“Universal Rule”: Trademark Licenses Not Assignable in Bankruptcy Absent Express Authorization

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Two fundamental goals of chapter 11 of the Bankruptcy Code are rehabilitating a debtor’s business and maximizing the value of the debtor’s estate for the benefit of various stakeholders. In serving these goals, section 365(a) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor in possession (“DIP”), subject to certain exceptions and the prerequisite to cure defaults and to provide adequate assurance of future performance, to assume and/or assign beneficial executory contracts and unexpired leases and to reject burdensome contracts and leases. U.S. bankruptcy law has long provided for the assumption and assignment of many kinds of executory contracts and unexpired leases without the consent of the nondebtor contracting party, even if the agreement expressly prohibits such assignment.

Section 365(c)(1) of the Bankruptcy Code, however, provides an exception to the general ability of a DIP or trustee to assume and assign executory contracts by providing that such a contract may not be assigned if “applicable law” excuses the nondebtor contracting party from accepting performance from an entity other than the debtor. A ruling handed down earlier this year by the Court of Appeals for the Seventh Circuit in *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011), relied on this “applicable law” exception in laying down a “universal rule” that a trademark license may not be assigned to a third party without the licensor’s consent.

Background

In 2009, clothing firm XMH Corp., formerly known as Hartmarx (“XMH”), filed for chapter 11 protection together with a number of its affiliates, including subsidiary Simply Blue, in Illinois. During the chapter 11 cases, XMH asked the bankruptcy court for permission to sell Simply Blue’s assets to a number of different purchasers.

Among the Simply Blue assets to be sold was an executory contract with another clothing firm, Western Glove Works (“Western”). The Western contract with Simply Blue indicated that Western was a licensee of the trademark “Jag Jeans.” “Jag” is a federally registered trademark owned by Jag Licensing LLC for various items of women’s clothing. The Western contract stated that Western granted Simply Blue a sublicense to sell women’s jeanswear bearing the “Jag” trademark until December 31, 2002. Simply Blue agreed to pay Western a license fee of 12.5 percent of Simply Blue’s net sales of the trademarked apparel during the period in which the contract was in effect. The contract did not prohibit or restrict assignment, nor did it permit it.

The duration of the trademark sublicense was initially only two weeks, as the contract had taken effect on December 17, 2002, but was extended to June 30, 2003. Thereafter, the relationship between the parties, pursuant to a series of agreements, converted to one whereby Simply Blue provided designing, sourcing, marketing, sales, merchandising, and customer services to Western in return for a fee.

Western objected to the assignment, arguing that the contract could not be assigned without its permission. According to Western, “applicable law” under section 365(c)(1) was trademark law because the contract stated that Western was a licensee of the Jag trademark.

Initially persuaded by Western, the bankruptcy court ruled that the sublicense could not be assigned to the purchasers because Western would not authorize the assignment. XMH appealed the decision to the district court. While the appeal was pending, XMH amended the sale agreement with the purchasers to provide that Simply Blue would retain title to the Western contract, but that the purchasers would assume all the obligations Simply Blue had owed to Western under the contract and would receive all the fees to which Simply Blue had been entitled thereunder.

The bankruptcy court approved the amendment to the sale agreement. Western appealed this decision. Meanwhile, the district court, addressing XMH's earlier appeal, granted a motion by the purchasers to be substituted for XMH and then reversed the bankruptcy court's order barring assignment of the contract between Western and Simply Blue, ruling that the trademark sublicense had expired by its terms on June 30, 2003, and remanding the case to the bankruptcy court for further deliberation. The ruling also disposed of the appeal by Western, which then appealed to the Seventh Circuit.

The Seventh Circuit's Decision

In its appeal to the Seventh Circuit, Western maintained that because its contract with Simply Blue included a sublicense to use the Jag trademark, the assignment to the purchasers was impermissible under section 365(c)(1) of the Bankruptcy Code. XMH countered that the sublicense had already expired at the time of the assignment and that section 365(c)(1) therefore did not bar XMH from assigning the agreement to the purchasers.

