Who Needs Section 365(n)? New Seventh Circuit Decision Provides Licensees of Bankrupt Trademark Licensors Alternate Grounds for Protecting Their Rights

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On July 9, 2012, the U.S. Court of Appeals for the Seventh Circuit issued a decision that could have far-reaching implications for licensees of trademarks, and more generally for all licensees of intellectual property, who find their licensors in bankruptcy. In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[1] the Seventh Circuit affirmed the decision of the U.S. Bankruptcy Court for the Northern District of Illinois (the "Bankruptcy Court") that a trademark licensee whose licensor rejected the license agreement in bankruptcy could nevertheless continue to use the licensed trademark. In the proceedings below, the Bankruptcy Court based its holding on "equitable grounds," effectively extending the protections for intellectual property licensees under section 365(n) of the Bankruptcy Code to trademarks, while recognizing that the statute (which protects patent and copyright licenses) does not include trademarks within those protections. The Seventh Circuit affirmed the Bankruptcy Court's judgment, but based its decision on a different analysis. Like the Bankruptcy Court, the Seventh Circuit reexamined the Fourth Circuit's landmark decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[2] in which the Fourth Circuit, prior to the enactment of section 365(n), found that a patent licensee loses its license rights when the licensor rejects the patent license in bankruptcy. But, rather than relying on "equitable grounds" to part company with *Lubrizol*, the Seventh Circuit concluded that the Fourth Circuit in *Lubrizol* reached the wrong result in interpreting the effects of rejection under section 365(g) of the Bankruptcy Code.

The Seventh Circuit started with the fundamental proposition that "rejection" of a contract in bankruptcy means simply that the debtor breached the contract (which, for the purposes of allowance of a licensee's claim, is deemed to occur as of the day immediately before the bankruptcy filing). But the licensee's rights to use the trademark should not necessarily be terminated simply because the debtor has "rejected," and is deemed to have breached, the license agreement. Accordingly, in the Seventh Circuit at least, a trademark licensor may effectively get the same protections as section 365(n), without being covered by the statute—the rights may not be compromised by rejection in the first place. The Seventh Circuit's decision examines once again the scope of a licensee's rights after rejection of a license agreement by the licensor, and the effect of a counterparty's rejection of an executory contract more generally. And the Seventh Circuit's decision creates a circuit split with the Fourth Circuit in *Lubrizol*, albeit one where the decisions are separated by a distance of 27 years.

Background

In 1985, the U.S. Court of Appeals for the Fourth Circuit issued its decision in *Lubrizol*. The Fourth

Circuit held that a licensee of intellectual property (in this case, patents) may not continue to use the licensed property after the licensor rejects the license in bankruptcy. In response, Congress swiftly enacted section 365(n) to the Bankruptcy Code in 1988. Section 365(n) prevents a licensor from unilaterally terminating the rights of a licensee under an "intellectual property" license by rejecting the license under section 365(a) of the Bankruptcy Code if the licensee elects to continue its rights and pay royalties as they become due. Although U.S. patents and copyrights are expressly included in the Bankruptcy Code's definition of "intellectual property," trademarks are notably absent.[3] The legislative history of the enactment of section 365(n) makes clear that Congress intentionally excluded trademarks from the scope of the section's protections because of the unique concerns inherent to trademark licensing relationships, namely that such relationships depend on the licensor's ability to control the quality of the products or services sold by the licensee. The legislative history provides that: "Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts."[4]

The exclusion of trademarks from the definition of "intellectual property" led a number of courts, including bankruptcy courts in the Southern District of New York and in Delaware, to conclude that Congress intended the effects of *Lubrizol*—that a licensee would lose its rights upon rejection—to apply to trademark licenses.[5] Others, like Judge Ambro of the U.S. Court of Appeals for the Third Circuit in his concurring opinion in *In re Exide Technologies*,[6] believed it inappropriate to conclude by negative inference that rejection of a trademark license triggers the same result as termination of that license. Instead, Judge Ambro believed that, in certain circumstances, courts should use their equitable powers to preserve a licensee's fairly-procured trademark rights. According to Judge Ambro, to do otherwise would "make bankruptcy more of a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve."[7]

The *Lakewood* Bankruptcy Court Decision: "Equitable Grounds" for Protection

Lakewood Engineering & Manufacturing Co. ("Lakewood") was one of the largest manufacturers of box fans in the United States. In 2008, Lakewood entered into a supply agreement with its manufacturer, Chicago American Manufacturing ("CAM"), under which CAM would use Lakewood's patents and trademarks to produce and distribute box fans for Lakewood in accordance with forecasted amounts set forth in the supply agreement. Because Lakewood was already experiencing financial difficulty at the time it entered into the supply agreement, Lakewood granted to CAM in the supply agreement a license to continue to use Lakewood's patents and trademarks for the purpose of selling fans that Lakewood had forecasted, but could not purchase.

