Patterson Belknap Webb & Tyler LLP

Business Reorganization and Creditors' Rights Alert November 2012

SUNBEAM PRODUCTS, INC. V. CHICAGO AMERICAN MANUFACTURING, LLC

The U.S. Court of Appeals for the Seventh Circuit in Chicago has issued a decision with significant implications for licensees of trademarks whose licensors become debtors in bankruptcy. In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, the Court considered whether rejection of a trademark license in bankruptcy deprives the licensee of the right to use the licensed mark.[1] Disagreeing with the holding of the Court of Appeals for the Fourth Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[2] the Court concluded that a licensee could continue to use the licensed mark notwithstanding the rejection of the license agreement. The decision may have important implications also for other types of intellectual property licenses and, indeed, all other kinds of contracts, licenses and leases as well.

***Lubrizol* and Congressional Response**

Lubrizol held that, when an IP license is rejected in the bankruptcy case of the licensor, the licensee "could not seek to retain its contract rights in the [IP] by specific performance." 746 F.2d at 1048. *Lubrizol* was universally understood to mean that the licensee loses the right to use any licensed IP following rejection of the license agreement. The licensee's sole remedy under the Bankruptcy Code following rejection of its license agreement, *Lubrizol* explained, is a claim for damages. *Id*.

Lubrizol created a dilemma for IP licensees. They could spend years and huge sums of money developing and marketing a new drug or electronic device based upon a compound or technology licensed from the patent holder, but they would always be at risk of losing the right to use the patented compound or technology if the license were to be rejected in the bankruptcy case of the patent-holding licensor and be left with nothing to show for its investment but an unsecured claim for damages.

Congress responded to these concerns, expressed with particular vigor by the computer and pharmaceutical industries, by enacting Section 365(n) of the Bankruptcy Code.[3] Passed into law expressly to overrule *Lubrizol*, subsection (n) permits a licensee of "intellectual property" to elect to retain the right to use the licensed IP after rejection of a license agreement, as long as it continues to perform its obligations under the license (*e.g.*, make all required royalty payments).[4] However, the definition of "intellectual property" that was added to the Bankruptcy Code as part of the 1987 Act did not include trademarks.[5] While it was clear after the enactment of the 1987 Act that rejection of an IP license in the licensor's bankruptcy would not interfere with the licensee's right to use copyrights and patents (along with trade secrets, plant varieties and mask works) if a licensee so elected, the effect of rejection on a licensee's right to use trademarks post-rejection was unaffected.

Sunbeam

More than 25 years after *Lubrizol*, another Court of Appeals has offered a starkly different understanding of the effect of rejection on a trademark licensee who, by congressional omission, is unable to make a continuing use election under Section 365(n). But in answering that question, it introduced new questions about Section 365(n) and its continuing significance for licensees of intellectual property.

Prior to becoming the subject of an involuntary bankruptcy proceeding, Lakewood Engineering & Manufacturing Co. licensed patents and trademarks to Chicago American Manufacturing (CAM) to permit CAM to manufacture and sell box fans.[6] After the bankruptcy case was commenced, Lakewood's trustee sold its assets to Sunbeam Products, including the trademarks and patents used in manufacturing and selling the fans, and rejected the license agreement with CAM. *Id*. CAM continued to sell the box fans notwithstanding the rejection, and Sunbeam sued CAM for trademark infringement. *Id*.[7]

As an initial matter, the *Sunbeam* Court rejected the notion that Congress approved the *Lubrizol* decision with respect to trademarks by excluding them from the definition of "intellectual property" added by the 1987 Act. "Some bankruptcy judges have inferred from the omission that Congress codified *Lubrizol* with respect to trademarks, but an omission is just an omission. The limited definition in §101(35A) means that §365(n) does not affect trademarks one way or the other."[8]

The *Sunbeam* Court then turned its analysis to the effect of the trustee's rejection of the trademark license on CAM's rights. The Court explained that, under Section 365(g) of the Bankruptcy Code, rejection constitutes a breach of the contract, not a termination:

> What §365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. [. . .] The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. ***But nothing about this process implies that any rights of the other contracting party have been vaporized.***

Id. at 377 (emphasis added). A "licensor's breach does not terminate a licensee's right to use intellectual property [. . .] outside of bankruptcy," the Court explained, and Section 365(g) preserves that result in bankruptcy. *Id*. at 376.[9]