A three-judge panel of the Seventh Circuit ultimately affirmed the decision of the district court authorizing XMH to assign the Western contract to the purchasers over Western's objection. However, in doing so, the court expressly held that the universal rule with respect to trademarks is that "trademark licenses are not assignable in the absence of a clause expressly authorizing assignment." Specifically, the court explained, section 365(c)(1) prohibits assignment of an executory contract if "applicable law" authorizes the other party to the contract to refuse to accept performance from an assignee, whether or not the contract prohibits or restricts assignment. The Seventh Circuit noted that the term "applicable law" means any law applicable to a contract (other than bankruptcy law) and includes trademark law.

Circuit judge Richard A. Posner took great pains to explain why trademarks are an exception to the general rule that debtors may assume and assign beneficial executory contracts:

> The purpose of a trademark, after all, is to identify a good or service to the consumer, and identity implies consistency and a correlative duty to make sure that the good or service really is of consistent quality . . . . If the owner of the trademark has broken off business relations with a licensee, he cannot ensure the continued quality of the (ex-)licensee's operation . . . . That is why the licensee is not permitted to sublicense the trademark to a seller over whom the trademark owner, having no contract with the sublicensee, will have no control [citations and quotations omitted].

Because the trademark owner is concerned about the quality of the trademarked product, Judge Posner noted, it makes sense to follow a universal rule that a trademark license is not assignable without the owner's express permission.

Applying this universal rule, the Seventh Circuit explained that if the Western contract with Simply Blue still included a trademark sublicense when XMH attempted to assign the contract to the purchasers, the contract was not assignable in light of Western's refusal to consent to the assignment. However, the Seventh Circuit determined that the contract at issue was actually not a trademark sublicense at all, but merely a "service agreement" with a trademark license component, and that the trademark sublicense had expired prior to assignment of the contract.

Outlook

XMH does not represent an abrupt turn in the area of assumption and assignment of trademark licenses under section 365 of the Bankruptcy Code. The ruling is consistent with several bankruptcy-court opinions following the "universal rule" that a trademark license cannot be assigned without the licensor's express consent. The decision is notable, however, as it is the first published opinion on the circuit level regarding the issue, although the Ninth Circuit previously affirmed a similar ruling by a lower court without a written opinion in *N.C.P. Marketing Group, Inc. v. BG Star Prods., Inc. (In re N.C.P. Marketing Group, Inc.)*, 279 Fed. Appx. 561 (9th Cir. 2008).

XMH, therefore, may be viewed as a victory for trademark licensors intent upon preventing assignments without their consent. It remains to be seen how *XMH* will be viewed in other circuits. Regardless, drafters of trademark licenses are well advised to draft an agreement carefully to ensure that it explicitly and unequivocally expresses the parties' intentions and expectations on this point.

XMH is also noteworthy for what it did not address. One issue that did not come to the fore, but has been the subject of considerable controversy in the courts in connection with trademark licenses, is whether Simply Blue, in lieu of assigning the agreement, could have assumed and continued performance under the contract with Western as part of its reorganization. There is a split of authority in the courts on this point. Some courts (representing the minority view) apply an "actual test" to a proposed assumption under section 365(c)(1), construing the provision to permit a debtor to assume an executory trademark license if the debtor does not "actually" seek to assign the license to a third party. Other courts (representing the majority view) have adopted a "hypothetical test," interpreting section 365(c)(1) to prohibit a debtor from assuming an executory trademark license under any circumstances if nonbankruptcy law would prohibit assignment absent consent.

In 2009, the U.S. Supreme Court denied certiorari in a case in which the lower court applied the "hypothetical test" to prevent the assumption of a trademark license. However, in denying review, two Justices stated that "[t]he division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization," but "[t]his petition for certiorari . . . is not the most suitable case for our resolution of the conflict."