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***Sunbeam Products*: Trademark Licensees Victorious in Seventh Circuit's Bankruptcy Ruling**

What's Next For Licensees and Debtor Licensors?

By G. Larry Engel, Norman S. Rosenbaum, and Alexandra Steinberg Barrage

Trademark licensees can continue using licensed trademarks after their licenses are rejected in bankruptcy, the U.S. Court of Appeals for the Seventh Circuit ruled on July 9, 2012, in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*.¹ The court's ruling repudiates a frequently criticized, but widely cited, 1985 decision of the U.S. Court of Appeals for the Fourth Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*² *Lubrizol* addressed a nonexclusive patent license and, among other things, held that rejection of such a license "deprived the non-debtor party of all rights under that license,"³ effectively terminating the license.

Lubrizol later inspired the enactment of section 365(n) of the Bankruptcy Code, generally providing certain protections to a licensee when the debtor is a licensor of certain "intellectual property."⁴ However, the Bankruptcy Code's definition of "intellectual property" omitted trademarks (as well as, it has been argued, other rights generally considered IP). Therefore, many bankruptcy courts have inferred from the statute's omission of trademarks that, because trademark licensees are not entitled to section 365(n) protection, *Lubrizol* still applied to trademarks.⁵

The Seventh Circuit was unpersuaded by *Lubrizol* and this line of cases. It found that the definition of "intellectual property" which Congress adopted for the Bankruptcy Code "does not affect trademarks one way or the other."⁶

Trademark licensees across the country will likely now cite *Sunbeam* for the proposition that rejection of their license agreements in bankruptcy does not terminate their licenses, allowing them to continue using the licensed trademarks post-rejection. The same arguments may also be made by licensees of other IP, particularly licensees of other rights not necessarily included within the Bankruptcy Code's definition of "intellectual property."

But what additional ramifications might *Sunbeam* have? Will *Sunbeam* affect how licensees address the protections for what bankruptcy law does define as "intellectual property" that are provided under section 365(n), which grants licensees the option of retaining certain rights upon rejection of a license"?⁷ How will courts apply *Sunbeam* to exclusive licenses? Could *Sunbeam*'s holding affect the bidding for trademark and other IP assets in bankruptcy, particularly if a potential asset purchaser risks having to compete with a rejected licensee that continues using the licensed IP? If a debtor elects to reject a trademark license, how does this affect the ability of the debtor or a purchaser of the trademark to police the use of the trademark as required by trademark law? To what extent could these potential outcomes affect a debtor's decision to assume and assign, rather than reject, such license?

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We do not yet have answers to these questions, but we can say that *Sunbeam* is likely to have significant and wide-ranging effects on the jousting between licensors in bankruptcy and their licensees.

THE DECISION

In *Sunbeam*, Lakewood Engineering & Manufacturing Co. (“Lakewood”) manufactured and sold a variety of consumer products, including box fans. After losing money on the box fans, Lakewood outsourced its manufacturing of the fans to Chicago American Manufacturing LLC (“CAM”) and executed a supply agreement that included a license to CAM to use its trademarks as well as its patents (the “Supply Agreement”).⁸ CAM was authorized to sell any of the 2009 production of box fans that Lakewood did not purchase. Several months after execution of the Supply Agreement, Lakewood was forced into involuntary bankruptcy, and a trustee was appointed.

Lakewood’s trustee rejected the Supply Agreement, eventually selling Lakewood’s business — including its trademarks and patents — to Sunbeam (d/b/a Jarden Consumer Solutions). After rejection of the Supply Agreement by the trustee, and subsequently after the bankruptcy auction, CAM continued manufacturing the Lakewood-branded fans in accordance with the rejected Supply Agreement. The trustee and Sunbeam then sued CAM for patent and trademark infringement.⁹ The bankruptcy court found in favor of CAM on all counts¹⁰ and permitted CAM, which had invested substantial resources in manufacturing Lakewood-branded box fans, to continue using the trademarks on equitable grounds.¹¹

