Bankruptcy law in trademark tangle

What can Tae Bo teach us about the intersection of trademark and bankruptcy law? **Miguel Ruiz** of Milbank, Tweed, Hadley & McCloy LLP investigates

In March, the Supreme Court declined to take up Tae Bo and denied certiorari in *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc. et al.*, No. 08-463 (March 23, 2009). Justice Kennedy filed a dissenting opinion, joined by Justice Breyer, stating that even though a circuit split exists on an important issue of bankruptcy law, this was not the appropriate case to determine the matter as the court does not wish to resolve the "antecedent questions" of "trademark-protection principles." (Id. at 3). The denial of certiorari was unfortunate because lower courts have taken varied approaches to the antecedent trademark questions, resulting in a lack of clarity regarding the current state of the law. This article addresses both the bankruptcy and trademark issues at the heart of *N.C.P. Marketing Group*, and thus attempts to gives practitioners the lay of the land in this increasingly important cross-disciplinary issue.

Warm-up

Before discussing *N.C.P. Marketing Group*, here is a brief introduction to the relevant bankruptcy background. When a company files for Chapter 11 bankruptcy, it becomes a "debtor in possession," an entity legally separate from the company that retains possession and control of the business. During this reorganisation, section 365 of the Bankruptcy Code allows a debtor in possession to "assume or reject" any executory contract of the debtor. In this context, to assume a contract is to assume the responsibilities and benefits of the contract whereas to reject the contract gives the debtor-in-possession the power to excuse itself from performing under the contract.

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The Bankruptcy courts define an "executory contract" as a contract in which both the debtor and another party have remaining obligations under the contract. For example, a rental agreement is an executory contract because the tenant must continue to pay rent and the landlord must provide the property. Intellectual property licenses are also executory contracts because the licensee typically pays royalties or has other conditions of using the licence, and the licensor agrees not to claim infringement against the licensee's use of the intellectual property.

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This situation particularly applies to trademarks, as the Lanham Act explicitly prohibits the “assignment in gross of a mark.” Thus, to avoid potentially nullifying their mark, trademark licensors oblige themselves to maintain “quality control” over the licensee’s use of the mark.

In re *N.C.P. Marketing*

With that background in mind, let’s consider Tae Bo, the total boxing fitness system. Billy Blanks, the creator of Tae Bo, formed BG Star Productions with his wife, and the company owns the trademark rights to Tae Bo and all affiliated marks. *In re N.C.P. Mktg Group, Inc.*, 337 B.R. 230, 232 (Bankr. D.Nev. 2005). In 1999, N.C.P. Marketing Group and BG Star entered into a licensing agreement for N.C.P. Marketing to begin selling Tae Bo videos and after some disputes regarding the scope of that arrangement, entered into the licensing agreement at issue in 2001. (Id).

After failing to pay the required royalties, BG Star sought arbitration and obtained a 2.1 million dollar judgment. Unable to pay the amount, N.C.P. Marketing Group filed for Chapter 11 bankruptcy. (Id. at 233.) In bankruptcy, N.C.P. Marketing Group claimed that it was the owner of the Tae Bo trademarks. BG Star disagreed, and filed a motion to reject the non-exclusive trademark licence. Recognising that this was a matter of first impression, the bankruptcy court analysed the issue by comparing trademarks to patents and copyrights, and ultimately found that N.C.P. Marketing Group could not assume the Tae Bo licence agreement because it was unable to assign the license agreement. (Id. at 235-37.)

N.C.P. Marketing Group appealed to the 9th Circuit, which affirmed the bankruptcy Court’s decision. See *N.C.P. Mktg. Group, Inc. v. B G Star Prod. (In re N.C.P. Mktg. Group, Inc.)*, 279 Fed.Appx. 561 (9th Cir. 2008). Unwilling to let the session cool down, N.C.P. Marketing Group took one more shot and appealed to the Supreme Court.

N.C.P. Marketing Group asked the court to consider the case because of a circuit split regarding the application of an exception permitting debtors in possession to assume executory contracts in certain limited circumstances. Section 365(c) prohibits a debtor in possession from assigning an executory contract where “applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession.” Courts have approached this test in different ways.

In N.C.P. Marketing Group, the bankruptcy court applied the “hypothetical test,” which means that if the applicable law prevents the debtor from assigning the executory contract to a third-party, then the section 365(c)(1) exception applies, and the debtor in possession cannot assume the executory contract. This is the approach also followed by the 3rd, 4th, and 11th Circuits. *See In re Sunterra Corp., 361 F.3d 257* (4th Cir. 2004); *In re James Cable Partners, L.P., 27 F.3d 534* (11th Cir. 1994) (per curiam); *In re West Electronics, Inc., 852 F.2d 79* (3rd Cir. 1988).

While closely aligned with the text of section 365(c)(1), Justice Kennedy noted that detractors of the test have criticised it for two policy reasons. The first is that this test unfairly hinders companies who have no interest in assigning any of these licenses, but rather need them for reorganisation, the whole purpose of bankruptcy. The second reason cited is that it may provide a windfall to the non-debtor parties. For example, if Company A issued a licence to Company B and in subsequent years, the value of the licence has increased such that the licence is now worth more than consideration that Company B paid for the licence. If Company B were to enter bankruptcy, Company A could reclaim its licence and sell that licence for a higher value, thus creating a windfall for Company A.

