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Bankruptcy and Trademarked Inventory: Potential Pitfalls for the Asset-Based Lender

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Recent data suggests that the economic headwinds of rising interest rates, inflation, labor shortages, supply chain disruptions and other operational stresses have become more difficult for businesses to withstand.

Commercial bankruptcies over the last several months have increased significantly over similar periods last year. In times such as these, a lender may wish to reassess the relative strength of its loan portfolio. In doing so, special attention should be paid to clients with advances against inventory that is manufactured and/or distributed by the borrower pursuant to a trademark license with a third party, otherwise known as trademarked inventory. Specifically, a lender should consider the potential impact a bankruptcy of either the third-party licensor or the borrower could have on the borrower's continued right to use the licensed trademark and sell the trademarked inventory.

License Agreements

A trademark is a word, phrase, symbol or design, or a combination of words, phrases, symbols or designs, that a person or entity uses to identify and distinguish its goods from goods sold by others. It is a property right which the trademark owner can use itself or license others to use on an exclusive or non-exclusive basis. The terms of the license are typically memorialized in a license agreement between the trademark owner and the licensee. A well-drafted license agreement often addresses such matters as term, territory, scope of use (i.e., the goods on which the trademark may be affixed), royalties, quality control, term and termination, assignability and post-termination rights and remedies.

A lender's diligence should always include a review of the license agreement. Among other items, the lender must understand the scope of the license and determine what rights the borrower may have to sell the trademarked inventory in the event the license expires or is terminated. Unless the lender can obtain an agreement directly with the licensor that provides the lender a direct right to sell trademarked inventory following a default by the borrower under a credit agreement, the lender's recourse against the trademarked inventory could be limited to the borrower's rights with respect to such inventory.

Assuming the borrower abides by the terms of the license agreement, the analysis is straight-forward. The borrower will continue to manufacture and/or distribute the trademarked inventory under the license, the trademarked inventory will be sold and converted into accounts receivable to be collected by the borrower, and the proceeds of those accounts receivable will be used to repay the borrower's obligations to the lender.

But what happens when either the licensor or the borrower is subject to a bankruptcy proceeding? Can the borrower continue to use the licensed trademarks and sell trademarked inventory or can the licensor limit such rights?

Licensor's Bankruptcy

Trademark licenses are generally considered to be executory contracts because both the debtor and non-debtor have material obligations under the contracts that remain unperformed. Section 365 of the U.S. Bankruptcy Code addresses the treatment of executory contracts in bankruptcy. Section 365(a) allows a debtor, subject to court approval, to assume or reject an executory contract, with the bankruptcy court generally approving the debtor's choice under the "business judgment" rule.

For many years, it was unclear what effect a bankruptcy filing by or against a licensor had on the license if the licensor rejected the contract. Decisions in two U.S. Courts of Appeals cases reached opposite conclusions. One federal appellate court held that a licensor's rejection of the contract constituted a breach of the contract but allowed the licensee to continue to use the licensed trademark. Another federal appellate court held a licensor's rejection of the contract rescinded the license and prevented the licensee from continuing to perform under the license. The latter interpretation could be devastating to a borrower whose business relies upon an important license by leaving the borrower (and potentially the lender) with inventory it cannot sell.

The U.S. Supreme Court's 2019 decision in *Mission Product Holdings, Inc. v. Tempnology, LLC* resolved the split in authority among federal appellate courts. Relying on Section 365(g) of the U.S. Bankruptcy Code, the court concluded that the rejection of a license agreement constituted a breach of contract by the licensor with the same effect as a breach outside of bankruptcy. First, the licensor's breach would give the non-breaching party (here, the borrower) a claim for damages against the licensor's estate. The Supreme Court aptly noted this claim would rarely make the borrower whole given that the claim would arise immediately prior to the bankruptcy filing rather than the actual post-petition rejection date. Second, and more importantly, the licensor's rejection of the license did not result in the contract being rescinded. Instead, the licensor's rejection leaves intact the rights the licensee received under the contract, specifically, the right to use the trademarks licensed pursuant to the license agreement in the manner provided under the license agreement.

Given that a license agreement will continue to govern the relationship between the licensor and licensee, a lender's due diligence should include confirming whether the license agreement contains terms regarding the parties' post-default and/or post-rejection rights and, if so, whether they favor the licensor or licensee. Such terms may include, among others:

1. Termination Upon Filing. A licensor might seek to maintain control over its trademark in bankruptcy by including a provision allowing the licensor to terminate the license if the licensor is subject to a bankruptcy proceeding. Any such right would be extremely detrimental to the licensee (and its lender) if the termination right is absolute and does not afford the licensee the ability to dispose of trademarked inventory in existence at the time of termination.

2. Wind Down Period. License agreements frequently contain a wind down period which allows the licensee to use the licensed trademarks to sell trademarked inventory after expiration or termination of the license. A lender should confirm whether such a period exists following a breach of the license agreement by the licensor. Although a wind down period removes some of the concerns that would exist upon termination, a lender also should confirm whether the wind down period is adequate for the borrower to sell all trademarked inventory within the time period contained in any appraisals received with respect to such inventory.

The existence of these terms (or lack thereof) is only a starting point. Ultimately, a lender should also consider if a credible risk of bankruptcy exists due to the licensor's financial condition and reassess that risk periodically if circumstances change. Only through proper due diligence and periodic monitoring can a lender adequately address the risk and effect of a bankruptcy and take appropriate precautions under its financing agreements with the borrower in respect of advances made against trademarked inventory.