On appeal, the Seventh Circuit addressed the effects of the trustee’s rejection of the Supply Agreement, including the trademark license, and CAM’s continued manufacture and sale of the box fans. The opinion, authored by Chief Judge Easterbrook, began with a discussion of *Lubrizol*. The *Sunbeam* court noted that three years after *Lubrizol*, Congress enacted section 365(n), which covers “intellectual property,” as defined in section 101(35A) of the Bankruptcy Code. This definition includes trade secrets and rights protectable under U.S. patent and copyright law, but does *not* cover trademarks. As the Seventh Circuit noted in *Sunbeam*:

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. According 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*. See S.Rep. No. 100–505, 100th Cong., 2d Sess. 5 (1988). See also In re Exide Technologies, 607 F.3d 957, 966–67 (3d Cir.2010) (Ambro, J., concurring) (concluding that § 365(n) neither codifies nor disapproves *Lubrizol* as applied to trademarks). The subject seems to have fallen off the legislative agenda, but this does not change the effect of what Congress did in 1988.¹²

THE LIMITS OF EQUITY

Although the Seventh Circuit ultimately upheld the bankruptcy court’s decision, it underscored that a bankruptcy court cannot override what the Bankruptcy Code provides by declaring that enforcement would be “inequitable.”¹³ Relying, in part, on the U.S. Supreme Court’s recently authored *RadLAX* decision,¹⁴ the Seventh Circuit said that rights depend “on what the Code provides rather than on notions of equity.”¹⁵

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Within this framework, the court analyzed the issue under section 365(g) of the Bankruptcy Code, which specifies the consequences of rejection of an executory contract under section 365(a) and provides that rejection “constitutes a breach of such contract.”¹⁶ The court focused on what would result *outside* of bankruptcy, noting that an IP licensor’s breach does not terminate a licensee’s right to use IP, and that a licensor cannot terminate a licensee’s rights to honor a contract by failing to perform its own duties.¹⁷

As the court noted, section 365(g) incorporates this outside-of-bankruptcy concept by classifying rejection as a breach and preserving a non-debtor’s rights.¹⁸

A 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. . . . [Rejection] It ‘merely frees the estate from the obligation to perform’ and ‘has absolutely no effect upon the contract’s continued existence’.¹⁹

The court reasoned that like the rejection of any executory contract or unexpired lease of real property, rejection is merely a breach — a licensee’s rights are neither terminated nor “vaporized” as a result.²⁰ Because the trustee’s rejection of the Supply Agreement did not abrogate CAM’s contractual rights, the court affirmed the bankruptcy court’s ruling in CAM’s favor.

FUTURE IMPLICATIONS

Ultimately, as advocated by many IP licensees, commentators, and practitioners, the Seventh Circuit was not persuaded by *Lubrizol*, which the court noted “devoted scant attention to the question whether rejection cancels a contract, worrying instead about the right way to identify executory contracts to which the rejection power applies.”²¹

What is less clear is how *Sunbeam*’s holding may apply beyond licenses of trademarks. For example, debtor licensors have argued that the Bankruptcy Code’s definition of “intellectual property” does not apply to non-U.S. patents and non-U.S. copyrights.²² Licensees are likely to use *Sunbeam* to argue that their licenses of foreign patents and copyrights should be preserved in the same way that the licensee’s trademark license in *Sunbeam* remained in effect. Moreover, if *Sunbeam* becomes the prevailing interpretation of the effect of bankruptcy on licenses generally, that would raise questions regarding the value of section 365(n) altogether. For example, to what extent might IP licensees have been afforded better results in the absence of section 365(n), e.g., allowing licensees to retain rights without the burdensome conditions of section 365(n), such as paying royalties and waiving setoffs?

Courts and commentators may take the view that *Sunbeam* effectively resets licensees’ expectations to what they should have been all along under section 365(g) — i.e., the same as any other counterparty whose contract had been rejected/breached by a debtor.

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Likewise, *Sunbeam* does not address the potential ramifications of the decision for the rights of the trademark owner. The opinion notes that Congress likely intended to address the treatment of trademark licenses as executory contracts in a future amendment because Congress viewed trademarks as distinct from other forms of intellectual property. *Sunbeam* may now compel trademark owners to confront this issue head on. What rights, if any, the licensor to a rejected trademark license, or the future owner of that trademark, have may well be the next test of this landmark decision.

