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A legal update from Dechert's Business Restructuring and Reorganization Group

Seventh Circuit Allows Trademark Licensees to Continue Using License After Rejection of Licensing Agreement

The Court of Appeals for the Seventh Circuit, in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[1] recently issued a decision that holds—contrary to the only other court of appeals that has addressed the issue—that rejection of a trademark licensing agreement by a debtor-licensor does not terminate the agreement and that a trademark licensee can thus continue using the license after rejection.

The Fourth Circuit's *Lubrizol* Decision

In 1985, the Court of Appeals for the Fourth Circuit issued a controversial opinion in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[2] holding that when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. In the Court's *Sunbeam* opinion, Chief Judge Easterbrook noted that while "[n]o other court of appeals has agreed with *Lubrizol*—or for that matter disagreed with it," "[s]cholars uniformly criticize *Lubrizol*."[3]

The Addition of Section 365(n)

Three years after *Lubrizol*, Congress added section 365(n) to the Bankruptcy Code. This section allows licensees of intellectual property to continue using the intellectual property after rejection by a debtor who is a licensor, provided certain conditions are met. However, the term "intellectual property" is defined in section 101(35A) of the Bankruptcy Code and includes patents, copyrights, and trade secrets, but does not include trademarks.

While some bankruptcy courts have inferred from this omission that Congress intended to codify *Lubrizol* with respect to trademarks, the Senate committee report on the bill that included section 365(n) notes that the omission was simply designed to allow more time for study.[4]

Factual Background

In 2008, Lakewood Engineering & Manufacturing Co. (Lakewood) contracted the manufacture of box fans covered by its patents[5] and trademarks to Chicago American Manufacturing (CAM). Lakewood was to take orders from retailers, and CAM would ship directly to the retailers on Lakewood's instructions. Because Lakewood was in financial distress at the time of the contract, CAM required that its agreement with Lakewood authorize CAM to sell the box fans for its own account if Lakewood did not purchase them.

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1 2012 BL 169446 (7th Cir. Jul 09, 2012).

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

3 2012 BL 169446 at 5, 9.

4 *See* S. Rep. No. 100-505, 100th Cong., 2d Sess. 5 (1988).

5 The Bankruptcy Court held that section 365(n) allowed CAM to use Lakewood's patents, and that ruling was not contested on appeal.

Three months into the contract, several of Lakewood's creditors filed an involuntary bankruptcy petition against it. Sunbeam Products, doing business as Jarden Consumer Solutions (Sunbeam), bought the assets, including Lakewood's patents and trademarks, from the bankruptcy trustee. Sunbeam did not want the Lakewood-branded fans CAM had in its inventory, nor did it want CAM to sell the fans in competition with Sunbeam's products. Lakewood's trustee rejected the executory portion of the contract with CAM under section 365(a) of the Bankruptcy Code. When CAM continued to make and sell Lakewood-branded fans, Sunbeam filed an adversary proceeding against CAM.

The Bankruptcy Court's Opinion

The Bankruptcy Court found that sections 365(n) and 101(35A) leave open the question whether rejection of an intellectual property license ends the licensee's right to use trademarks. Without deciding whether a contract's rejection under section 365(a) ends the licensee's right to use the trademarks, the Court stated that it would allow CAM, which invested substantial resources in making Lakewood-branded box fans, to continue using the Lakewood marks "on equitable grounds."[6] Sunbeam appealed the judgment.

The Seventh Circuit's Affirmance[7]

Writing the opinion for the Court, Chief Judge Easterbrook first disapproved of the Bankruptcy Court's reasoning by noting that "[w]hat the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be 'inequitable.'"[8] The Court then looked at section 365(g) of the Bankruptcy Code and found that the only relevant language is that rejection of an executory contract "constitutes a breach of such contract." Seemingly anticipating an appeal to the Supreme Court, the Seventh Circuit focused on the plain language of the Bankruptcy Code, not the purposes behind the statute.

Thus, since section 365(n) is silent with respect to trademarks and section 365(g) merely provides that rejection constitutes a breach, the Court considered the consequences of a breach outside of bankruptcy, finding that "[o]utside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property . . . . outside of bankruptcy, 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."[9]

The Court also distinguished between rejection and avoidance or rescission, noting that "rejection is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the position they occupied before the contract was formed."[10]

Implications

The Seventh Circuit's decision demonstrates the insignificance of the omission of trademarks from section 365(n) of the Bankruptcy Code by finding that trademark licensees can continue to use the intellectual property despite rejection of the licensing agreement by a licensor-debtor. Moreover, the opinion cautions bankruptcy courts against overestimating the impact of rejection of executory contracts in general by emphasizing that breach of a contract by a debtor does not abrogate the counterparty's contractual rights.

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6 *In re Lakewood Engineering & Manufacturing Co.*, 459 B.R. 306 (Bankr. N.D. Ill. 2011).

7 The District Court certified a direct appeal to the Court of Appeals under 28 § U.S.C. 158(d)(2)(A).

8 2012 BL 169446 at 4.

9 *Id.* at 7.

10 *Id.* at 8-9 (citations omitted).

Practice group contacts

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