Borrower's Bankruptcy

The executory nature of trademark licenses can also impact a borrower's rights when the borrower is subject to a bankruptcy proceeding. A lender should understand the treatment of the executory license in bankruptcy when the lender is considering whether to exercise remedies against collateral consisting of trademarked inventory following the borrower's bankruptcy or to provide debtor-in-possession financing during a bankruptcy proceeding.

Section 365(a) of the U.S. Bankruptcy Code allows a borrower, with court approval, to assume an executory contract. Section 365(f) allows a borrower, also with court approval, to assign an executory contract to a third party. These general principles are both subject to Section 365(c), which provides:

"The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if:

(1)(A) 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, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment …"

Many courts assessing executory trademark and other intellectual property licenses consider the reference to "applicable law" in Section 365(c) to include federal common law. Under federal common law, courts have held that the right to use intellectual property under a non-exclusive license is personal to the licensee and, as such, cannot be assigned absent the consent of the licensor.

Federal courts interpreting the language of Section 365(c) have developed three unique tests to determine whether a licensor must consent to a licensee's assumption of an executory license agreement in bankruptcy. Each test reaches a different conclusion and casts uncertainty on how a trademark license will be treated in a bankruptcy of the borrower depending on the court in which the bankruptcy proceeding is pending. Unfortunately, the U.S. Supreme Court has not (as of yet) granted review of a case to establish a single rule to apply to all federal courts. The three tests are:

1. The Hypothetical Test. The "hypothetical" test provides that a debtor can neither assume nor assign an executory contract, such as a license agreement, without the consent of the counterparty (here, the licensor). Courts adopting this approach look to the language in Section 365(c) which addresses the ability to "assume or assign" an executory contract. Either the assumption or assignment of the contract will trigger the licensor's consent right. It is commonly referred to as the "hypothetical" test because it applies to the assumption of the contract whether or not the debtor actually intends to assign the contract to a third party. The U.S. Court of Appeals for the third, fourth, ninth and 11th circuits have all adopted this test. These appellate courts cover a large portion of the United States, including most of the eastern (Pennsylvania to Florida) and the western (Arizona and Montana westward to the Pacific coast) parts of the country.

2. Actual Test. The "actual" test reads Section 365(c) differently. It provides that an executory contract, such as a license agreement, cannot be assumed if the debtor actually intends to assign the contract to a third party, such that the licensor would be required to accept performance from a party other than the debtor with whom it originally contracted. It does not restrict the assumption by the debtor-in-possession. The U.S. Court of Appeals for the first and fifth circuits, as well as multiple bankruptcy courts in other circuits, have adopted this test. These appellate courts cover the remainder of the eastern United States (Maine to New York) as well as Texas, Louisiana and Mississippi.

3. Footstar Test. The "Footstar" test arises from a decision of the U.S. Bankruptcy Court for the Southern District of New York. This test permits an executory contract, such as a license agreement, to be assumed by the debtor-in-possession but not a bankruptcy trustee. Unlike the two prior tests, the Footstar court focused on the use of the word "trustee" (and not "debtor-in possession") in the text of Section 365(c). No consent of the licensor would be needed if the trademark license is assumed by the debtor-in-possession in bankruptcy, but consent would be needed if the trustee were the assuming party. The "Footstar" test has also been adopted by the U.S. Bankruptcy Court for the District of New Mexico.

Suggestions Due to Nonuniform Authority

The disparate approaches across courts can pose a risk to both borrowers and lenders with respect to the status of trademarked inventory. If the court administering a borrower's bankruptcy follows the "hypothetical" test, the borrower could be prevented from manufacturing and selling trademarked inventory post-bankruptcy unless the licensor consents to the borrower's assumption of the license in bankruptcy. To mitigate this risk, a borrower could seek to negotiate provisions into its license agreement with the licensor that:

- Prevent the licensor from terminating the license in a Chapter 11 bankruptcy so long as the borrower, as debtor-in-possession, continues to perform under the agreement,

- Permit the debtor-in-possession or trustee to assume the license in a Chapter 11 bankruptcy and prevent the licensor from relying upon Section 365(c) of the U.S. Bankruptcy Code to prevent such assignment, and/or

- Permit assignments by the borrower to a third party.

Whether these provisions can be negotiated will depend on the relative negotiating power of the borrower and the licensor. From a lender's perspective, absent a clear rule regarding a borrower's ability to assume the license, or the negotiated terms mentioned in this article, an issue may exist in bankruptcy about whether the borrower has the right to continue to sell any existing trademarked inventory or to manufacture additional trademarked inventory. This has the potential to adversely affect a lender's ability to foreclose on existing trademarked inventory given that a court might view the lender's rights to the trademarked inventory to be derivative of the borrower's rights. In addition, if a lender considers providing DIP financing to the borrower in a Chapter 11 proceeding, the borrower's ability to continue to manufacture and distribute trademarked inventory could weigh heavily into whether the borrower's plan of reorganization is viable.

Until resolution of the split among federal courts by the U.S. Supreme Court, there is no easy way to ensure that a borrower can assume or assign an executory trademark license. Although courts that have adopted either the "actual" or "Footstar" tests may provide a benefit to the borrower (and, thereby, the lender), determining whether one or more of the jurisdictions would be appropriate for a voluntary bankruptcy filing can only be determined on a borrower-by-borrower basis. Moreover, in an involuntary proceeding, the borrower (and, thereby, the lender) would be subject to forum selected by the borrower's creditors, which could include the licensor of the trademarks at issue. In short, a lender should embark on its relationship with a borrower with a full understanding of this risk and be aware of the potential downside in the event of a bankruptcy.