

Intellectual Property & Technology Law Journal

February 2013

Eighth Circuit Affirms that Perpetual Royalty-Free Trademark License Was an Executory Contract

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The U.S. Court of Appeals for the Eighth Circuit recently issued an opinion in the first Interstate Bakeries Corporation bankruptcy case (the *Interstate* case) addressing whether a perpetual royalty-free trademark license constituted an executory contract that could be assumed or rejected in bankruptcy. The Eighth Circuit, in affirming the opinion of the district court, concluded that material obligations remained unperformed by the parties on each side of the license and that as a result, it was an executory contract.

Background

On December 27, 1996, Interstate Brands Corporation (IBC), the Chicago Baking Co. (CBC) and Lewis Brothers Bakeries, Inc. (LBB) entered into an Asset Purchase Agreement (the APA) whereby LBB and CBC paid IBC \$20 million, plus the assumption of certain liabilities, for IBC's Butternut Bread business operations in the Chicago market as well as the Sunbeam Bread business operations and assets in the Central Illinois market. Pursuant to the APA, IBC granted LBB and CBC a "perpetual, royalty-free, assignable, transferable, exclusive license" (the License) to use the Butternut trademark, and other IBC trademarks, in the Chicago market. At the same time as the execution of the APA, IBC, LBB and CBC executed the License.

On September 22, 2004, Interstate Bakeries Corporation (Interstate) and eight related subsidiaries and affiliates, including IBC, filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code (collectively the Debtors) in the Western District of Missouri.

Interstate did not originally disclose the License as an executory contract in its Bankruptcy Schedules and Statement of Financial Affairs. The first time Interstate disclosed the License was in a November 21, 2008 filing of an amended exhibit to its proposed Plan of Reorganization (the Plan); the filing identified the License as an executory contract that Interstate intended to assume in connection with its Plan. In response, on December 1, 2008, LBB and CBC filed an adversary proceeding against Interstate seeking a declaratory judgment that the License was not an executory contract that could be assumed or rejected under 11 U.S.C. § 365.

On December 4, 2008, Interstate filed a motion to reject the License, and on January 8, 2009, Interstate filed an Answer and Counterclaim to LBB and CBC's complaint which reiterated Interstate's intent to reject the License. Both Interstate and LBB/CBC filed motions for summary judgment in the adversary proceeding; shortly after each side had responded to the other's motion for summary judgment, Interstate filed a notice to withdraw its motion to reject the License and its Counterclaim seeking rejection.

The Bankruptcy Court's Decision

The sole issue before the bankruptcy court was whether the License was an executory contract pursuant to 11 U.S.C. § 365. Section 365 allows a debtor-in-possession to "assume or reject any executory contract or unexpired lease. . . ." ¹ In determining that the License was an executory contract, the bankruptcy court applied the "Countryman Standard," which provides that a contract is executory when "obligations of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing performance by the other." ² The bankruptcy court further held that state law is used to determine if an obligation is indeed material. The License in the *Interstate* case was governed by Illinois law, which provides that a material obligation is an "important or substantial" obligation, the breach of which entitles the non-breaching party to damages. ³

At the outset of its discussion on whether the facts in the Interstate Case lead the License to be categorized as an executory contract, the bankruptcy court noted that the courts that have applied the Countryman Standard generally hold that license agreements are executory contracts under Section 365. ⁴ The bankruptcy court focused the majority of its analysis on the seminal case of *In re Exide Technologies, Inc.*, ⁵ which the bankruptcy court found analogous to the situation before it in the Interstate Case. In *Exide Technologies*, the debtor, Exide Technologies, Inc. (Exide), sold its industrial battery division to EnerSys Delaware, Inc. (EnerSys) and entered into a number of agreements related to the transaction including a license agreement and an asset purchase agreement. Over a decade later, Exide filed for bankruptcy and sought to reject the license agreement as an executory contract. The court in *Exide Technologies* considered the obligations of Exide and EnerSys under the licensing agreement and concluded that both had unperformed, material obligations. ⁶

The bankruptcy court in the *Interstate* case found that IBC and LBB/CBC had similar unperformed material obligations to each other, including quality standards, market-specific restrictions on the use of the trademarks, restraint from suit for using the trademarks, and indemnity provisions. LBB and CBC made a number of arguments to convince the bankruptcy court that the License was not an executory contract, including that certain material obligations were not being actively performed or enforced, that IBC had treated the License as a complete sale internally for tax and accounting purposes and that IBC had waived, or should be estopped from arguing, that the License was an executory contract because the License was not listed as such on its bankruptcy schedules. The bankruptcy court; however, found these arguments unavailing and concluded that the License was an executory contract.

The District Court and Eighth Circuit Affirm

LBB and CBC appealed the bankruptcy court's decision to the United States District Court for the Western District of Missouri. The district court affirmed the decision of the bankruptcy court finding that at least one explicit material obligation remained outstanding – LBB and CBC's promise to maintain the character and quality of the goods sold under the trademark. The district court found the *Exide Technologies* case, which was heavily cited by the bankruptcy court, to be factually similar to the *Interstate* case, but not analogous.⁷ The district court concluded Section 5.2 of the License created a crucial factual distinction between the *Interstate* case and *Exide Technologies*. Section 5.2 of the License stated that “a failure of [LBB/CBC] to maintain the character and quality of the goods sold under the Trademarks...” shall constitute a “material breach”, entitling IBC to terminate the License.⁸ The district court concluded that it did not need to engage in the same materiality analysis of the unperformed obligations that the *Exide Technologies* court undertook because the explicit language of the License acknowledged that that character and quality of the trademark was material and LBB/CBC's obligations in this regard remained ongoing. Like the bankruptcy court before it, the district court determined that LBB and CBC's arguments on the points of waiver, estoppel and sale versus license were unconvincing and affirmed the order of the bankruptcy court.

