FINANCING TRADEMARKED INVENTORY: CONSIDERATIONS FOR THE ASSET-BASED LENDER

Anthony C. Cianciotti
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* Senior Counsel, McGuireWoods LLP.
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Asset-based loans are a form of secured lending in which the amount of the loan is based primarily on the value and quality of the collateral that the borrower pledges to its lender. These loans typically are based on a borrower’s accounts receivable, inventory, equipment or other asset that can be valued by an independent authority, such as an appraiser. An asset-based lender may be asked from time to time to extend loans to a borrower based on inventory consisting of goods bearing a trademark owned by a third party (“Trademarked Inventory”). This paper examines the issues that arise when the borrower is either a manufacturer or authorized distributor of Trademarked Inventory for the trademark owner (sometimes referred to herein as the “licensor”).

As discussed below, a trademark owner may have the right to preclude the sale of Trademarked Inventory (or claim damages due to any sales) following the termination of a license or distribution agreement, or upon the bankruptcy of the borrower or trademark owner. This right may be based on claims of trademark infringement, breach of contract, or the United States Bankruptcy Code as it pertains to executory intellectual property licenses. Understanding the basis for and scope of the trademark owner’s rights, the potential defenses that a borrower and its lender may have, and the steps that both the borrower and lender can take to address those rights, are essential for a lender to make an informed credit decision as to whether and when to advance funds based on the value of Trademarked Inventory.

I. OVERVIEW: PROTECTED TRADEMARKS

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. For example, the “Polo” trademark, along with the image of a polo player riding on horseback, identifies apparel made by Ralph Lauren, and distinguishes such apparel from that produced by other manufacturers. Under some circumstances, trademark protection can extend beyond words, phrases or symbols to include a product’s packaging or a unique, identifying color. The unique

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1 This paper assumes that the party with whom the borrower has contracted is the owner of the trademark. The analysis would be similar if such party is itself a licensee of the trademark from the trademark owner, and the borrower is a sub-licensee.

shape of a Coca-Cola bottle or the particular blue color of a Tiffany’s box may serve as identifying features.

Trademarks indicate to consumers the source of a particular good. Trademarks also provide consumers with an impression of the quality of the good associated with the mark. Rights under trademarks can arise under common law or state or federal statute. State common law originally provided the main source of protection for trademarks. Protection under state and common law still exists, but protection under those laws may be limited to the locale in which the trademark is used. The Lanham Act is the applicable federal law that provides the mechanism for registering trademarks and bestowing rights on the holder of a federally registered trademark.

A. Types of Trademarks

To qualify as a trademark, a mark must be distinctive so as to identify the source of a particular good. Trademarks are commonly grouped into four categories based on the relationship between the mark and the underlying product: (i) arbitrary or fanciful, (ii) suggestive, (iii) descriptive, or (iv) generic. A mark is afforded the greatest protection if it is arbitrary or fanciful. The level of protection decreases with each successive category, with generic marks not afforded any protection.

Fanciful marks are marks that are invented for use on a product. Examples include “Lexus” for automobiles and “Exxon” for gasoline. Arbitrary marks are marks that exist in vocabulary, but bear no relation to the product on which they are affixed. “Jaguar” automobiles and “Shell” gasoline constitute arbitrary marks.

Suggestive trademarks suggest, rather than describe, the qualities of the underlying product. At the same time, however, the mark is not totally unrelated to such product. In other words, “the exercise of some imagination is required to associate a suggestive mark with the product.” Examples of suggestive marks are “Liquid Paper” for correction fluid and “Roach Motel”

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5 George & Co. LLC v. Imagination Entm’t Ltd., 575 F.3d 383, 394 (4th Cir. 2009).
for insect traps. Like arbitrary or fanciful marks, suggestive marks are inherently distinctive and are given a high degree of protection.

Descriptive marks directly describe a particular characteristic of the product in a way that does not require any exercise of the imagination. They are not inherently distinctive, but instead require a showing of secondary meaning in order to be afforded trademark protection. “Saying that a trademark has acquired secondary meaning is shorthand for saying that a descriptive mark has become sufficiently distinctive to establish a mental association in buyers’ minds between the alleged mark and a single source of the product.” “After Tan” post-tanning lotion and “Holiday Inn” hotels constitute descriptive marks.

Finally, a generic mark describes a product in its entirety, and “neither signifies the source of goods nor distinguishes the particular product from other products on the market.” Unlike distinctive marks, a generic mark is never entitled to trademark protection. For example, the term “oil” is a generic term. Thus, a petroleum company cannot claim an exclusive right to use the term “oil” with respect to its product. Sometimes, however, the distinction between descriptive and generic terms is not entirely clear. For example, the marks “All News Channel” and “Discount Mufflers” have been adjudged to be generic and not entitled to any protection, despite assertions that the marks acquired a secondary meaning.

B. Abandonment

A trademark owner loses its right to enforce its trademark if the mark is deemed abandoned. Abandonment can be unintentional, and occurs when the owner causes or permits the mark to lose its significance as an indicator of

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7 George & Co., 575 F.3d at 394 (citation and internal quotation marks omitted). To determine whether a given term has acquired secondary meaning, courts often look to: (i) the amount and manner of advertising; (ii) the volume of sales; (iii) the length and manner of the term’s use; and (iv) results of consumer surveys. Zatarain’s, Inc. v. Oak Grove Smokehouse, Inc., 698 F.2d 786, 795 (5th Cir. 1983).
8 Retail Servs., 364 F.3d at 538.
the origin of goods or services. This can occur due to a failure to defend the mark or by “naked” licensing of the mark.

A failure to pursue infringers can result in two adverse outcomes. First, if the use of the trademark becomes widespread, then the term could be deemed to be generic and not subject to protection. The terms “linoleum,” “aspirin” and “thermos” were once trademarked terms that have since been declared generic due to widespread usage. Second, if a trademark owner does not take action against an infringing use, then the owner could be deemed to have abandoned the trademark and the “infringing” party may be able to obtain legal rights to it.

Naked licensing involves the licensing of a mark without exercising “reasonable control over the nature and quality of the goods, services, or business on which the [mark] is used by the licensee.” A naked license may be deemed to exist if the license does not contain any quality standards and the licensor does not take any affirmative action to ensure that quality is maintained to such standards. The mark is deemed to lose protection because a trademark is a representation to the public of the quality of the product or service associated with the mark, and the lack of quality controls indicates that there is no consistent standard of quality.

10 Abandonment can also be intentional, namely, when the trademark owner ceases actual use of the mark for three or more years, with no intention of using the trademark again in the future. 15 U.S.C. § 1127 (2006).

11 See, e.g., Cumulus Media, Inc. v. Clear Channel Commc’ns, Inc., 304 F.3d 1167, 1173 (11th Cir. 2002) (holding that “a defendant who successfully shows that a trademark plaintiff has abandoned a mark is free to use the mark without liability to the plaintiff”); California Cedar Prods. v. Pine Mountain Corp., 724 F.2d 827, 830 (9th Cir. 1984) (“The first party to use an abandoned trademark in a commercially meaningful way after its abandonment, is entitled to exclusive ownership and use of that trademark.”).

12 Eva’s Bridal Ltd. v. Halanick Enters., Inc., 639 F.3d 788, 789 (7th Cir. 2011) (quoting RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 33 (1995)).

13 Id. Barcamiatria Int’l USA Trust v. Tyfield Imps., Inc., 289 F.3d 589, 597 (9th Cir. 2002) (holding that licensor of “Da Vinci” mark in connection with wine could not prevent use of “Leonardo Da Vinci” mark by a competitor where the license agreement did not contain any quality control standards and the licensor did not have “any involvement whatsoever regarding the quality of the wine and maintaining it at any level”).
II. BORROWERS THAT MANUFACTURE TRADEMARKED INVENTORY

A. License Agreement Due Diligence

If a borrower manufactures inventory under a trademark license from a third party, its ability to manufacture and sell Trademarked Inventory likely will be governed by the terms of the license agreement with the licensor. So long as the license agreement remains in effect and the borrower is in compliance with the terms thereof, then the licensor will be precluded from bringing a trademark infringement action against the borrower. If, however, the license agreement expires or is terminated, the borrower will lose its ability to use the trademark unless the agreement provides for a period of use after such expiration or termination or the sale of Trademarked Inventory is otherwise permitted by applicable law.

A lender that is asked to extend financing against Trademarked Inventory should review the license agreement to determine its material terms and understand the borrower’s rights and obligations under the license. Items to look for include the following:

- **Licensor**: Is the party named as licensor the owner of the trademark (based on a search at the United States Patent and Trademark Office or other due diligence)?
- **Strength of Mark**: Is the trademark arbitrary or fanciful or has it acquired a secondary meaning?
- **Term**: How long will the license last? Does the period correspond to the term of the proposed credit facility to be extended to the borrower?
- **Territory**: Is the borrower’s right to sell Trademarked Inventory limited by geographic area (e.g., the United States or a specific part thereof)? Has the borrower complied with this limitation?
- **Products**: What products can the borrower manufacture under the terms of the license that incorporate the licensed trademark and how is the trademark affixed? Is it possible to remove the licensed trademark from the product without incurring significant cost or damage to the product?
- **Quality Controls**: What steps will the licensor take to ensure that the Trademarked Inventory is of a quality consistent with that required by the licensor? Have there been any quality control issues during the life of the license agreement?
• Royalties: How are royalties calculated and when are they paid? Is there a minimum royalty requirement? If so, has the borrower exceeded the minimum for each measurement period during the license agreement?

• Financial Covenants: Must the borrower satisfy any financial covenants? If so, has it done so in the past and do its projections indicate that it will satisfy them over the life of the proposed credit facility?

• Assignability: Can the license be assigned by the borrower to a third party?