<u>Open Questions</u>

Sunbeam should minimize the disruption that a licensor bankruptcy will have on a trademark licensee's ongoing business and use of the licensed mark (at least in jurisdictions within the Seventh Circuit). But the decision also raises a host of new questions. First, if the right of a licensee to use IP is preserved by Section 365(g), then was Section 365(n) really necessary in the first place? Do licensees of other IP--the types within the definition of "intellectual property" added by the 1987 Act--have another avenue to preserve their right to use IP, or must those licensees look only to Section 365(n) for protection? And, if the right to use IP following rejection of a license is preserved without resort to Section 365(n), should counsel advise clients to make a 365(n) election and take on the additional burdens that comes with it (*e.g.*, continued performance, waiver of setoff claims, etc.)?[10] Might the applicable non-bankruptcy law that permits the licensee to use IP after rejection *à la Sunbeam* present a more attractive means of preserving rights than Section 365(n)?

Even beyond IP licenses, *Sunbeam* raises questions about the legal effect of rejection of all kinds of executory contracts, including other kinds of licenses, and leases. By treating Section 365(g) not merely as stating that rejection constitutes a breach of the agreement but as implicitly defining rejection as only a breach, the exclusive alternative to which is a "vaporizing" termination, the *Sunbeam* Court failed to consider the possibility that, while a rejection does not terminate a contract, it is more than a mere breach. And it did so in the face of its own clear recognition[11] that, "[a]fter rejecting a contract, a debtor is not subject to an order of specific performance,"[12] even though a mere breach would not necessarily have that effect.

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It is possible that some of the questions raised by *Sunbeam* will be resolved by the Supreme Court since there is now a direct split of authority between the Fourth and Seventh Circuits regarding the impact of rejection on IP licenses. It is also possible that Congress will step in after a long "postponement" and resolve the issues raised by *Sunbeam*. But many of these new questions could remain unsettled for years to come.

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[1] 686 F.3d 372, 375 (7th Cir. 2012).

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

[3] *See* Intellectual Property Bankruptcy Protection Act of 1987 ("1987 Act"), P.L. 100-506, enacted October 18, 1988. *See also* "Amendments to the Bankruptcy Code Respecting Licenses of Intellectual Property Rights," Patterson Belknap Client Alert, October 24, 1988. Congress modelled subsection (n) on subsection (h), which provides somewhat analogous rights to real property lessees in the bankruptcy cases of their lessors. *See* Senate Report on P.L. 100-505, at 4 (1988).

[4] A Section 365(n) election comes with some additional baggage. In addition to continued performance, the licensee must waive any setoff claim arising under the license agreement and any claim for an administrative expense under Section 503(b) arising from its performance under the license agreement. *See* Section 365(n)(2)(C).

[5] Tradenames and service marks are also excluded. *See* Bankruptcy Code § 101(35A) (definition of "intellectual property"). Congress believed that trademark licenses--

> raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. 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. Senate Report on P.L. 100-505, at 5.

"[P]ostpone" suggests that Congress intended to revisit the issue of trademarks, but, in the nearly 25 years since enactment of the 1987 Act, it has never done so.

[6] *Sunbeam*, 686 F.3d at 374.

[7] It was undisputed that CAM could elect to retain its rights to use the patents under Section 365(n).

[8] *Id*. at 375. According to *Sunbeam*, the legislative history of Section 365(n) indicates that "the omission [of trademarks from the "intellectual property" definition] was designed to allow more time for study, not to approve *Lubrizol*." *Id*. *See also* n.5, *supra*.

[9] The Court was clear that, unlike the Bankruptcy Court, it did not base its holding on equitable notions of fairness to CAM but rather a straightforward explication of the Bankruptcy Code. *See id*. at 376. It thus declined the Senate's invitation to "develop[] equitable treatment of this situation …."

[10] Given the choice, we think many licensees of IP would still prefer to take advantage of Section 365(n) when it is available to them, notwithstanding its burdens, because subsection (n)(1)(B) preserves licensees' right to enforce exclusivity provisions in license agreements. By contrast, it remains an open question whether a licensee that stands on its *Sunbeam* rights to use IP would be entitled to compel the debtor or its trustee to honor a contractual exclusivity provision.

[11] Recognition it had no choice but to give in light of a Supreme Court statement on the issue in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984).

[12] *Sunbeam*, 686 F.3d at 377.

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