Instead of this “hypothetical test,” the First Circuit and several bankruptcy courts have applied an “actual test,” declining to apply Section 365(c)(1) in cases where the debtor in possession will assume the contract for itself and not actually assign it to a third party. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir.1997); *Texaco Inc. v. Louisiana Land and Expl. Co.*, 136 B.R. 658, 668-71 (M.D.La.1992); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 231-33 (Bankr.D.Neb.1996); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 362-63 (Bankr.M.D.Fla.1994); *In re Fastrax*, 129 B.R. 274, 277 (Bankr.M.D.Fla.1991); *In re Hartec Enters., Inc.*, 117 B.R. 865, 871-73 (Bankr.W.D.Tex.1990), *vacated on other grounds*, 130 B.R. 929 (W.D.Tex.1991).

However, as both Justice Kennedy and the 9th Circuit note, such a test conforms to sound policy at the expense of the plain reading of the text. See N.C.P. Marketing Group, 08-463 at p. 3; *In Re Catapult Entertainment, Inc*, 165 F.3d 747, 751-52 (9th Cir. 1999).

This circuit split has existed for several years without Supreme Court intervention, and it is unclear which view will ultimately prevail. The majority of circuit courts that have weighed in on the issue and the plain text favour the hypothetical rule. However, the actual test seems to be more common in bankruptcy courts located in circuits that have not yet ruled on the issue.

Blanking on the trademark issue

The issue that Justice Kennedy appeared reluctant to answer is whether trademark licences are assignable under the Lanham Act. There is very little case law on this issue, so first it is helpful to explore how courts treat other forms of intellectual property.

Non-exclusive v. exclusive licences

In looking at a licence for copyright and patents, courts have focused on whether the licence was exclusive. Without an agreement to the contrary in the licence, a non-exclusive licence to a patent is a personal licence and not assignable in bankruptcy. *See e.g. In re Catapult*, 165 F.3d at 751. On the other hand, an exclusive patent licence is generally a freely-transferable property right. As such, section 365(c) would not prohibit a debtor in possession from assuming an exclusive patent licence. Note, however, that a bankruptcy court in Arizona expressly held the opposite, finding that such a system “would create a situation where a patent holder loses control over the identity of its licence holders whenever the licence agreement provides a licensee with an exclusive right. Such a result, which effectively treats the grant of an exclusive license as the equivalent of an

outright assignment of the patent, is inconsistent with federal law." *In re Hernandez*, 285 B.R. 435, 439 (Bankr. D. Ariz. 2002).

Copyright is much the same, as non-exclusive licences are personal and non-assignable. Because an exclusive copyright licence entitles a copyright licensee to all rights under the Copyright Act, including the right to assignment, courts have found that an exclusive licensee of a copyright licence can assign such license under 365(c). S*ee I.A.E. v. Shaver*, 74 F.3d 768, 775 (7th Cir. 1996); *In re Golden Books*, 269 B.R. 311, 318 (Bankr. D. Del. 2001). However, outside of the bankruptcy context, the 9th Circuit has held that an exclusive licensee to a copyright cannot sub-license a licence without consent of the licensor. *See Harris v. Emus Records Corp.*, 734 F.2d 1329 (9th Cir.1984) (applying the 1909 Copyright Act); *Gardner v. Nike*, 279 F.3d 774 (9th Cir. 2002) (applying the 1976 Copyright Act).

The case law

The court in *In re N.C.P. Marketing Group* recognised that the issue was one of first impression in the circuit. (337 B.R. at 235.) The court began by stating that all intellectual property licences are treated in the same fashion, citing *In re Catapult* for the proposition that all patent licences are personal and cannot be assigned under section 365(c)(1). (Id. at 235.) This is a clear misstatement of law, as footnote 3 of *In re Catapult* specifically notes that this "we express no opinion regarding the assignability of exclusive patent licenses under federal law." *In re Catapult*, 165 F.3d at 750 fn. 3 (emphasis in original). From this foundational error, the In re *N.C.P. Marketing Group* court reasoned that since trademark licences should be treated similarly to patent and copyright licences, these trademark licences should be unassignable under section 365(c)(1). (In re *N.C.P. Marketing Group*, 337 B.R. at 235-37).

In comparing trademark licences to copyright licences, the In re *N.C.P. Marketing Group* court's analysis relied heavily on *Miller v. Glenn Miller Productions*, 318 F.Supp.2d 923 (C.D.Cal., 2004), a case involving the likeness and trademark rights of the famous bandleader. Similar to its treatment of copyright in *Harris* and *Gardner*, the 9th Circuit found that "copyright and trademark licensors share a common retained interest in the ownership of their intellectual property - an interest that would be severely diminished if a licensee were allowed to sub-license without the licensor's express permission." *(Id. at 938).* The Miller court based their reasoning on the fact that:

"a trademark owner has an affirmative duty to supervise and control the licensee's use of its mark, in order to protect the public's expectation that all products sold under a particular mark derive from a common source and are of like quality. Licensors who fail to meet this obligation may lose their right to enforce the trademark license. Common sense suggests that if a trademark licensee could unilaterally sub-license a mark without notifying or obtaining consent from the licensor, then a trademark licensor would lose his ability to police his mark, thereby becoming estopped from enforcing his ownership rights vis-à-vis the licensee. Such a result is illogical, undesirable, and at odds with the nature of intellectual property rights." (Id. at 937 (internal citations omitted).)