• Termination: What events will trigger the licensor’s right to terminate the license (e.g., failure to pay royalties; failure to maintain quality controls)? Are there any events that would result in immediate termination (e.g., a bankruptcy is filed by or against the borrower)?

• Cure Rights: Can the borrower cure certain defaults that might otherwise enable the licensor to terminate the license (e.g., payment of minimum royalties)?

• Post-Termination Rights: Does the license agreement allow the borrower to sell Trademarked Inventory after expiration or termination? Does the licensor have the right (or obligation) to repurchase Trademarked Inventory and, if so, how is the purchase price calculated?

The answers to these questions will help determine whether it may be appropriate for the lender to extend financing based on Trademarked Inventory and, if so, the parameters to calculate advance rates associated with such inventory. For example, if the borrower has exhibited quality control issues, a lender may not elect to lend against Trademarked Inventory. As discussed in greater detail below, a sale of Trademarked Inventory that is of insufficient quality can constitute trademark infringement. In addition, the advance rates used with respect to such inventory should take into account the licensor’s right to repurchase inventory (and the purchase price paid), the sell-off period that would otherwise apply, any royalties that may be due to the licensor, and the lender’s overall risk assessment.

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14 An advance rate is the percentage that the lender applies to the value of the inventory to determine the amount of the asset-based loan. Advance rates typically are determined based upon the dollar amount that inventory can yield in an orderly sale of such inventory within a specified period of time, usually within 60–90 days.
the licensor, and, if the licensed trademark can be removed from the Trademarked Inventory, the value of the goods absent the trademark.

An appraiser that is calculating the orderly liquidation value of Trademarked Inventory should also be cognizant of the time period during which the borrower would be able to dispose of the inventory. The liquidation period used by the appraiser should not be longer than the sell-off period provided in the license agreement, and the valuation should be based on such sell-off period. However, such valuation may be adjusted if the licensed trademark can be removed from the Trademarked Inventory without undermining the integrity of the inventory, thereby allowing it to be sold in its altered state without such restrictions beyond the contractual sell-off period.

B. Post-Default Foreclosure Against License Agreement

If the lender’s loans are secured by a blanket security interest in the borrower’s assets, that security interest would include, as a general intangible, all rights that the borrower has under its license agreement. However, there may be occasions where the license agreement restricts assignments or encumbrances without the licensor’s consent. Such restrictions raise questions regarding: (i) the effectiveness of the security interest granted in favor of the lender, and (ii) the lender’s ability to foreclose upon its security interest in the license agreement and continue performance under the license agreement.

The “anti-assignment” provision contained in Section 9-408(a) of the Uniform Commercial Code (the “UCC”) renders ineffective any contractual language limiting the borrower from granting a security interest in the license agreement. That section provides:

[A] term in . . . an agreement between an account debtor and a debtor which relates to a . . . general intangible, including a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the . . . account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the . . . general intangible, is ineffective to the extent that the term:

(1) would impair the creation, attachment, or perfection of a security interest; or

(2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of
recoupment, claim, defense, termination, right of termination, or remedy under the . . . general intangible.15

The provision’s purpose is to give value to the otherwise unassignable rights under license agreements so that debtors can obtain more credit.16 Notwithstanding this objective, Section 9-408(d) severely limits the lender’s rights with respect to the license and Trademarked Inventory produced pursuant to the license. That section provides:

To the extent that a term in . . . an agreement between an account debtor and a debtor which relates to a . . . general intangible or a rule of law, statute, or regulation described in subsection (c) would be effective under law other than this article but is ineffective under subsection (a) or (c), the creation, attachment, or perfection of a security interest in the . . . general intangible:

(1) is not enforceable against the . . . account debtor;
(2) does not impose a duty or obligation on . . . the account debtor;
(3) does not require the . . . account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;
(4) does not entitle the secured party to use or assign the debtor’s rights under the . . . general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the . . . general intangible;
(5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the . . . account debtor; and
(6) does not entitle the secured party to enforce the security interest in the . . . general intangible.17

Based on Section 9-408(d), the secured party cannot “use or assign the debtor’s rights” under the license for the purpose of manufacturing or selling Trademarked Inventory. While seemingly inconsistent with Section 9-408(a), this limitation preserves the licensor’s ability to control which entities may use its intellectual property. As such, the licensor is not required to

15 U.C.C. § 9-408(a) (2012) (emphasis added). U.C.C. Section 9-102(a)(3) defines an account debtor as a person obligated on an account, chattel paper or general intangible. Therefore, the term “account debtor” as used in Section 9-408 can refer to the licensor or the borrower (as licensee), depending on the context.
recognize the grant of a security interest by its licensee to its lender, and can prohibit the lender from foreclosing upon its security interest in the license and the rights running in favor of the borrower in such license. The effect of these restrictions is that the lender cannot rely upon its grant of a security interest in the license as a means to liquidate Trademarked Inventory, but instead must look to some other legal basis that permits its sale.

C. Post-Termination Sale of Trademarked Inventory

1. Licensor Agreement between Lender and Licensor

In light of the restrictions contained in Section 9-408(d), the lender’s best solution is to seek an agreement directly with the licensor regarding the lender’s rights with respect to Trademarked Inventory. By doing so, the lender can address any deficiencies that may exist in the license agreement and afford the lender sufficient time to realize upon its collateral. Common components of a licensor agreement include:

- **Acknowledgment and Consent**: The licensor’s acknowledgment and consent to the borrower’s grant of a security interest to the lender in the borrower’s rights under the license agreement and the Trademarked Inventory.

- **Non-Exclusive License**: The licensor’s grant to the lender of a non-exclusive license to use the licensed trademark in conjunction with the lender’s marketing and sale of any Trademarked Inventory. The license can include both the right to sell finished goods and, if appropriate, convert raw materials and work in process into finished goods.

- **Term**: The parties’ agreement regarding the period of time during which the lender can exercise the non-exclusive license, which ideally should be at least the projected liquidation period as indicated by the underlying appraisal. If possible, the lender should seek to have such period tolled in the event of the borrower’s bankruptcy.

- **Territory**: The parties’ agreement with respect to the territory in which the Trademarked Inventory may be sold.

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18 Weise, supra note 16, at 1094–95.
• **Royalties**: The lender’s agreement to pay royalties at the same rate as provided in the license agreement. If the agreement contains a minimum royalty requirement, the lender might also seek to exclude it from any responsibility to pay such amount.

• **Notice and Cure Right**: The lender should seek the licensor’s agreement to provide notice to the lender of any default by the borrower under, or termination by the licensor of, the license agreement. If the default is curable (e.g., failure to pay royalties by the applicable due date), the lender may also seek to add a cure period during which it has the right to cure such default.

• **Repurchase Right**: If the license agreement contains a repurchase option, the lender may wish to restate the manner in which the purchase price is calculated. If the license agreement does not contain an option, it may be advantageous for the lender to add such a provision to assist in liquidation. In any event, the lender should also require that any amount paid by the licensor to purchase Trademarked Inventory should be at a price that is in excess of the advance rate applicable to the loan extended by the lender to the borrower, that all amounts should be paid directly to the lender, and that all payments should be made without offset against any liabilities that may be owing by the borrower to the licensor (e.g., for past due royalties or other charges).

2. **Lender’s Rights Absent a Licensor Agreement**

A licensor agreement is the preferred approach to ensure the lender can realize upon its collateral, either pursuant to an orderly liquidation or foreclosure sale. However, it may not always be feasible to obtain such an agreement. A licensor may be unwilling to enter into such an agreement, or even if it is willing, the delays, costs, and potential limitations imposed by the licensor may make reaching an agreement prohibitive. In such instances, a lender may rely on the rights granted to the borrower in the license agreement in an orderly liquidation. Once the license agreement has terminated and any sell-off period has expired, the lender would need to fall back on whatever rights may be afforded under applicable law regarding the sale of goods bearing licensed trademarks. The greatest immediate threat to the asset-based lender is the risk that the licensor obtains an injunction that prohibits future sales of the Trademarked Inventory. To protect against this...
risk, a lender should include in its loan agreement with the borrower a
covenant that the borrower notify the lender of any default under the license
agreement or receipt of notice from the trademark owner of its intention to
terminate the license agreement.

The licensor’s ability to obtain injunctive relieve will hinge upon the
application of the Lanham Act in the particular case. Notably, the Lanham
Act does not grant the trademark owner an absolute right to prevent the sale
of Trademarked Inventory. Decisional case law construing the Lanham Act
limits a trademark owner’s right to control the sale of licensed products after
a “first sale” of “genuine goods” has occurred.19 These limitations are
addressed below.

a. First Sale

The “first sale” doctrine provides that the trademark owner’s right to
control the distribution of a product bearing its trademark does not extend
beyond the first sale of its product.20 The doctrine protects the trademark
owner by preventing others from confusing consumers about the origin or
make of a product, which confusion ordinarily does not occur when a
“genuine article” bearing a true mark is sold.21 However, the doctrine also
seeks to preserve competition by limiting the producer’s power to control a
product’s resale after the initial sale. In other words, the first-sale doctrine
provides that “a purchaser who does no more than stock, display, and resell
a producer’s product under the producer’s trademark violates no right
conferred upon the producer by the Lanham Act.”22

When a lender seeks to realize on its collateral, the primary question to
resolve is whether a first sale has occurred. If so, the licensor may be
precluded from bringing an infringement action. Unfortunately, there does
not appear to be any case law addressing whether a lender’s liquidation of

uniformity as to whether both requirements are necessary for a sale to be free of trademark infringement,
although the better reasoned analysis concludes that both criteria must be satisfied to avoid liability under
the Lanham Act.
20 Sebastian Int’l, Inc. v. Longs Drug Stores Corp., 53 F.3d 1073, 1074 (9th Cir. 1995), cert. denied,
22 Sebastian, 53 F.3d at 1076.
collateral runs afoul of the first sale doctrine. Most case law and commentary suggests that sales by a licensee made after expiration of a license agreement (and any subsequent sell-off period provided in the license) constitute infringement by the licensee, although this conclusion is not universal. The case law discussed below highlight the inconsistent application of the first sale doctrine.