Three months into the contract, Lakewood's creditors placed it into involuntary bankruptcy. In bankruptcy, the chapter 7 trustee for Lakewood rejected Lakewood's contract with CAM under section 365(a) of the Bankruptcy Code and sold Lakewood's assets, including its patents and trademarks, to an affiliate of Sunbeam Products. After the sale of Lakewood's assets and rejection of Lakewood's agreement with CAM, CAM continued to manufacture and sell box fans. Sunbeam and Lakewood's bankruptcy trustee filed suit against CAM, asserting that CAM was not entitled to continue producing and selling the fans using the Lakewood patents and trademarks. The Bankruptcy Court held that CAM retained its license to use Lakewood's *patents* based on Lakewood's election of its rights under section 365(n) of the Bankruptcy Code. The Bankruptcy Court also held that CAM's right to use Lakewood's *trademarks* survived the rejection of the supply agreement, notwithstanding the omission of trademarks from the scope of section 365(n) of the Bankruptcy Code. The Bankruptcy Court, relying heavily on Judge Ambro's concurring opinion in *Exide*, based its decision on "equitable grounds" rather than on any particular provision of the Bankruptcy Code.[8]

The Seventh Circuit's Decision in *Lakewood*: Protection under Section 365(g)

The Seventh Circuit affirmed the Bankruptcy Court's decision, but on different grounds. The Seventh Circuit called the Bankruptcy Court's reliance on its equitable powers "untenable," because "what the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be inequitable."[9] Nevertheless, the Seventh Circuit proceeded to reexamine the Fourth Circuit's landmark decision in *Lubrizol*, which spawned section 365(n) in the first place. The Seventh Circuit concluded that the *Lubrizol* court was mistaken in its analysis of the consequences of rejection of an executory contract.

Focusing on section 365(g) of the Bankruptcy Code, which governs the consequences of rejection of an executory contract, the Seventh Circuit emphasized that rejection of a contract merely constitutes a breach of such contract by the debtor. The Seventh Circuit noted that outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use the licensed intellectual property.[10]So too, in bankruptcy, a licensee's rights should remain intact despite rejection by the licensor. The Seventh Circuit explained that the consequence of rejection is simply that the debtor cannot be forced to perform—its unfulfilled obligations are instead converted to damages. Nothing about section 365(a), however, implies that any rights of the licensee have been "vaporized."[11] The court contrasted sections of the Bankruptcy Code that may be used to eliminate contractual rights—like the Bankruptcy Code's avoidance powers—with section 365, which is not an avoidance power. The Seventh Circuit concluded that the Fourth Circuit in *Lubrizol* confused rejection with the use of an avoidance power or the remedy of rescission. Accordingly, the Seventh Circuit rejected the *Lubrizol* approach and upheld the Bankruptcy Court's decision.

The Bottom Line

The Seventh Circuit's decision provides some comfort to trademark licensees, who have long faced the possibility that their rights were unprotected in the event of a rejection of their license by the licensor, and who were dependant on the equitable powers of bankruptcy judges for the protection of those rights. The extent of the comfort that they draw from *Lakewood* may depend in part on the terms of the licensee's rights under the applicable agreement.[12]

But the Seventh Circuit's critique of *Lubrizol* goes much further. By clarifying that rejection is not the same as termination, the Seventh Circuit calls into question whether section 365(n) is the exclusive protection available to intellectual property licensees in the event of rejection by a licensor. Indeed, it calls into question the need for section 365(n) in the first place, or for its sister section that provides protection for real estate lessees, section 365(h). For example, the Seventh Circuit's decision could mean that a licensee's rights in foreign patents (which may not be covered by section 365(n)) survive rejection as well, even if such rights could, like trademarks, be interpreted to be outside the scope of section 365(n).

But a trademark licensee may not be home free in the Seventh Circuit. Although the issue was apparently not raised by Sunbeam, a purchaser of assets could argue that a "free and clear" sale under section 363 of the Bankruptcy Code eliminates the rights of licensees. The Seventh Circuit itself has found that section 363 may effect a sale "free and clear" of unasserted section 365(h) rights with respect to a commercial lease.[13] Might section 363 also free a trademark purchaser from the continuing rights of a licensee such as CAM?

Accordingly, while the Lakewood decision may favor trademark licensees in some respects, it also raises questions that may have implications for both trademark licensees and others when contract counterparties enter bankruptcy.

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[1] Case No. 11-3920 (7th Cir. Jul. 9, 2012). The case is referred to as "*Lakewood*" based on the name of the Bankruptcy Court debtor.

[2] 756 F.2d 1043 (4th Cir. 1985).

[3] 11 U.S.C. § 101(35A).

[4] S. Rep. 100-505, at 5, *reprinted in* 1988 U.S.C.C.A.N. at 3204.

[5]*In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] trademark . . . ."); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademark stops on rejection.").

[6] 607 F.3d 957 (3d Cir. 2010).

[7]*Exide*, 607 F.3d at 967-68 (Ambro, J., concurring).

8*Sunbeam Products, Inc. v. Chicago American Manufacturing, Inc. (In re Lakewood Engineering & Manufacturing Co., Inc.),* 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011).

9*Sunbeam*, Case No. 11-3920, slip op. at 4-5.

10*Id.* at 7.

11*Id.* at 8.

12 Before even reaching the issue of whether rejection terminated CAM's rights to use the trademarks, the Bankruptcy Court held as a matter of contract interpretation, and the Seventh Circuit agreed, that one of CAM's remedies for breach of the supply agreement by Lakewood was that CAM would have a trademark license to sell the fans that were the subject of the agreement. This focus on the contractual terms suggests that there could have been a different result had the parties agreed to different remedies.

13*Precision Industries, Inc. v. Qualitech Steel SBQ LLC*, 327 F.3d 537 (7th Cir. 2003).

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