The only other case to analyse a trademark licence under the Lanham Act was In re *Travelot Co.*, 286 B.R. 447 (S.D.Ga. 2002), a case concerning the CNN trademark. In discussing the impact of section 365(c), the court definitely states that a non-exclusive trademark licence would not be assignable. (Id. at 450.) The court's reasoning was that "the grant of a non-exclusive licences is 'an assignment in gross', that is, one personal to the assignee and thus not freely assignable to a third party. E.g., *Tap Publn's, Inc. v. Chinese Yellow Pages (New York), Inc.*, *925* F.Supp. 212, 218 (S.D.N.Y. 1996); In re Golden Books, 269 B.R. at 310 (addressing patent license)."

Accordingly, a licensor need not accept performance from or render performance to an entity other than the licensee. *(Id.)* Ultimately, the holding of the case centred on whether the licence was perfected in the first case. In discussing these trademark licences, *In re Travelot* made explicit that it was only considering the case of a non-exclusive trademark licence and made no reference to the assignability of exclusive licences. Moreover, the cases cited by *In re Travelot* are not dispositive on these issues, as the court even notes that *In re Golden Books* deals only with patent licences. *Tap Publications* is more similar, but like Miller, deals with the trademark issue outside the bankruptcy context and does not involve exclusive trademark licences.

Other trademark licence cases

A few bankruptcy courts have allowed the transfer of trademark licences, but none focused its analysis on the Lanham Act. One such case arose over a debtor necktie manufacturer who had an exclusive licence to use the "Bill Blass" menswear trademark. *In re Rooster, Inc.*, 100 B.R. 228, 229 (Bankr. E.D.Pa 1989). *In re Rooster, Inc.*, the court did conduct an analysis of whether such a trademark licence fits within section 365(c)(1), but framed the discussion as a question of whether the license violated Pennsylvania personal-services contract law. (*Id.* at 231-35.) In ruling that such a contract did not amount to a personal services contract and could be assigned, the bankruptcy court did not reach whether the contract conformed to the Lanham Act.

Two cases in Florida have allowed franchise agreements (which included trademarks) to be assigned in bankruptcy. *See In re Sunrise Restaurants, Inc.*, 135 B.R. 149 (Bankr. M.D. Fla. 1991); *In re Varisco*, 16 B.R. 634, 638 (Bankr. M.D.Fla. 1981). However, the Florida court in *In re Sunrise Restaurants* did not make a finding of what is the "applicable law" under 365(c)(1) nor did it expressly deal with the Lanham Act or trademarks in general. (See 135 B.R. at 152-53).

Different treatment for trademarks?

The previous cases make clear that courts are taking vastly different approaches to resolving trademark licences. That said, no bankruptcy court has conducted the sort of thorough analysis of trademark licences that courts have undertaken with regard to patent and copyright licences. In addition, no court has examined the assignability of an exclusive trademark licence under section 365(c)(1). However, a threshold questions lingers: should courts should approach trademarks differently? As the Supreme Court notes, there are "fundamental differences" between trademarks, copyrights and patents. *See Sony Corp. of America v. Universal City Studios*, 464 U.S. 417, 439 n. 19 (1984). The government grants copyright and patent protection to encourage creative authorship and invention whereas a grant of trademark protection is to protect the public's expectation regarding the source and quality of goods. (Id. at 429.) In that sense, a trademark is really only the symbol of the goodwill in the business behind the mark, making it more of a personal contract than, for example, a patent licence. Finally, in a more technical point, trademarks do not fall within the definition of Intellectual Property in the Bankruptcy Code. (See 11 USC § 101 (35A)).

On the other hand, the only circuit to examine the issue, the 9th Circuit, doesn't agree. Based on their precedents in *Miller and In re N.C.P. Marketing Group*, the Court found a "common shared interest" between copyright and trademark licensors. Although both courts make detailed and thorough arguments for grouping trademarks in with copyright and patents, it is unclear how much weight other courts will grant their analysis, given that several courts have disagreed with the 9th Circuit approach to copyright licences. Therefore, it is possible that a bankruptcy court may make a similar break with the 9th Circuit over its interpretation of trademark law.

Conclusion and cool-down

Because the case law is still developing in this area, it seems clear that the Supreme Court did not want to take the lead on this issue at the crossroads of trademark law and bankruptcy. However, its refusal to give guidance on these issues means that quite a bit of uncertainty exists for companies licensing their trademarks. Practitioners should be ready to counsel their clients on the circuit split on the issue of the hypothetical test versus the actual test and the arguments and potential risks regarding the assignability of trademark licences.