*Bill Blass, Ltd. v. SAZ Corp.*\(^23\) involved a dispute between a licensor (Bill Blass) and a licensee that were parties to two separate license agreements, the first of which related to the manufacture and sale of women’s coats and the second of which related to the manufacture and sale of men’s coats. Both licenses had a fixed term which had expired. The license relating to women’s coats provided a three-month sell-off period for previously manufactured inventory following expiration of the license. The license relating to the men’s coats was silent as to the sell-off period. The licensee sold its assets to the defendant after both licenses and the sell-off period for women’s coats had expired. The asset purchase agreement also provided that the defendant assume all of the licensee’s rights and obligations under the license agreements. Bill Blass learned of the continued sale of the licensed inventory despite expiration of the licenses, and sued to enjoin future sales on the basis of trademark infringement.

The U.S. Court of Appeals for the Third Circuit held that the defendant’s sale of trademarked inventory after termination of the license agreements constituted trademark infringement. Due to the expiration of the sell-off period for women’s coats, the court concluded that the sales of such coats constituted infringement. More importantly, the court also rejected the defendant’s argument that it had an indefinite period to liquidate the men’s coats because the license relating to those coats, unlike the license for the women’s coats, was silent as to the sell-off period. The court found that the “far more reasonable construction” was that the licensee under the men’s coat license “undertook the risk that if it kept its inventory at too high a level the inventory might not be sold by the expiration date of the license.”\(^24\) The court also rejected the defendant’s alternative argument that it was a “bona fide first purchaser” of the inventory from the licensee and, under the first sale

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\(^23\) 751 F.2d 152 (3d Cir. 1984).

\(^24\) Id. at 155.
doctrine, was authorized to resell the garments without removing the Bill Blass label.

A similar conclusion was reached by the U.S. District Court for the Southern District of New York in Ryan v. Volpone Stamp Company. That case involved former major league pitcher Nolan Ryan, who had licensed to the defendant the right to manufacture, sell and sublicense numerous products bearing Ryan’s likeness and/or signature. A dispute arose regarding minimum guaranteed payments due under the license agreements, in response to which Ryan terminated the agreements and, through his counsel, informed the defendant that it was no longer authorized to manufacture, sell, distribute or promote any products.

The defendant asserted that the first sale doctrine precluded a finding of trademark infringement with respect to goods manufactured prior to termination of the license, because the goods were not altered and consumers received “exactly what they expected.” The court rejected the defendant’s assertion, instead holding that “[i]f the trademark owner did not approve the original sale, the goods cannot be considered genuine as a matter of law and infringement is established.” According to the district court:

[If a licensee could sell inventory manufactured during the term of the license over an indefinite period after its termination or expiration, the expiration date would have little force or meaning. One can imagine a scenario where a licensee intentionally creates a large surplus and thereby grants to itself a de facto extension of the license. Although Plaintiff does not make such an allegation in the present case, Defendant does not have the right to liquidate its inventory and disregard Plaintiff’s objections, simply because the products were manufactured prior to termination.

Contrary to the conclusion reached in cases such as Bill Blass and Ryan, some courts have held that a first sale after termination of a trademark license is not actionable. In Monte Carlo Shirt, Inc. v. Daewoo Int’l (America) Corp., Monte Carlo contracted with Daewoo for the manufacture of 2,400

26 Id. at 382, relying upon RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 24 cmt. c (1995) (“[t]rademarked goods produced by a manufacturer under contract with the trademark owner are not genuine goods until their sale under the mark is authorized by the trademark owner. Thus, if the trademark owner rejects the goods, the manufacturer may not use the mark in reselling the goods to others.”).
27 Id. at 385. See also FURminator, Inc. v. Kirk Weaver Enters., Inc., 545 F. Supp. 2d 685, 690 (N.D. Ohio 2008) (“Goods are not genuine goods until their sale is authorized by the trademark owner.”).
28 707 F.2d 1054 (9th Cir. 1983).
men’s dress shirts with the Monte Carlo label. Monte Carlo rejected the shirts because Daewoo delivered them too late for Christmas sales. Daewoo, through a subsidiary, sold the shirts to discount retailers without Monte Carlo’s permission. The court held that Daewoo’s unauthorized sale was not a trademark violation under California state trademark law. The court noted that the goods were “genuine,” and that state and federal trademark law requires a “showing of buyer confusion as to the source, origin, or sponsorship of goods,” which was absent in this case. According to the court, “[t]he goods sold by Daewoo were not imitations of Monte Carlo shirts; they were the genuine product, planned and sponsored by Monte Carlo and produced for it on contract for future sale. . . . [T]he absence of Monte Carlo’s authorization of the discount retailers to sell does not alter this.”

Similarly, a California state appellate court in Unzipped Apparel, LLC v. Sweet Sportswear, LLC, relying in part on the Monte Carlo decision, held that infringement did not occur upon a first sale in an action involving the sale of jeans made by a non-licensee former manufacturer. The action involved a fallout between Iconix Brands, owner of the “Bongo” trademark, and Sweet Sportswear, which created a joint venture with Iconix named Unzipped Apparel. Iconix licensed the “Bongo” name to Unzipped, which was managed by Sweet. Sweet subcontracted production of the jeans to an affiliate, Azteca. When the deal soured, Iconix terminated the license, demanded that all sales of the Bongo-branded jeans stop, and began efforts to obtain all Bongo-branded jeans in Sweet’s possession, including those that were in the middle of the manufacturing and distribution process. Sweet ignored the demands and continued to sell all Bongo-branded jeans manufactured by Azteca to all accounts that purchased them, as well as any leftovers due to cancellations or other reasons. According to Sweet, these

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29 The Ninth Circuit subsequently noted in an unpublished decision that because California trademark law is “substantially congruent” to the Lanham Act, Monte Carlo may provide guidance in cases arising under federal trademark law, although it is not binding. Grateful Palate Inc. v. Joshua Tree Imports, LLC, 220 Fed. Appx. 635, 637 (9th Cir. 2007).

30 Monte Carlo, 707 F.2d at 1057–58.

31 2010 Cal. App. Unpub. LEXIS 5127 (Cal. App. July 7, 2010). As an unpublished decision, California rules do not permit the decision to be cited as authority, except when the opinion is relevant under the doctrines of law of the case, res judicata, or collateral estoppel. California Rules of Court Rule 8.1115.
actions were taken to mitigate damages following what Sweet perceived to be a wrongful termination of the license.

Sweet argued that the sale was permitted because the jeans were genuine goods manufactured according to the licensor’s specifications. Iconix, relying on Ryan and similar cases, countered that the genuine goods defense was not applicable where Iconix had not authorized the initial sale. The court failed to apply the first sale doctrine as a basis for prohibiting Sweet’s sales despite Iconix’s demands for the return of the goods. In reaching its decision, the court considered (and ultimate distinguished) case law and commentary supporting the view posited by the court in Ryan, holding:

If the defendant manufacturer were required to prove authorization in order to invoke the genuine goods defense, then manufacturers could never resell rejected or leftover goods when the trademark holder terminates the contract, refuses to pay for the goods, or wrongfully claims that the goods are defective. . . . Defendants’ sale of the Bongo jeans in their possession after the August 5, 2004 termination letter may have been a breach of contract, or it may have been a tort. . . . It may have been unprofessional and mean spirited. It was not, however, trademark infringement.

It is unclear whether the two lines of cases can be reconciled. One possible explanation is that a first sale will be deemed to occur when the licensor first authorizes a private-label manufacturer to affix the mark to the goods on behalf of the licensor, but later revokes its authorization. Whether or not these disparate interpretations can be harmonized, a lender should always take note of the licensor’s and borrower’s conduct surrounding the termination of the underlying license. By doing so, the lender can better analyze whether the facts might support the continued sale of Trademarked Inventory without the specter of trademark infringement. A court may view more favorably post-termination sales of Trademarked Inventory if the licensor’s termination was arbitrary or unauthorized as opposed to an expiration of the term per the express language of the license.

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33 Id. at *190. See also McCoy v. Mitsubishi Cutlery, Inc., 67 F.3d 917, 922 (Fed. Cir. 1995), cert. denied, 516 U.S. 1174 (1996) (licensee could sell knives bearing the licensor’s trademarks after termination of the license agreement when the licensor refused to pay for the knives; court held that licensee had an implied license to sell the remaining inventory because there was “no reason why the owner of intellectual property rights deserves to evade application of the ordinary contract remedy of resale for an unjustified refusal to pay”).
b. Genuine Goods

Even if a first sale has occurred, trademark infringement can also exist if the goods are not “genuine goods.” Issues regarding the genuineness of goods typically arise in either the context of quality control, or when goods have been repackaged or otherwise modified prior to resale.

(1) Quality Control

One of the most important protections afforded by the Lanham Act is “the right to control the quality of the goods manufactured and sold under the holder’s trademark.” Based on this general principal, case law widely supports the conclusion that goods bearing licensed trademarks may not be sold when the licensor has not had an opportunity to confirm whether the goods are of sufficient quality.

For example, in El Greco Leather Products, El Greco contracted with Solemio to manufacture shoes with the “Candie’s” trademark. The contract required an inspection certificate issued by El Greco’s local agent before Solemio could receive payment. El Greco cancelled the last two orders because they were defective. Solemio then sold the shoes to the defendant. The Second Circuit found that the shoes were not genuine and held the defendant liable for trademark infringement. According to the court:

> [o]nce it cancelled the order, El Greco was entitled to assume that Solemio would not dispose of the shoes without either removing the CANDIE’S trademark (as in the custom and practice in the industry), or affording El Greco an opportunity to inspect the goods and certify their quality prior to disposal, or, at the minimum, seeking instructions from El Greco on how to dispose of them.