After the district court's ruling, LBB and CBC appealed to the United States Court of Appeals for the Eighth Circuit.⁹ The Eighth Circuit began its analysis by concluding that the lower courts in the *Interstate* Case were correct in deciding that state law, rather than federal law, was the relevant law to apply in deciding if the License was an executory contract and that the Countryman Standard was the relevant standard for determining if a contract was executory. Additionally, the Eighth Circuit concentrated its attention on Section 5.2 of the License, the same section that the district court had found crucial in its analysis. The Eighth Circuit noted that in *Exide Technologies* the parties did not contemplate or discuss any quality standards and consequently, the Third Circuit refused to conclude that such an obligation was material; whereas in the *Interstate* case, the quality standards were explicitly set forth as a material obligation in the License. Furthermore, the Eighth Circuit held, that in addition to LBB and CBC having unperformed material obligations under the License, IBC had its own unperformed material obligations, including: notice and forbearance related to the trademarks, as well as maintaining and defending the trademarks and other infringement related obligations. Finding that both sides to the License had at least one unperformed material obligation, the Eighth Circuit affirmed the district court's holding that the License was an executory contract

Finally, the Eighth Circuit also rejected LBB and CBC's contention that IBC should be estopped from contending the License was an executory contract because IBC treated the License as part of fully completed sale and IBC did not list the License as an asset on its bankruptcy schedules for the first four years of its bankruptcy. The Eighth Circuit agreed with the district court that LBB and CBC could not establish the first element of an estoppel claim – that a promise was made for sale of the trademarks and that moreover, the Eighth Circuit did not find LBB and CBC arguments regarding the parties' course of conduct to be persuasive in the face of the plain language of the License.

Conclusion

The Eighth Circuit's ruling in the litigation among Interstate and LBB/CBC underscores the importance of diligence when drafting a licensing agreement. Even if the license is perpetual and royalty free and even if it is entered into as part of a larger purchase agreement, the Eighth Circuit will confine its analysis to the specific terms of the license. If provisions in the licensing agreement explicitly detailing a section, provision, or duty are identified as material, and it remains unperformed, that is enough of a hook for the court to conclude that the license is an executory contract, subject to assumption or rejection and related provisions, in a bankruptcy case even if such case is filed over a decade after the licensing agreement is executed.

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¹ 11 U.S.C. § 365.

² *In re Interstate Bakeries Corp.*, 2010 WL 2332142 at *6 (Bankr. W.D. Mo. 2010).

³ *Id.*

⁴ The bankruptcy court mentioned that LBB and CBC did not identify any precedent contrary to its understanding that license agreements generally were considered executory contracts; however, the district court in considering the appeal of the bankruptcy court's ruling, citing *In re Quintex Entm't, Inc.*, 950 F.2d 1492, 1495 (9th Cir. 1991), acknowledged that although trademark license agreements are usually held to be executory contracts, they are not universally accepted as executory.

⁵ 340 B.R. 222 (Bankr. D. Del. 2006) *aff'd* *Energys Delaware, Inc. v. Exide Technologies, Inc.* 2008 WL 522516, Case No. 02-11125 (D. Del. Feb 27, 2008). Subsequent to the bankruptcy court's decision in the *Interstate* case, but prior to the ruling by the district court and the Eighth Circuit, the United States Court of Appeals for the Third Circuit determined that, counter to the conclusions reached by the bankruptcy court and district court in *Exide Technologies*, the agreement at issue in *Exide Technologies* did not contain at least one ongoing material obligation and thus was not an executory contract. See *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010). The Third Circuit vacated the ruling by the district court affirming the bankruptcy court's holding in *Exide Technologies* and remanded the case to the bankruptcy court for further proceeding consistent with its ruling. *Id.* at 964.

⁶ Factors the *Exide Technologies* court considered in determining that there were unperformed material obligations included: Exide had an obligation to allow EnerSys to use the trademarks covered by the agreement, Exide had a duty not to prosecute EnerSys for use of the trademarks, and Exide was barred from granting licenses to third parties to use the trademarks in the same area as EnerSys. Concurrently, EnerSys was required to maintain certain quality standards while using the trademarks and EnerSys could not use the Exide trademark outside the industrial battery business. Finally, the *Exide Technologies* court noted that EnerSys and Exide had reciprocal indemnity obligations and that these obligations were material to both parties.

⁷ The Third Circuit vacated the district court's decision in *Exide Technologies* prior to the district court in the *Interstate* Case considering the appeal by LBB and CBC of the bankruptcy court's ruling.

⁸ See *In re Interstate Bakeries Corp.*, 447 B.R. 879, 886 (W.D. Mo. 2011).

⁹ *Interstate* filed a second voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code after oral arguments had occurred on the appeal to the Eighth Circuit in this matter. The bankruptcy court in the second *Interstate* bankruptcy case approved the parties' stipulation modifying the automatic stay to allow the Eighth Circuit to issue a ruling on this appeal.