

In re Interstate Bakeries Corporation: Eighth Circuit Affirms Invalidation of Prepaid, Exclusive Trademark License in Bankruptcy

Acquirors of branded businesses often acquire prepaid, perpetual, exclusive trademark licenses to use the business's trademarks. On August 30, 2012, the U.S. Court of Appeals for the Eighth Circuit ruled that a bankrupt licensor that had granted this type of license may reject the license and cut off the acquiror's right to use the marks.

The case, *In re Interstate Bakeries Corporation*, involved a common fact pattern in merger and acquisition transactions where the buyer acquires a business under an asset purchase agreement and licenses related trademarks under a separate license agreement. One possible implication of the ruling is that buyers of assets may lose their rights to use trademarks related to businesses they acquire if the seller, even many years later, encounters financial distress and becomes a debtor in bankruptcy.

In 1995, Interstate Bakeries Corporation ("IBC") sought to acquire Continental Baking Company, the owner of the Wonder Bread and Hostess brands and trademarks. In an antitrust challenge to the transaction brought by the U.S. Department of Justice, IBC was forced to divest itself of certain business lines as a condition for approval of the transaction. To comply with this requirement, IBC sold its Butternut Bread and Sunbeam Bread business in the Chicago and Central Illinois areas to Lewis Brothers Bakeries ("LBB"). The transaction was documented as an asset purchase agreement with a prepaid, perpetual, exclusive license agreement for the Butternut Bread and Sunbeam Bread trademarks in the Chicago and Central Illinois markets.

In 2004, IBC filed a voluntary Chapter 11 bankruptcy petition. In its proposed plan of reorganization, IBC sought to characterize the LBB license agreement as an executory contract subject to assumption or rejection in the bankruptcy case. A contract is generally classified as executory when the obligations of both the debtor and the non-debtor counterparty are so far unperformed that the failure of either party to carry out those obligations would constitute a material breach excusing the performance of the other. Under the Bankruptcy Code, a debtor is authorized either to assume or reject executory contracts. In the case of trademark licenses, the risk to the non-debtor licensee of rejection of an executory license is that it may lose its right to use the trademark and simply have an unsecured, prepetition damages claim against the debtor licensor.

Concerned about the potential consequences of a rejection, LBB filed an adversary proceeding seeking a declaratory judgment that the license was an integral part of a completed acquisition of a line of business, that the acquisition was fully performed, and that the license was not an executory contract that could be rejected in IBC's bankruptcy. The bankruptcy court entered summary judgment in favor of IBC on the grounds that each party to the license agreement had numerous continuing obligations to take action or to refrain from taking action relating to the trademarks. The district court affirmed the bankruptcy court's decision, relying principally on the fact that the parties expressly acknowledged in a provision of the license agreement that the failure to maintain the quality of goods sold would constitute a material breach.

The Eighth Circuit Court of Appeals, in a two-to-one decision of the three judge panel, affirmed, holding that the licensee's obligations to maintain quality standards in using trademarks and the licensor's obligations to forbear from use of trademarks in the exclusive territory were material obligations that rendered the contract executory and subject to rejection in bankruptcy. In reaching this result, the Eighth Circuit distinguished the decision of the Third Circuit Court of Appeals in *Exide Technologies*, a case in which, on very

similar facts, an exclusive prepaid license was held not to be an executory contract. The Eighth Circuit noted that the quality standards covenant in the license agreement at issue in the *Exide Technologies* case was not enforced by the parties and was deemed by the Third Circuit to be a “minor” obligation. In light of this difference, the Eighth Circuit did not see any inconsistency in holding LBB to the plain language of the license agreement, which specified that failure to maintain quality standards was a material breach that permitted termination of the license.

Writing in dissent, Judge Colloton argued that the majority had focused too narrowly on the license agreement rather than on the entire integrated agreement between the parties, which consisted of both the asset purchase agreement and the license agreement. Viewing these agreements as a single, integrated agreement, the dissent noted that IBC had substantially performed all of its obligations and that a contract under which only a single party owes material obligations cannot be executory.

The *Interstate Bakeries* case is one of two circuit level decisions this summer that have addressed the rights of trademark licensees in bankruptcy. On July 9, 2012, the U.S. Court of Appeals for the Seventh Circuit in a controversial decision that created a circuit split held that the right of a trademark licensee to continue to use licensed trademarks survives rejection of a trademark license in a licensor’s bankruptcy. *See Sunbeam Products, Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012). Although circuits are split on the implications of contract rejection for trademark licensees, the *Interstate Bakeries* case, the dissent in the *Interstate Bakeries* case, and the *Exide Technologies* case provide guidance for structuring and documenting M&A transactions to minimize licensor insolvency risk where licensed trademarks are an important part of a business being acquired.

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