Other courts have similarly found trademark infringement to exist where the licensor’s quality control standards have not been met or the licensor did not have an opportunity to verify, even in instances involving a sale of the licensed goods in the licensee’s bankruptcy.

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36 Id. at 396.
37 See, e.g., Ford Motor Company v. Cook, 28 U.S.P.Q. 2d 1316 (N.D. Ill. 1993) (court enjoined bankruptcy auction of licensed automobile grilles due to existence of Ford’s quality control procedures that required actual inspection; the grilles sold pursuant to the auction had not been inspected). See also
Indeed, the courts in *Monte Carlo* and *Unzipped Apparel* concluded—*en route* to their holdings that the goods could be sold by the defendants—that sufficient quality control oversight existed such that the goods were “genuine.” In *Monte Carlo*, the licensor rejected the shipment solely because they were delivered late, not because they failed to meet the licensor’s standard of quality. In *Unzipped Apparel*, the court acknowledged that the plaintiff had not presented any evidence that it did not have the opportunity to exercise its quality control rights before the post-termination sale of the jeans, or that a quality control issue existed with any of the jeans.38

**(2) Material Difference**

A variant of the “genuine goods” line of cases involves goods that have been repackaged or modified since the time of their first sale. Trademark infringement can exist if the modified goods are “materially different” than those sold by the trademark owner, such that they generate consumer confusion about the source and quality of the trademarked product. Case law suggests that materiality must be determined on a case-by-case basis.39 This fact-specific analysis has resulted in seemingly inconsistent case law concluding that goods can be materially different even without significant modification, and that significant modification may not result in trademark infringement when the modification is fully disclosed.

The U.S. district court in *Davidoff & CIE, SA v. PLD Int’l Corp.*40 found infringement in resold goods where the packaging for Davidoff Cool Water fragrances had been modified. PLD purchased goods that were intended for sales overseas or in duty-free shops, and sold them to discount retailers for distribution in the United States. Prior to reselling the goods, PLD removed the batch codes from the bottom of the bottles by using an etching tool, which

Mary Kay, Inc. v. Weber, 661 F. Supp. 2d 632, 642 (N.D. Tex. 2009) (infringement when cosmetics were sold that were expired or past shelf life); Shell Oil Co. v. Commercial Petroleum, Inc., 928 F.2d 104 (4th Cir. 1991) (enjoining sale of oil where Shell’s quality control requirements were not observed); Adolph Coors Co. v. A. Genderson & Sons, Inc., 486 F. Supp. 131 (D. Colo. 1980) (enjoining sale of beer that was not stored consistent with Coor’s quality control specifications).

40 263 F.3d 1297 (11th Cir. 2001).
left a small mark on each bottle. 41 Davidoff sued for trademark infringement on the basis that the mark left from the removal of the batch code could create a likelihood of confusion for the consumer, who might think the product had been the subject of tampering. The court found infringement to exist, holding that the removal of the batch code constituted a material difference not protected by the first sale doctrine. Agreeing with the district court, the U.S. Court of Appeals for the Eleventh Circuit held that consumers could conclude that the etchings denoted tampering, and further concluded that tampering with the packaging (and not the product itself) was immaterial to its conclusion. 42

In contrast, there may be occasions where significant changes to the product do not result in trademark infringement, so long as the seller has disclosed the changes made to the product. For example, in Champion Spark Plugs v. Sanders, 43 the defendant collected used Champion spark plugs, repaired and reconditioned them, and resold them as “renewed” Champion spark plugs. The Champion spark plug trademark remained on the plugs and boxes, and the defendant’s name and address did not appear on the boxes. The U.S. Supreme Court held that the defendant’s acts did not give rise to trademark infringement. The court noted that the case dealt with second hand goods which may have inferior qualities, and so long as the trademark owner is not identified with the inferior qualities and the reseller is disclosing that the goods have been reconditioned, “full disclosure gives the manufacturer all the protection to which he is entitled.” 44

Similarly, the U.S. Court of Appeals for the Federal Circuit held in favor of a company that “reconditioned” golf balls in Nitro Leisure Products, L.L.C. v. Acushnet Company. 45 There, the defendant took marred golf balls

41 According to the court, the mark was approximately 1/8 inches long by 1/8 inch wide.
43 331 U.S. 125, 130 (1947).
44 Id. at 130. See also Prestonettes, Inc. v. Coty, 264 U.S. 359, 367–68 (1924) (trademark infringement did not exist where defendant purchased plaintiff’s toilet powders, subjected them to pressure and added a binder, and sold in a metal case; defendant disavowed on its packaging any affiliation with plaintiff and identified to the consumer that defendant had compounded and packaged the product independent from plaintiff).
45 341 F.3d 1356 (Fed. Cir. 2003).
and reconditioned the balls by (i) removing the base coat of paint, the clear coat layer, and the trademark and model marks, (ii) repainting the balls, and (iii) reaffixing the original manufacturer’s trademark. The defendant further labeled each golf ball as “refurbished” with a disclosure of the steps that may have been taken to recondition the balls, as well as that the balls had not been endorsed or approved by the original manufacturer or protected under the original manufacturer’s warranty. The plaintiff, maker of Titleist golf balls, asserted that the described process caused the end product to bear no resemblance to the original product in terms of performance, quality or appearance. Relying upon the Supreme Court’s decision in *Champion*, the *Nitro* court held that “so long as the customer is getting a product with the expected characteristics, and so long as the goodwill built up by the trademark owner is not eroded by being identified with inferior quality, the Lanham Act does not prevent the truthful use of trademarks, even if such use results in the enrichment of others.”46 The court concluded that consumers would not expect the reconditioned balls to perform as well as new golf balls, reaffirming the district court’s conclusion that the repairs to the golf balls were not so extensive so that they could not be labeled with the Titleist mark.

Notwithstanding *Champion* and similar cases, some courts have held that seemingly “full” disclosure can be inadequate to avoid a likelihood of confusion. In *Beltronics USA, Inc. v. Midwest Inventory Distribution, LLC*,47 the U.S. Court of Appeals for the Tenth Circuit found trademark infringement to exist where the defendant sold on eBay radar detectors bearing the plaintiff’s trademarks. Similar to *Davidoff*, the serial numbers had been removed from the radar detectors to avoid identifying the distributors that had sold the products to the defendant in violation of the distributor’s distribution agreement with the plaintiff. The removal of the serial numbers caused the radar detectors to be ineligible for software upgrades, rebates, service assistance, warranties, and recalls. Unlike *Davidoff*, however, the defendant disclosed on eBay that the products did not bear a serial number, that the manufacturer would not honor the warranty if purchased off eBay, and that the defendant provided the purchaser its own one-year warranty. Notwithstanding these disclosures, the court held that the substitute warranty

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46 Id. at 1362.
47 562 F.3d 1067 (10th Cir. 2009).
and the manner in which the defendant disclosed the warranty to the consumer were not sufficient to overcome potential confusion and infringed on the trademark owner’s goodwill.\textsuperscript{48}

A similar result was reached in a case involving sales by Staples, Inc. of Montblanc pens on which the serial number and other markings had been removed.\textsuperscript{49} Unlike Beltronics, however, Staples made extensive disclosures regarding the source of the pens. First, Staples included a disclosure at the display case in which the pens were housed informing consumers that it was not an authorized reseller of Montblanc products. Second, Staples placed a sticker on the bottom of each pen box that described the serial numbers and other marks that were removed from the pen, explained the manufacturer’s service guide and warranty were not included in the package, and notified customers that Montblanc may not honor its warranty if the pens were purchased from Staples.\textsuperscript{50} Notwithstanding Staples’ extensive disclosures, the U.S. District Court for the District of Massachusetts declined to follow \textit{Champion}, instead finding that the disclosures did not address the problem of post-sale confusion by non-purchasers, such as gift recipients. Notably, nothing in the Supreme Court’s decision in \textit{Champion} suggests that the need for full disclosure extends to users beyond the initial purchaser. The absence of any such discussion may indicate that the \textit{Montblanc} decision went too far. Every product can be resold or transferred after its initial purchase and, in each such case, the risk of non-disclosure exists as to each subsequent

\textsuperscript{48} Id. at 1075–76.


\textsuperscript{50} The full disclosure on the box stated: “This package contains one authentic and genuine Montblanc\textsuperscript{®} pen or pencil in the original Montblanc\textsuperscript{®} box, which this store sells at a significant discount to the manufacturer’s suggested retail price. The package does not include the manufacturer’s service guide and warranty, which was placed by the manufacturer in this original Montblanc\textsuperscript{®} box. In addition, a PIX\textsuperscript{®} trademark originally stamped on the inside of the clip, on the central band in the middle of the pen and/or on the Montblanc\textsuperscript{®} refill has been removed. The serial number assigned to the Montblanc\textsuperscript{®} pen by the manufacturer has also been removed. Because the importer, The Alpha Group is not an authorized Montblanc\textsuperscript{®} dealer and because the manufacturer’s service guide and warranty are not included in this package, the manufacturer may not honor its warranty from customers who purchased Montblanc\textsuperscript{®} pens or pencils from this store. This store, however, guarantees everything it sells, including Montblanc\textsuperscript{®} pens & pencils. If you purchase a Montblanc\textsuperscript{®} pen or pencil from us and it malfunctions, simply return it to the store within 30 days in the original box with your sales receipt for a replacement or full refund. Montblanc\textsuperscript{®} is a registered U.S. trademark of Montblanc-Simplo GmbH, PIX\textsuperscript{®} is a registered U.S. trademark of Montblanc, Inc. The Alpha Group and this store are not affiliated with either Montblanc-Simplo GmbH or Montblanc, Inc.” Id. at 241–42.
recipient. If Montblanc were more broadly adopted, it seemingly could swallow the rule created in Champion.51

3. Liability for Infringement and Risks to Lender

a. Injunctive and Monetary Relief

If the borrower’s sale of Trademarked Inventory is not permitted under the license agreement or due to the application of the first sale doctrine, then the licensor would be entitled to both injunctive and monetary relief. Monetary relief may include: (i) the borrower’s profits attributable to unauthorized sales of Trademarked Inventory, (ii) damages sustained by the licensor as a result of such sales, and (iii) the costs of the action. Damages can also be trebled in cases where the licensor has demonstrated the borrower’s bad faith.52

Each of these remedies can have a significant adverse effect on the borrower and its lender. As for the borrower, injunctive relief could impede the borrower’s ability to conduct business going forward if the manufacture and sale of Trademarked Inventory represents a significant part of its business. Monetary damages could also place a financial obligation on the borrower that it is unable to satisfy.

