Trademark Licenses in Bankruptcy: The Seventh Circuit Fires a Shot Across the Bow of *Lubrizol*

September/October 2012

Charles M. Oellermann
Mark G. Douglas

In 1988, Congress added section 365(n) to the Bankruptcy Code, which grants some intellectual property licensees the right to continued use of licensed property notwithstanding rejection of the underlying executory license agreement by a debtor or bankruptcy trustee. The addition came three years after the Fourth Circuit Court of Appeals ruled in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), that if a debtor rejects an executory intellectual property license, the licensee loses the right to use any licensed copyrights, trademarks, and patents. Despite the addition of section 365(n), the legacy of *Lubrizol* endures—by its terms, section 365(n) does not apply to trademark licenses and other kinds of "intellectual property" outside the Bankruptcy Code's definition of the term.

During the last few years, federal circuit courts of appeal have had an opportunity to confront *Lubrizol* by weighing in on how rejection in bankruptcy of a trademark license impacts the rights of the nondebtor licensee. In *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), the Third Circuit concluded, however, that the trademark license agreement at issue was not executory because the licensee had materially performed its obligations under the agreement at the time that the debtor filed for bankruptcy. Thus, the court never addressed whether rejection of the agreement (had it been found to be executory) would have terminated the licensee's right to use the debtor's trademark.

In July 2012, the Seventh Circuit took up the gauntlet, holding as a matter of first impression in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), that when a trademark license is rejected in bankruptcy, the licensee does not lose the ability to use any licensed intellectual property ("IP"). In doing so, the Seventh Circuit expressly rejected *Lubrizol*, providing a compelling invitation to U.S. Supreme Court review of this important issue to resolve the resulting split in the circuits.

***Lubrizol* and Bankruptcy Code Section 365(n)**

In *Lubrizol*, the Fourth Circuit held that a debtor could reject an executory agreement pursuant to which it had licensed the exclusive right to use its IP, and upon rejection, the licensee lost the right to use that IP. Despite recognizing the "chilling effect" its holding might have on IP licensing agreements, the court saw no way around the plain language of the Bankruptcy Code as it existed at that time: the licensing agreement was an executory contract, the debtor rejected the executory contract, and it was "clear that the purpose of [section 365] is to provide only a damages remedy for the non-bankrupt party."

Section 365(g) of the Bankruptcy Code provides that rejection of an executory contract "constitutes a breach of such contract" effective "immediately before the date of the filing of the petition." According to the Fourth Circuit in *Lubrizol*:

> Under [section 365(g)], Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it 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.

In response to *Lubrizol*, Congress added section 365(n) to the Bankruptcy Code to protect the rights of many (but not all) IP licensees. Section 365(n) gives such licensees two options when a debtor or trustee rejects an executory license agreement. The licensee may either: (i) treat the agreement as terminated (as in *Lubrizol*) and assert a claim for rejection damages; or (ii) retain the right to use the IP (with certain limitations). The legislative history of section 365(n) reveals that Congress intended to "make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy."

But the story does not end there. "Intellectual property," as defined in section 101(35A) of the Bankruptcy Code, covers only certain types of IP, namely and only to the extent protected by applicable nonbankruptcy law: a trade secret; an invention, process, design, or plant protected under title 35 of the U.S. Code; a patent application; a plant variety; a work of authorship protected under title 17 of the U.S. Code; or a mask work protected under chapter 9 of title 17 of the U.S. Code.

Notably, trademarks, trade names, and service marks are not included in the definition of "intellectual property." Thus, the protections afforded IP licensees under section 365(n) do not apply to trademark licensees. Since section 365(n) was added to the Bankruptcy Code, courts have struggled to determine the proper treatment of trademark licenses in bankruptcy. For example, the Third Circuit 2010 ruling in *Exide Technologies* highlighted the uncertainty faced by trademark licensees when a debtor or trustee seeks to reject a trademark license agreement.

In *Exide Technologies*, the debtor, one of the world's largest producers of lead-acid batteries, licensed its trademark to another company for use in the industrial-battery business. After filing for chapter 11 protection in 2002, the debtor sought court approval to reject the trademark license agreement. The bankruptcy court held that the trademark license agreement was executory and that upon the debtor's rejection of the agreement, the rights of the licensee to use the debtor's trademarks were terminated because, among other things, the protections of section 365(n) do not apply to trademark licensees. According to the bankruptcy court, "Congress certainly could have included trademarks within the scope of § 365(n) . . . but saw fit not to protect them." The district court affirmed on appeal.

The Third Circuit reversed. The court concluded that the agreement was not executory because the nondebtor licensee had materially completed its performance under the contract prior to the debtor's bankruptcy filing. Thus, the court ruled, the agreement could not be assumed or rejected at all. As a consequence, the Third Circuit never addressed whether rejection of the agreement (had it been found to be executory) would have terminated the licensee's right to use the debtor's trademarks.

However, in a separate concurring opinion, circuit judge Thomas L. Ambro took issue with the bankruptcy court's conclusion that rejection of a trademark license agreement necessarily terminates the licensee's right to use the debtor's trademark. Congress's decision to leave treatment of trademark licenses to the courts, Judge Ambro argued, signals nothing more than Congress's inability, at the time it enacted section 365(n), to devote enough time to consideration of trademarks in the bankruptcy context; no negative inference should be drawn by the failure to include trademarks in the Bankruptcy Code's definition of "intellectual property." As Judge Ambro concluded, "[I]t is simply more freight than negative inference will bear to read rejection of a trademark license to effect the same result as termination of that license."

