ct. App. 2018)

A secured party failed to comply with a Missouri statute that requires notification of the debtors' right to cure because the notification sent listed a "Loan Amount," a "Payment Amount," a "Payoff Amount," and a "Past Due Amount," and then stated that the debtors cure the default by paying the "Current Due Amount (above)," which was in fact never identified, and thus it failed to conspicuously advise the debtors of the amount which must be paid to cure the default. The secured party also failed to send to consumer debtors a proper surplus/deficiency explanation under § 9-616 because the explanation sent, after stating the current amount of the deficiency, referred only to a single circumstance that would alter the deficiency balance in the future – the accrual of interest at the rate of \$1.27 per day – when in fact the deficiency was reduced by a GAP refund and an extended warranty rebate, and increased by a detail fee and attorney's fees.

*Magnolia Financial Group v. Antos*,  
[2018 WL 1089971](#) (E.D. La. 2018)

Summary judgment was not appropriate on whether an account debtor that continued to pay the debtor after being instructed by the secured party to make payment directly to the secured party had discharged its obligation. The account debtor had requested proof of the assignment before making payment and while the secured party had provided a copy of the note and security agreement, the account debtor demanded a court order acknowledging the secured party's right to payment. Because the assignment was not effective until the debtor defaulted, the request for proof of default was a request for proof of the assignment, and the reasonableness of the request remained in dispute.

### **Liability Issues**

*Tracy v. Minne*,  
[2018 WL 835387](#) (N.D. Ind. 2018)

Minority owners of a business stated a claim against the business's president for violation of fiduciary duty by alleging, in part, that the president claimed a security interest in corporate assets despite the fact that the security agreement was signed by the vice president and the corporate bylaws require all instruments to be signed by the president unless otherwise provided by the board of directors.

## **BANKRUPTCY**

*Merit Management Group, LP v. FTI Consulting, Inc.*,  
[138 S. Ct. 883](#) (2018)

The protection from avoidance for settlement payments by or to a financial institution does not protect a transfer that is conducted through a financial institution that is neither the debtor nor the transferee, but merely a conduit. Thus, when determining whether the protection for settlement payments saves from avoidance a transfer conducted in several stages, courts must look at the whole transfer that the trustee seeks to avoid, not at each of its stages. Accordingly, a settlement payment the debtor made for the purchase of securities, which was handled by a bank as an escrow agent, was not protected and could be avoided as a fraudulent transfer to the seller of the securities.

## LENDING &amp; CONTRACTING

*HSBC Bank USA v. Buset*,

[2018 WL 735265](#) (Fla. Dist. Ct. App. 2018)

The fact that a promissory note was secured by and referenced a mortgage that purportedly limited transferability did not prevent the note from being negotiable because the note did not incorporate the terms of the mortgage.

*Foursome Properties, LLC v. Rite Aid of Kentucky, Inc.*,

[2018 WL 1439830](#) (Ky. Ct. App. 2018)

The trial court did not err in ruling that a lease that provided that “the Landlord shall not, either directly or indirectly, . . . authorize or permit the operation of any other . . . pharmacy” should be interpreted to restrict not only the landlord, but also the landlord’s owners and their other entities, in part because the clause included an express exception for a tenant of one of those other entities.

*NY Capital Asset Corp. v. F & B Fuel Oil Co.*,

[2018 WL 1310218](#) (N.Y. Sup. Ct. 2018)

A transaction purporting to be a sale of \$87,000 of future receipts for \$60,000 was a true sale, not a loan, and thus not subject to state usury law, because the buyer took the risk that future receipts would be less than \$87,000, the agreement did not have a finite term, and the agreement contained a reconciliation provision that allowed the seller to seek an adjustment to the amounts paid daily based on its actual cash flow.

*In re Rienzi & Sons, Inc.*,

[2018 WL 1157821](#) (E.D.N.Y. 2018)

A bankruptcy debtor’s court-approved stipulation that modified a confirmed plan to resolve a dispute about a secured creditor’s entitlement to attorney’s fees, and which provided that if the debtor failed to make specified other payments by February 28, 2017, then the debtor would “owe” \$186,000, did not mean that the debtor had to pay that amount on March 1. There is a difference between “owing” and “paying,” and the debtor was instead obligated merely to pay the amount over the life of the loan.

■ ■ ■

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