As for the lender, injunctive relief may limit the lender’s ability to realize on the collateral supporting its loans to the borrower. In the most extreme case, Trademarked Inventory may incorporate a trademark that cannot be removed without rendering the inventory unsalable. If

51 Courts also employ the material difference test where the goods are “gray market” goods—goods legally produced for a market outside the United States that are imported and sold in the United States. The goods are found to be “genuine” (and can be resold in the U.S.) if the goods are not materially different from their U.S. equivalent. See, e.g., Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc., 982 F.2d 633 (1st Cir. 1992) (owner of Perugina trademark entitled to injunctive relief where gray market chocolates differed from U.S. chocolates due to higher percentage of milk fat, different packaging, and less-stringent climate-controlled storage); Original Appalachian Artworks, Inc. v. Granada Elecs., Inc., 816 F.2d 68 (2d Cir. 1987) (owner of Cabbage Patch trademark entitled to injunctive relief where re-imported dolls intended for Spanish market differed from U.S. market dolls due to Spanish language packaging, birth certificate, and adoption papers); Zip Int’l Group, LLC v. Trilini Imps., Inc., 2011 U.S. Dist. LEXIS 55270 (S.D.N.Y. May 24, 2011) (granting summary judgment in favor of gray market importer of sunflower seeds; the importation of packaged sunflower seeds intended for non-U.S. markets did not constitute trademark infringement where the product and packaging were identical, notwithstanding the adverse competitive impact suffered by the licensor’s authorized U.S. distributor).

Trademarked Inventory cannot be sold, then the portion of the advances made against the value of such inventory could effectively become an unsecured obligation. In certain cases, it may be possible to remove the licensed trademark. However, the inventory may carry a lesser value in its altered state, and the lender could be undercollateralized if it advanced funds based on the value of the inventory with the licensed trademark. The lender may be able to protect itself by setting an advance rate based on an appraisal that values the inventory with the licensed trademarked removed from the inventory.

b. Contributory Infringement

It is also conceivable that a lender could face a claim for direct liability to the trademark owner as a contributory infringer. The U.S. Supreme Court in *Inwood Laboratories Inc. v. Ives Laboratories, Inc.* set forth the following two-part test for finding contributory liability in the context of trademark infringement: (i) the manufacturer or distributor of the infringing product intentionally induces another to infringe a trademark, or (ii) the manufacturer or distributor continues to supply its product to one whom it knows or has reason to know is engaging in trademark infringement. Since *Inwood*, courts have expanded the concept of contributory infringement beyond manufacturers and distributors. A court now may examine the extent of control the defendant has over the infringing activity or the service provided by the defendant that enables the infringer to engage in the infringing activity.

The expanded contributory infringement standard has been applied to find directly liable entities that have provided services that facilitate the sale of infringing goods, including internet web hosting services, lessors and licensors of real property, and entities assisting in shipping functions. A
lender’s services appear to be of a different character as compared to third parties that provide services that facilitate the sale of infringing goods. Nonetheless, it is plausible that a trademark owner could assert that a lender that has encouraged the borrower to sell Trademarked Inventory after termination of the underlying license as a way to pay down its outstanding obligations has exercised sufficient control over the borrower’s infringing activity to warrant direct liability as a contributory infringer, resulting in joint and several liability with the borrower to the trademark owner.56

c. Constructive Trust in Proceeds of Accounts

A North Carolina state appellate court decision raises the novel proposition that a borrower’s trademark infringement could undermine a secured lender’s lien in accounts generated by the sale of infringing goods.57 The case involved the sale by Prime Apparel to its customer, Variety, of certain goods bearing the “Newport Bay” trademark. After the goods were sold, Quick Response demanded that Variety cease making any payments to Prime Apparel on the basis that Quick Response, and not Prime Apparel, owned the disputed trademark. Variety, unsure of the rightful payee, brought an interpleader action in North Carolina state trial court and asked the court to determine to whom payment should be made. Prime Apparel’s factor, CIT, which had purchased the underlying receivables owing by Variety and made advances against the receivables, claimed it had a superior interest in the payments because it possessed a valid and perfected security interest in such receivables and the proceeds thereof.

At the trial court level, Prime Apparel had failed to respond to various pleadings, resulting in entry of a default judgment against it for trademark owner of the sale of infringing goods on sites hosted by the defendant; defendant had direct control over the “master switch” that kept the websites online but chose not to act); Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc., 955 F.2d 1143, 1149 (7th Cir. 1992) (holding that flea market owner that was “willfully blind” to the sale of infringing goods by vendors on its premises could give rise to trademark infringement); Cartier Int’l B.V. v. Liu, 2003 U.S. Dist. LEXIS 6381 (S.D.N.Y. Apr. 16, 2003) (holding persons that arranged for the shipment of counterfeit goods on behalf of counterfeiters liable based on contributory infringement due to, among other evidence, existence of steady stream of merchandise and payment of shipping charges in cash and C.O.D.).

56 Tighe, supra note 54, at 59.
infringement. The trial court further held that Quick Response was entitled to the proceeds of the infringing sales as damages and that CIT had no interest in such proceeds. On appeal, a North Carolina court of appeals affirmed the lower court’s decision.

With little legal analysis or citation to case law, the appellate court held that Prime Apparel had no right to the goods bearing the Newport Bay trademark or the proceeds from the sale of the goods due to Prime Apparel’s infringement of the trademark. According to the court, Prime Apparel had “no accounts receivable it could pass on to CIT through their prior agreement. Thus, CIT had no security interest in the interpleader funds and [CIT’s] argument must fail.”

Commentators have since labeled the decision as “draconian,” “unorthodox” and “simply wrong.” As of the date of this paper, the decision has not been referenced by any other court. The general consensus appears to be that the court viewed the proceeds from the sale of the inventory bearing the infringing mark as subject to a constructive trust for the benefit of the trademark owner. As one commentator noted in response to the decision:

federal and state law does provide courts with substantial latitude in crafting remedies for trademark infringement violations, some of which may impact an infringing seller’s secured lender. Courts have broad powers to issue injunctions against future infringing sales, to freeze assets during the pendency of a trial and/or to require the infringing party to take certain actions such as accounting for the profits realized.

Nonetheless, most decisions give the trademark holder an unsecured claim for damages, which, contrary to the court’s decision, would not be superior to the interests of a secured creditor.

Whether the decision is wrong or merely an overzealous effort to craft a remedy in light of the default judgment entered by the trial court, it

58 Id. at *6–7.
60 Stein & Grushka, supra note 59.
61 Sepinuck & Adams, supra note 59.
represents a possible outcome in at least one jurisdiction. The risk of such an interpretation reinforces the need for a lender to conduct adequate due diligence before advancing funds based on Trademarked Inventory, including confirmation regarding the owner of the underlying trademark.

III. BORROWERS THAT DISTRIBUTE TRADEMARKED INVENTORY

There may also be instances where a borrower distributes, but does not manufacture, Trademarked Inventory that is sold to it by the trademark owner for resale to third parties. A lender asked to lend against such Trademarked Inventory should undertake due diligence here as well. The borrower may be party to a distribution agreement with the trademark owner. The agreement may grant to the borrower a distribution right that is exclusive or non-exclusive, contain territorial boundaries, and grant to the borrower a license to use the trademark owner’s trademark in connection with the display, marketing and sale of the Trademarked Inventory. A lender should review the distribution agreement to determine: (i) the term of the agreement, (ii) the borrower’s distribution territory, (iii) the borrower’s ability to assign the agreement, (iv) the events that may trigger the termination of the agreement by either the trademark owner or borrower, (v) the right or obligation of the trademark owner to repurchase (or for the borrower to require the trademark owner to repurchase) any Trademarked Inventory upon the termination or expiration of the agreement, and (vi) the ability of the borrower to sell Trademarked Inventory after termination or expiration.

To address any deficiencies in the underlying distribution agreement, a lender may wish to pursue a direct agreement with the trademark owner. The items addressed in such an agreement would be similar to those in the case of a borrower that manufactures Trademarked Inventory, including (i) the territory into which the Trademarked Inventory can be sold, (ii) the lender’s receipt of notice of any default under the distribution agreement and right to cure such default, (iii) the trademark owner’s right to repurchase (or the borrower’s right to require the trademark owner to repurchase) Trademarked Inventory, (iv) the price at which any Trademarked Inventory would be repurchased by the trademark owner, and (v) the payment of the repurchase price directly to the lender, without offset against amounts owing by the borrower to the trademark owner. As noted above, it may not always be possible for the lender to obtain such an agreement due to the trademark owner’s unwillingness, the perceived cost, or the borrower’s concern that
requesting such an agreement might jeopardize its business relationship with the trademark owner. The discussion that follows addresses the lender’s analysis in instances where the lender does not obtain such an agreement.