CONCLUSION

Given the split between the Seventh and Fourth Circuits on this issue, it may not be resolved until the United States Supreme Court considers the matter or Congress intervenes again. If *Lubrizol* is effectively overruled, licensees of trademarks and perhaps other IP will celebrate.

In the meantime, *Sunbeam* will be championed by the IP licensee community and commentators alike, both for its result and useful discussion of the effect of non-bankruptcy breach — i.e., realigning the rejection of IP licenses with the other types of executory contracts rejected in bankruptcy.

Pending future action by courts (or possibly Congress), the IP community should be thinking critically about broader, more strategic questions, such as how license agreements can be revised to adjust to *Sunbeam*, whether for licensees or licensors.

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¹ *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, No. 11-3920, 2012 WL 2687939 (7th Cir. July 9, 2012) [*“Sunbeam”*].

² 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057, 106 (1986) [*“Lubrizol”*].

³ *Id.* at 1048.

⁴ See 11 U.S.C. § 101(35A).

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⁵ See e.g., *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)*, 281 B.R. 660, 673, n. 24 (Bankr. N.D. Cal. 2002) (“[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 trademarks stops on rejection.*”) (emphasis added); see also *In re Chipwich, Inc.*, 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985) (citing *Lubrizol* for the principle that only a damage claim arises from the rejection of a trademark license).

⁶ *Sunbeam*, 2012 WL 2687939, at *1.

⁷ See 11 U.S.C. § 101(35A).

⁸ *Sunbeam*, 2012 WL 2687939, at *2. Lakewood’s license of patents was not addressed by the Seventh Circuit because the bankruptcy trustee was no longer contesting the bankruptcy court’s determination that the licensee’s right to practice the patents was protected by section 365(n).

⁹ See *Szilagyi v. Chi. Am. Mfg., LLC (In re Lakewood Eng’g & Mfg. Co., Inc.)*, 459 B.R. 306, 310 (Bankr. N.D. Ill. 2011) (also noting claims for unfair competition under the Lanham Act).

¹⁰ *Id.*

¹¹ *Id.* at 345 (noting that section 365(n) does not apply to the rejection of trademark licenses, but that the court was required to make its determination on equitable grounds to avoid a situation that “let[s] a licensor take back trademark rights it bargained away.”) (citing *Exide*, 607 F.3d at 967)).

¹² *Sunbeam*, 2012 WL 2687939, at*1.

¹³ *Id.* at *2 (citing *Toibb v. Radloff*, 501 U.S. 157 (1991), *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004), *In re Sinclair*, 870 F.2d 1340 (7th Cir. 1989)).

¹⁴ *Id.* (citing *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, [CITE] (2012)). For more on the *RadLAX* decision and Morrison & Foerster’s role in the case, please see: <http://www.mofo.com/files/Uploads/Images/120529-Credit-Bidding.pdf>.

¹⁵ *Id.* The continuing debate over the scope of a bankruptcy court’s equity powers was recently raised by *Stern v. Marshall*, 131 S.Ct. 2594 (2011), as illustrated by A. Ahart, *A Stern Reminder That the Bankruptcy Court Is Not a Court of Equity*, 86 AM. BK. L.J. 191 (2012).

¹⁶ Section 365(g) of the Bankruptcy Code provides:

Except as provided in subsections (h)(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.

¹⁷ *Sunbeam*, 2012 WL 2687939, at *3.

¹⁸ *Id.*

¹⁹ *Id.* (internal citations omitted).

²⁰ *Id.*

²¹ *Id.* at *4.

²² The definition of “intellectual property” in 11 U.S.C. § 101(35A) includes inventions and the like “protected under title 35” (patents) and works “protected under title 17” (copyrights), which some read as a limitation but which others read as an illustration of or reference to types of IP. No reported decisions have definitely resolved this issue. Historically, debtor licensors have argued for narrow interpretations in order to limit section 365(n), while nondebtor licensees have argued for expansive interpretations in order to expand section 365(n). If *Sunbeam* becomes the prevailing view, some licensees may prefer to avoid section 365(n) in order to retain their rights without the burdensome conditions of section 365(n), such as paying royalties and waiving setoffs.