In *Sunbeam*, the Seventh Circuit picked up where Judge Ambro left off.

Sunbeam

Lakewood Engineering and Manufacturing Co. ("Lakewood") entered into a supply contract with Chicago American Manufacturing ("CAM") in 2008 to produce Lakewood's box fans using motors manufactured by Lakewood. The contract included a nonexclusive license authorizing CAM to use Lakewood's patents and place Lakewood's trademarks on the fans. Because Lakewood was experiencing financial difficulty, CAM was reluctant to gear up its manufacturing operations with no assurance that Lakewood could pay for the 1.2 million fans that CAM was required to produce under the supply contract for the 2009 season. CAM accordingly bargained for the right to sell the 2009 run of box fans for its own account if Lakewood did not purchase them.

Three months into the contract, certain of Lakewood's creditors filed an involuntary chapter 7 petition against the company in Illinois. The chapter 7 trustee later sold the business, including Lakewood's patents and trademarks, to Sunbeam Products, Inc., which operates under the name "Jarden Consumer Solutions" ("Jarden"). Jarden wanted neither the fans in CAM's inventory nor CAM as a competitor in the box-fan market.

Although the bankruptcy trustee later rejected the supply contract, CAM continued to make and sell Lakewood-branded fans. Jarden and the trustee sued for infringement, seeking to prevent any further manufacturing or sale of the fans and claiming that, under the supply contract, CAM was obligated to stop making and selling fans once Lakewood stopped having requirements for them. The bankruptcy court, concluding that the supply contract was ambiguous, ultimately ruled that CAM was entitled to make as many fans as Lakewood estimated it would need in 2009 and to sell them bearing Lakewood's marks.

However, the bankruptcy court declined to address whether the trustee's rejection of the IP licenses precluded CAM from using Lakewood's trademarks. Agreeing with Judge Ambro's observation in *Exide* that sections 365(n) and 101(35A) leave open the question of whether rejection of an IP license ends the licensee's right to use trademarks, the bankruptcy court permitted CAM to continue using Lakewood's trademarks "on equitable grounds." Jarden's appeal was certified directly to the Seventh Circuit.

The Seventh Circuit's Ruling

Addressing the issue as a matter of first impression, the Seventh Circuit held that the rejection of a trademark license agreement does not abrogate the licensee's right to use the trademarks. The court of appeals faulted the bankruptcy court's reliance on equitable grounds for permitting continued use of Lakewood's trademarks as "untenable" but found that such reliance "does not necessarily require reversal."

Focusing on the impact of section 365(g), the Seventh Circuit explained that, outside bankruptcy, a licensor's breach does not terminate a licensee's right to use IP. Under the Uniform

Commercial Code, CAM could have elected to treat the breach as ending its own obligations under the supply contract, or it could have opted to cover in the market by purchasing motors and billing Lakewood for the extra costs. CAM bargained for the right to sell Lakewood-branded fans for its own account if Lakewood defaulted. As such, the Seventh Circuit emphasized, "Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender's right to collect just by declaring that the debt will not be paid."

Section 365(g), the Seventh Circuit explained, does not alter these rights. "What § 365(g) does by classifying rejection as breach," the court wrote, "is establish that in bankruptcy, as outside of it, the other party's rights remain in place." The debtor's unfulfilled obligations under the contract are converted to damages, which, if the contract has not been assumed, are treated as a pre-petition obligation. "[N]othing about this process," the court remarked, "implies that any rights of the other contracting party have been vaporized." Instead, rejection "merely frees the estate from the obligation to perform and has no effect upon the contract's continued existence" (internal quotation marks and citation omitted).

The Seventh Circuit reasoned that lawmakers' failure to include trademark licenses within the ambit of section 365(n) should not be viewed as an endorsement of any particular approach to the ramifications to the licensee of rejection of a trademark license agreement. According to the court, "[A]n omission is just an omission." Moreover, the Seventh Circuit wrote, "[a]ccording to the Senate committee report on the bill that included §365(n), the omission was designed to allow more time for study, not to approve *Lubrizol*." *Lubrizol* itself, the court noted, devoted scant attention to the question of whether rejection cancels a contract, “worrying instead about the right way to identify executory contracts to which the rejection power applies.” For this reason, the Seventh Circuit concluded, “*Lubrizol* does not persuade us.”

Outlook

The draft opinion in *Sunbeam* was circulated to all active judges on the Seventh Circuit before publication because of the split it creates between the Fourth Circuit and the Seventh Circuit. No judge favored a hearing en banc, and the issue has now been framed squarely for potential review by the U.S. Supreme Court (or perhaps legislative clarification). Resolution of this important issue has already been a long time coming for trademark licensees, who doubtless will keep close tabs on developments in *Sunbeam* as well as other cases that make their way through bankruptcy and appellate courts. Interestingly, the Eighth Circuit Court of Appeals recently had an opportunity to weigh in on the issue in *Lewis Brothers Bakeries Inc. and Chicago Baking Co. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 2012 WL 3744504 (8th Cir. Aug. 30, 2012), but declined to do so, ruling that a trademark license was executory and therefore capable of being assumed or rejected, but not addressing what the ramifications of rejection would be for the nondebtor licensee.

In the meantime, trademark licensees (at least those in the Seventh Circuit) can be expected to invoke *Sunbeam* for the proposition that rejection of a trademark license agreement in bankruptcy does not terminate a licensee’s ability to continue using a licensed trademark post-rejection. The same strategy may be employed by licensees of similar rights not necessarily encompassed by section 101(35A)’s definition of “intellectual property,” such as patents and copyrights that are not protected under the U.S. Code.