A. Trademark Concerns

The trademark analysis is more streamlined when the borrower is a distributor, as opposed to a manufacturer. As noted above, a purchaser who merely stocks, displays, and resells a product under the trademark owner’s trademark does not violate the Lanham Act. So long as a first sale has occurred, and the goods are sold in an unaltered state (such that no material difference exists), trademark liability should not attach when the goods are resold.

Whether a first sale has occurred is seemingly a question of contract. The terms of the agreement may provide when title to the Trademarked Inventory passes from the trademark owner to the borrower. If it does, then the contract term is the logical reference as to when a first sale has occurred.62 Assuming that title has passed from the trademark owner to the borrower no later than the time the Trademarked Inventory has been received by the borrower, a trademark owner would be hard pressed to assert that a first sale has not yet occurred after the inventory is in the borrower’s possession.

As noted above, the trademark owner would also have the ability to contest the applicability of the first sale doctrine if the Trademarked Inventory had been repackaged or modified from the state in which it was received. A lender should take steps to confirm that the products the borrower sells have not been altered in any manner, such as splitting the goods into smaller lots or components, or repackaging the goods to meet specific customer needs. Any of these actions potentially could cause the sales to be...

62 See, e.g., Italverde Trading, Inc. v. Four Bills of Lading, 485 F. Supp. 2d 187, 210 (E.D.N.Y. 2007) (holding that a determination whether goods seized by a customs broker were seized after a “first sale” depended on whether title to the goods had previously passed from the licensor-seller to the consignee-distributor); McDonald’s Corp. v. Shop at Home, Inc., 82 F. Supp. 2d 801, 812 (M.D. Tenn. 2000) (plaintiff could not halt unauthorized sale of Beanie Babies toys from franchisee, even if unauthorized by franchisor, when the sale to the franchisee had been authorized and title passed).
subject to claims of trademark infringement if the distribution agreement is no longer in effect.63

It bears noting that at least one court has viewed the post-termination sale by a distributor to constitute trademark infringement, even though the goods were genuine. *Citizens of Humanity, LLC v. Caitac Int′l, Inc.*64 involved an action by Citizens, a manufacturer of jeans, against Caitac, a distributor of Citizens’ jeans in Japan. Citizens alleged breach of contract and trademark infringement where Caitac continued to sell Citizens’ jeans in Japan following Citizens’ termination of its distribution agreement with Caitac due to Caitac’s failure to satisfy minimum volume requirements. The distribution agreement contained explicit terms that precluded Caitac from selling the jeans once the agreement was terminated.

The jury found in favor of Citizens, and a portion of the verdict included more than $2 million in damages reflecting the revenues received by Caitac due to its post-termination sales. The jury allocated this amount solely to the trademark infringement claim. The appellate court affirmed the jury’s verdict, including the dollar amount awarded and its finding of trademark infringement. Citing the *Ryan* decision, the court held that:

> unless a contract specifically permits a posttermination sale of inventory, if a former licensee were permitted to sell off its inventory over an indefinite period of time after termination of the license, the expiration date would have little force or meaning. The licensee could create a large surplus and give itself a de facto extension of the license.65

Following the reasoning of the courts in *Ryan* and *Bill Blass*, the court concluded that Caitac assumed the risk that if it kept its inventory level too high, it might not be able to sell the goods in the event the distribution agreement was terminated.

Viewing this decision in light of the first sale doctrine and the ability to resell unaltered goods, it does not appear that the court in *Citizens v. Caitac* invoked the correct legal basis to find liability. There was no dispute that Caitac had purchased the inventory from Citizens or that Caitac had altered

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63 In addition, a distributor can be liable for trademark infringement if it continues to hold itself out as an authorized reseller or distributor of the licensor’s products once the distribution agreement has been terminated. See infra note 67. In cases where the borrower uses the licensor’s name in its business, this may necessitate that the borrower change its legal or trade name.


65 *Id.* at *19* (citations and internal quotations omitted).
the goods in any manner. As such, the first sale doctrine should have precluded a finding of trademark infringement. A more appropriate basis for assessing liability would have been a breach of the distribution agreement which prohibited post-termination sales of the jeans. Indeed, in another California case involving the same plaintiff that was decided prior to Citizens v. Caitac, the California appellate court appears to have stated the rule correctly:

Once the manufacturer has sold its goods to a distributor, the manufacturer can have no control over the retailers to whom the distributor resells the goods. If the manufacturer wishes to retain this control, it can best do so by means of its contract with its distributors. Even then, the manufacturer’s remedy is generally against its distributor for breach of contract; the manufacturer can only pursue the retailer if the retailer maliciously induced the breach.66

B. Breach of Contract

A lender should determine during the due diligence process the rights available to the borrower after termination and whether those rights include a sell-off period for Trademarked Inventory. If continued sales are restricted, then the borrower’s post-termination sale of Trademarked Inventory may constitute a breach of the underlying distribution agreement and give rise to a claim for damages or injunctive relief.

A distribution agreement can address the borrower’s ability to make post-termination sales in a number of manners. For example, the agreement may prohibit all post-termination sales. Alternatively, the agreement may provide the trademark owner the obligation or right to repurchase Trademarked Inventory, and afford the borrower the ability to sell any Trademarked Inventory not repurchased. In either of these circumstances, it is apparent whether post-termination sales would be permitted. However, the possibility also exists that the agreement is silent regarding the borrower’s ability to sell Trademarked Inventory after termination. This last alternative presents an interesting question regarding the borrower’s rights. Citizens v. Caitac suggests that such sales should not be permitted, relying on the reasoning of the courts in Bill Blass and Ryan. However, the reasoning in

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those cases—that the borrower assumes the risk if it keeps its inventory at too high a level—may not apply where a distribution agreement is at issue.

In both *Bill Blass* and *Ryan*, a first sale had not yet occurred within the meaning of the Lanham Act. In contrast, when Trademarked Inventory purchased by a distributor is resold without alteration, the trademark owner does not have the ability to restrict future sales based on the Lanham Act. If the trademark owner wishes to prohibit future sales, then it is incumbent on the trademark owner to limit such sales in the underlying contract. Absent such a restriction, the borrower’s continued sale of Trademarked Inventory does not breach any contract term. Without the protections of the Lanham Act—which should not apply—there should not be a basis to restrict such sales.

If continued sales are permitted, however, the borrower will likely need to take steps to make clear it is not an authorized distributor. Distribution agreements customarily provide that in the event of a termination, the former distributor may no longer hold itself out as an authorized distributor or use any trademarks of the trademark owner in connection with the promotion and sale of Trademarked Inventory. A borrower that breaches these provisions can be subject to both a breach of contract claim as well as trademark infringement because it is seeking to trade off the trademark owner’s goodwill by suggesting an official association with or endorsement by the trademark owner.67 In light of these provisions, a lender should monitor the post-termination conduct of the borrower to remove references to the trademark owner’s trademarks in its marketing and sale of Trademarked Inventory so as to avoid potential trademark liability.

C. Tortious Interference with Contract

A trademark owner could also attempt to pursue a direct claim against the lender based on tortious interference with contract. “One who

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67 See, e.g., Bel Canto Design, Ltd. v. MSS HiFi, Inc., 837 F. Supp. 2d 208 (S.D.N.Y. 2011) (preliminary injunction granted where defendant, a former authorized distributor of plaintiff’s products, represented itself to be affiliated with and endorsed by plaintiff); Stormor, a Division of Fuqua Indus., Inc. v. Johnson, 587 F. Supp. 275 (W.D. Mich. 1984) (preliminary injunction granted on grounds of trademark infringement where defendant held himself out as an authorized distributor of plaintiff’s storm doors, including use of plaintiff’s promotional literature that had been stamped with the defendant’s name).
intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.68 The elements of a state-law claim of tortious interference typically include:

1. Improper action or wrongful conduct by the defendant without privilege;
2. The defendant acted purposely and with malice with the intent to injure;
3. The defendant induced a breach of contractual obligations . . . and
4. The defendant’s tortious conduct proximately caused damage to the plaintiff.69

Of particular importance are the “malice” and “privilege” elements. Malice exists where the defendant’s conduct arises from an unauthorized interference without legal justification or excuse, or that the defendant acted without privilege or exercise of its own economic interest.70

There does not appear to be any decisional case law involving a claim of tortious interference with contract against a lender seeking to liquidate its borrower’s inventory. However, there is authority that generally supports the view that a lender that is acting to enforce its security interest has a legitimate business purpose whose conduct is privileged.71 These cases may suggest

71 See, e.g., Noble Sys. Corp. v. Alorica Central, LLC, 543 F.3d 978 (8th Cir. 2008) (perfected secured party that foreclosed its security interest was not liable to unperfected secured party for tortious interference with contractual relationship even though it may have known of the unperfected security interest); Energy Acquisition Corp. v. Millennium Energy Fund, L.L.C., 611 F. Supp. 2d 1147, 1165 (D. Colo. 2009) (holding that secured creditor was authorized to hold mortgage pursuant to terms of credit agreement and its failure to release the lien created thereby did not constitute tortious interference); Daimler Chrysler Motors Co., LLC v. Clemente, 668 S.E.2d 737, 753 (Ga. App. 2008) (Chrysler’s use of a financial keeper at troubled dealership was consistent with its rights as a secured creditor and constituted “privilege” that precluded a tortious interference claim by a customer of the dealership); Dalton Diversified, Inc. v. AmSouth Bank, 605 S.E.2d 892, 898 (Ga. App. 2004) (holding that lender’s actions regarding its security interest did not as a matter of law, constitute tortious interference). See also Zachary Newman & Anthony Ellis, Navigating the Nuances of Tortious Interference Claims, ABA SECTION OF LITIGATION B. TORTS J. (Summer 2011) (noting cases holding that lender’s actions against collateral constitute a legitimate business purpose and not “malice”), http://www.hahnhesse.com/uploads/39/doc/2011_06_zgn_ae_navigatingnuances.pdf.
that a lender is privileged when it encourages the borrower to sell Trademarked Inventory in which the lender has a security interest so as to facilitate repayment of the obligations owing by the borrower to it.

Even if not privileged, the trademark owner would also need to establish its damages. Damages are usually measured with respect to injury to the brand caused by a “fire sale” or other disposition where Trademarked Inventory is offloaded into the marketplace. If the borrower sells the product in the ordinary course of business to the same customers, in the same manner and for the same price as before termination of the distribution agreement, then the trademark owner would have difficulty proving that it suffered damages as a result of the borrower’s continued sales, whether or not the lender encouraged such sales. As a result, a lender should monitor the manner in which Trademarked Inventory is sold post-termination and, if possible, support an orderly liquidation.

IV. IMPACT OF BANKRUPTCY ON TRADEMARK LICENSES

The possibility of a bankruptcy of the borrower or the licensor also poses risks to a lender regarding the borrower’s ability to sell Trademarked Inventory after commencement of a bankruptcy proceeding.

A. Effect of Borrower’s Bankruptcy on License

A bankruptcy filing by or against the borrower may limit its ability to assume a pre-existing license agreement based on principles of non-bankruptcy law. 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. 72 Section 365 of the Bankruptcy Code addresses the treatment of executory contracts in

72 The most widely adopted test for determining whether a contract is executory is the “Countryman” test. Under that test, a contract is executory if the “obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.” Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 MINN. L. REV. 439, 460 (1973). Courts regularly find the obligations contained in an intellectual property license (other than the obligation to pay) as sufficient to create an executory contract. Neil S. Hirshman, Michael G. Fatall & Peter M. Spingola, Assignability of Intellectual Property Licenses in Bankruptcy, 21 IPL Newsletter 11, 17 n.50 (Fall 2002), http://www.kirkland.com/siteFiles/kirkexp/publications/2512/Document1/IPLFall02.pdf.
bankruptcy. Section 365(a) allows a debtor, subject to court approval, to assume an executory contract. Section 365(f) allows a debtor, also subject to court approval, to assign an executory contract to a third party. These general principles are subject to Section 365(c) when the contract is an intellectual property license.

Section 365(c) of the Bankruptcy Code provides, in relevant part:

(c) 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 . . . .73

Many courts considering executory intellectual property licenses, have viewed the reference to applicable non-bankruptcy 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.74 The bulk of decisional authority concerns non-exclusive licenses, the argument being that an exclusive license may be more akin to a sale of the underlying intellectual property, causing the license not to be personal in nature. While not entirely clear, an exclusive trademark license could also be deemed personal to the licensee given the quality control aspects that are inherent in most trademark licenses.75

The language of Section 365(c) has resulted in three separate tests employed by federal courts to determine whether a licensor must consent to

75 Hirshman, Fatall, and Spingola, supra note 72, at 17 n.32 (“there are strong arguments that trademark licenses are likely never assignable without the licensor’s consent, because the licensor always maintains its duty to control the quality of the goods and services sold under the licensed mark, whether the license at issue is exclusive or nonexclusive”).
a licensee’s assumption of an executory license agreement in bankruptcy. Each of the tests is discussed below.

1. Hypothetical Test

The Third, Fourth, Ninth and Eleventh Circuits have held that a debtor cannot assume a non-exclusive executory contract where applicable non-bankruptcy law restricts the ability to assign the contract, even if the debtor does not intend to assign the contract. These courts reason that the use of “or” in the references to “assignment or assumption” in Section 365(c) should be read as disjunctive. Therefore, the debtor can neither assume nor assign an executory contract such as a license agreement if the right to assign the contract is limited by applicable non-bankruptcy law. This is commonly referred to as the “hypothetical test,” because the debtor is barred from assuming the license agreement regardless of whether the debtor has any actual intent to assign the contract to a third party.

2. Actual Test

The First and Fifth Circuits (and a number of bankruptcy courts in other circuits) have adopted a different approach. Assumption of an executory contract such as a license agreement is precluded only if the debtor actually intends to assign the contract to a third party, such that the licensor will be required to accept performance from a party other than the debtor with whom it originally contracted. Hence the reference to the “actual test.”

Both the hypothetical and actual tests were discussed briefly by U.S. Supreme Court Justices Kennedy and Breyer in connection with the Supreme Court’s denial of certiorari in N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc. In a statement by the two Justices, they acknowledged the relative merits of both tests. They noted that the hypothetical test, while true to the statutory text, sacrifices sound bankruptcy policy by possibly undermining a debtor-in-possession’s ability to effectively reorganize and

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76 In re West Elecs., Inc., 852 F.2d 79, 83 (3d Cir. 1988); In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999); In re James Cable Partners, 27 F.3d 534 (11th Cir. 1994).
77 Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997), cert. denied, 521 U.S. 1120 (1997); In re Mirant Corp., 440 F.3d 238, 251 (5th Cir. 2006).
providing a windfall to a licensor who would otherwise be unable to renege on its agreement outside bankruptcy. They further noted that the actual test, in contrast, aligns with sound bankruptcy policy “at the cost of departing from at least one interpretation of the plain text of the law.” The Justices nonetheless acknowledged that the other legal issues presented in N.C.P. did not make that case ideal for resolving the “significant question” raised by the split of authority.

3. Footstar Test

The U.S. Bankruptcy Court for the Southern District of New York has adopted a third approach which permits assumption of the contract by the debtor-in-possession, and not a bankruptcy trustee. Rather than focus on the term “or,” the court in In re Footstar, Inc. 79 instead focused on the use of the term “trustee” in the introductory language of Section 365(c). The court reasoned that the Section does not state “debtor” or “debtor-in-possession” and that the Bankruptcy Code does not define “trustee” to be synonymous with those terms. As such, the court concluded that the term “trustee” should not be substituted for “debtor-in-possession” in Section 365(c)(1). Under Footstar, no issue should arise if the contract is assumed by the debtor-in-possession, because it would not require that the licensor accept performance from an entity other than the debtor.80 Assumption of the executory contract would require the third party’s consent only if the trustee were the assuming party.

4. Suggestions Due to Non-Uniform Authority

The disparate rules among courts poses several risks to both a borrower and its lender with respect to Trademarked Inventory. If the court administering the borrower’s bankruptcy proceeding follows the hypothetical test, then the borrower and its lender may not have the legal ability to sell Trademarked Inventory post-bankruptcy unless the licensor consents to the borrower’s assumption of the license in bankruptcy. A borrower may be able to negotiate provisions to its license agreement to mitigate this risk. Those provisions include:

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80 Id. at 576.
Assignment: A provision that permits for assignments by the borrower.

Termination Provision: A provision that states that the license cannot be terminated in a Chapter 11 bankruptcy so long as the debtor-in-possession continues to perform under the agreement.

Assumption: A provision that states that in the event the borrower files under Chapter 11, the borrower may assume the license, and nothing in Section 365(e) of the Bankruptcy Code may be used by the licensor to prevent such assignment. In light of Footstar, a possible additional provision would allow a trustee to assume the license in a Chapter 11 bankruptcy.81

Whether these provisions are or can be included may be determined by the relative sophistication of the parties or the negotiating power (or lack thereof) of the borrower. If absent, the borrower could evaluate as part of any possible bankruptcy filing, whether the filing might be appropriate in a jurisdiction in which the law permits a debtor to assume an executory license without the licensor’s consent (i.e., the “actual” or Footstar tests). Until resolution of the split by the U.S. Supreme Court, this could afford some comfort to the borrower and its lender that the borrower’s ability to sell Trademarked Inventory would not be jeopardized solely due to the borrower’s bankruptcy.

B. Effect of Licensor’s Bankruptcy on License

The licensor’s bankruptcy poses a separate issue regarding the continued validity of a trademark license. As noted above, executory contracts can either be rejected or assumed by a debtor in bankruptcy, and intellectual property license agreements are commonly considered to be executory contracts. If the licensor files for bankruptcy (or an involuntary petition is filed against it), the borrower and its lender face the risk that the licensor might reject the executory license agreement. Such action could preclude the borrower from continuing to manufacture or sell any Trademarked Inventory. In addition, even in instances where the lender successfully obtained a licensor agreement directly with the licensor, that

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agreement could also be deemed to be executory, in which case it too could be rejected by the licensor.

The issues regarding the licensor’s rejection of executory intellectual property licenses were highlighted in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. The court in that case held that a debtor-licensor’s rejection and breach of a non-exclusive patent license denied the licensee any right to use the licensed technology. The court determined that Section 365(g) of the Bankruptcy Code provided only a damages remedy for the non-debtor licensee and not a specific performance remedy. The court reasoned that the lack of a specific performance remedy meant that a licensee could not “seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract.” The court then concluded that where the debtor rejected the executory contract, the licensee lost its rights under the license, such that rejection of the contract constituted termination of the license.

In response to Lubrizol, Congress amended the Bankruptcy Code by adding Section 365(n) which expressly permits intellectual property licensees to retain their rights to use the licensed property if certain statutory conditions are satisfied. However, Congress omitted trademarks from the Bankruptcy Code’s definition of “intellectual property,” which has the effect of excluding trademark licenses from the protections afforded under Section 365(n). There does not appear to be a clear and singular reason why

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83 The court relied on the legislative history regarding Section 365(g), noting that the House Report “makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party.” Id. at 1048. Section 365(g) provides “Except as provided in subsections (b)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition; or (2) if such contract or lease has been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title (A) if before such rejection the case has not been converted under section 1112, 1208, or 1307 of this title, at the time of such rejection; or (B) if before such rejection the case has been converted under section 1112, 1208, or 1307 of this title (i) immediately before the date of such conversion, if such contract or lease was assumed before such conversion; or (ii) at the time of such rejection, if such contract or lease was assumed after such conversion.” 11 U.S.C. § 365(g) (2006).
84 Lubrizol, 756 F.2d at 1048.
85 The Bankruptcy Code defines “intellectual property” to mean a "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17 . . . ." 11 U.S.C. § 101(35A) (2006).

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Congress chose to treat trademarks differently than other types of intellectual property. Some courts and commentators have suggested that it is because trademarks are unique among intellectual property and the need to maintain quality control is paramount. Others have suggested that Congress merely desired additional time to evaluate how trademarks should be treated under the Bankruptcy Code, and the need to act dissipated over time given the substantial improvement that Section 365(n) provided over Lubrizol for most types of intellectual property.

Notwithstanding the Congressional response to Lubrizol, the decision has been criticized over the years as incorrectly concluding that Section 365(g) had the effect of terminating the intellectual property license. In December 2012, the U.S. Court of Appeals for the Seventh Circuit in Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, became the first federal appellate court to hold in favor of a trademark licensee and permit a licensee to continue to manufacture and distribute trademarked goods following a bankrupt licensor’s rejection of an executory license agreement under Section 365.

Sunbeam involved a debtor, Lakewood, that had licensed certain intellectual property to Chicago American Manufacturing (“CAM”). The license permitted CAM to make and sell box fans under Lakewood’s patents bearing Lakewood’s trademarks. Due to Lakewood’s financial condition, CAM was reluctant to make investments to produce the number of fans Lakewood estimated would be needed for the 2009 season. In response, the parties agreed that CAM would be permitted to sell any excess Lakewood box fans manufactured by CAM during the 2009 season that Lakewood did not otherwise purchase. After the filing of an involuntary bankruptcy against Lakewood, the trustee sold Lakewood’s assets to Sunbeam, including the patents and trademarks that had been licensed to CAM. As a condition to purchase, Sunbeam required that the trustee reject the license agreement with CAM. Notwithstanding the rejection, CAM continued to use the patents and trademarks, and Sunbeam brought suit against CAM for infringement. The bankruptcy court held in favor of CAM based upon considerations of equity, acknowledging that Section 365(n) did not apply to the trademark license agreement.

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87 686 F.3d 372 (7th Cir. 2012), cert. denied, 133 S. Ct. 790 (2012).
(although it did apply to the patent license). Sunbeam appealed directly to the Seventh Circuit.

The Seventh Circuit affirmed the bankruptcy court’s decision, but disagreed that equity warranted such a conclusion. Instead, the court took direct issue with the Fourth Circuit’s decision in *Lubrizol* and, in particular, that court’s reading of Section 365(g). Writing for the court, Chief Judge Easterbrook first reasoned that Section 365(n), while passed in response to *Lubrizol*, did not validate the *Lubrizol* court’s reasoning. The Seventh Circuit noted that the Senate committee report on the bill omitted trademarks from the definition of intellectual property “to allow more time for study, not to approve *Lubrizol*.”88

Having determined that Congress did not intend to codify *Lubrizol* as it pertained to trademarks, the court then questioned the Fourth Circuit’s reading of Section 365(g). The court in *Lubrizol* equated rejection of a contract with avoidance powers. The Seventh Circuit declined to follow this determination. Relying on the text of Section 365(g)—which provides that a rejection of an executory contract constitutes a breach of contract—the court concluded that a non-debtor licensee retains all rights in bankruptcy as it would have outside of bankruptcy. “[R]ejection is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed. It merely frees the estate from the obligation to perform.”89

The Seventh Circuit’s reading of Section 365(g) has not met universal support. The U.S. Court of Appeals for the First Circuit in *In re Tempnology*90 recently reversed a decision of the Bankruptcy Appellate Panel for the First Circuit that applied the reasoning of *Sunbeam* in holding for the aggrieved licensee. The case involved a licensee (“Mission Products”) that had an exclusive right to distribute certain branded products within the United States and a non-exclusive license to use the licensor’s marks. The licensor terminated the license which triggered a two-year wind-down period for Mission Products to sell the remaining inventory. The licensor filed for bankruptcy prior to the end of such period and promptly terminated the license upon filing its bankruptcy petition. The Bankruptcy Appellate Panel

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88 Id. at 375.
89 Id. at 377 (citation and internal quotation marks omitted).
90 In re Tempnology, 879 F.3d 389 (1st Cir. 2018).
first noted that Section 365(n) did not protect Mission Products’ interest in the trademarks.91 However, rather than require that Mission Products cease selling the trademarked inventory, the court applied *Sunbeam*. The Bankruptcy Appellate Panel found that Section 365(g) deems the licensor’s rejection of the contract in bankruptcy to be a breach of contract and, outside of bankruptcy, a breach of contract would not terminate the licensee’s rights to sell the trademarked inventory.92

The First Circuit rejected the Bankruptcy Appellate Panel’s decision (and the reasoning of the Seventh Circuit in *Sunbeam*) regarding Mission Products’ continued right to sell the trademarked inventory.93 The court noted that rejection of the contract did not eliminate all rights of a licensee as the licensee retained its claim for damages. Moreover, the court noted that “the approach taken by *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the [Bankruptcy] Code otherwise allows the debtor to free itself from executory burdens.”94 The court reasoned that if Mission Products could still perform the license, then the licensor would be forced to continue to take steps to ensure the quality and integrity of its product—or risk the license being deemed a naked license and lose the value of its trademark—all of which is contrary to the Bankruptcy Code’s “fresh start options” for a debtor.

*Sunbeam* and *Tempnology* create an obvious split of authority regarding the interpretation of Section 365(g) and the effect that a debtor-licensor’s rejection of an executory trademark license has vis-à-vis the licensee. In light of these divergent decisions, it is possible that the Supreme Court could address the issue. Moreover, Congress may revisit how a licensor’s trademark license should be treated and whether trademarks should be included within the definition of “intellectual property.” Either resolution is likely some time away.

A lender could protect its interest by investigating the financial condition of the licensor to evaluate whether there is a credible risk of its bankruptcy during the life of the credit facility with the borrower. The lender might also be able to preserve the borrower’s (and lender’s) right to sell

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92 *Id.*
93 The First Circuit upheld the Bankruptcy Appellate Panel’s decision that trademark licenses fell outside the scope of Section 365(n). *In re Tempnology*, 879 F.3d at 401.
94 *Id.* at 404.
Trademarked Inventory if the license were rejected through one of the following methods:

- **Security Interest in Licensed Trademark:** The borrower could require that the licensor grant to it a security interest in the underlying trademarks. While this would not provide any assurance that the borrower could continue to use the licensed marks pursuant to the license agreement, it would provide the borrower a secured claim in bankruptcy in the event that the underlying license agreement is rejected. However, the ability to obtain a security interest may be limited, whether due to the relative negotiating positions of the borrower and licensor, covenants that the licensor may have with its own lenders, and the fact that the licensor may license the mark to various third parties.  

- **Covenant Not to Sue:** The borrower may seek to add a covenant into its license agreement that, if the licensor rejects the license agreement in bankruptcy, the licensor will not sue the licensee for infringement. It is not clear whether a covenant not to sue would continue to be effective in a jurisdiction endorsing *Lubrizol*—which has been interpreted to equate rejection with avoidance—or be enforceable notwithstanding *Lubrizol* as a matter of bankruptcy policy.

- **Structuring License as a Non-Executory Contract:** While a non-executory contract is not subject to rejection, this may be difficult to achieve in most license arrangements due to typical quality controls that obligate continued performance by the licensee and oversight by the licensor. A borrower may have success in the very limited context of a perpetual, prepaid license obtained as part of an acquisition, although even in that context, great care would need to be taken to structure the license so that the contract would not be deemed to be executory.

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96 *See, e.g.* *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010), *cert. denied*, 131 S. Ct. 1470 (2011) (holding that grant of exclusive license in conjunction of sale of business did not constitute an executory contract because the asset purchase agreement and license were an integrated contract and purchase had substantially performed by paying the purchase price). *See also* Wilton & Devore, *supra* note 86, at 777–78 (noting that to be deemed non-executory, the license would need to be incorporated as an integrated contract with the purchase agreement that documents the sale of the products or business unit, and the
Bankruptcy Remote Entity: The risk of rejection would be reduced if the licensor in the transaction is not an operating company, but a holding company whose sole purpose is to hold the trademarks of an affiliate (and cannot incur any debt), which are licensed to both the affiliate and to third parties. While a borrower may not be able to facilitate such a transaction as a mere licensee, a lender could take comfort if such a structure already existed.

V. CONCLUSION

Lending against Trademarked Inventory poses risks to a lender in the event of termination of a license agreement or distribution agreement, as termination may have the effect of preventing liquidation of such inventory following termination. Only through appropriate due diligence can a lender understand the borrower’s contractual rights to sell Trademarked Inventory. Good due diligence will allow a lender to better quantify the risks surrounding the sale of Trademarked Inventory, and to determine whether (and at what price) the lender can liquidate such inventory.

license should recite “the parties’ intention that the license is not an executory contract and provide that default by the licensee, including default for the licensee’s failure to maintain the quality of trademarked goods or services, is not a material default that permits the licensor to terminate the license of the trademark”).

97 The remote entity’s articles of incorporation and by-laws (or similar organizational documents) should (i) limit the entity’s authority to engage in any business (other than licensing the trademarks); (ii) prohibit the entity from incurring debt or otherwise encumbering its assets; and (iii) prevent the entity from filing a voluntary petition for bankruptcy. Richard M. Cieri & Michelle M. Morgan, Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee’s Intellectual Property and Technology Investment, 55 BUS. LAW. 1649, 1690 (2000).