To: Our Clients and Friends July 20, 2012

Seventh Circuit Bankruptcy Decision Is a Victory for Trademark Licensees

Trademark licensees won a victory on July 9, 2012, when the Court of Appeals for the Seventh Circuit issued its decision in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*. The opinion holds that the rights of a trademark licensee do not automatically terminate when its license agreement is rejected by a trademark owner in bankruptcy. Nevertheless, the significance of that victory will only become clarified if and when other courts, including possibly the Supreme Court, and Congress address the issues raised in *Sunbeam*.

IP Licenses in Bankruptcy

The rejection of intellectual property licenses in bankruptcy has a long history. In the 1985 landmark decision of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), the Fourth Circuit Court of Appeals considered whether a patent licensee could continue to use a patent after the relevant licensing agreement was rejected as an executory contract in bankruptcy. The *Lubrizol* court reasoned that because section 365(g) of the Bankruptcy Code provides "only a damages remedy for the non-bankrupt party," and not specific performance, the licensee loses all rights to use the patent once the license is rejected. The *Lubrizol* decision left licensees in a serious lurch. In many cases, the rejection of a license would require a full-scale production shutdown by the licensee, with the licensee's only hope of recovery consisting of a general unsecured claim for damages against the bankrupt licensor.

In 1988, in reaction to the *Lubrizol* case, Congress amended the Bankruptcy Code to include section 365(n). That section largely reversed the *Lubrizol* opinion by generally permitting licensees to retain their rights to use licensed “intellectual property” if the applicable licensing agreement is rejected in bankruptcy. Congress also added a definition of "intellectual property" to the Bankruptcy Code. That defined term, however, does not include trademarks. This omission has been widely construed to mean that trademark licensees do not receive the protections of section 365(n).

The *Sunbeam* Decision

In *Sunbeam*, the Seventh Circuit Court of Appeals addressed whether the rejection of a trademark license in bankruptcy terminates the licensee's right to use the trademark. Lakewood Engineering & Manufacturing Co. made and sold box fans under its “Lakewood” brand name and owned a series of patents and trademarks used in connection with its fans. In 2008, experiencing significant losses due to its production costs, Lakewood outsourced the manufacture of its box fans to Chicago American Manufacturing (“CAM”). Under this contract, CAM was authorized to produce fans under Lakewood’s patents and bearing Lakewood’s trademark. Concerned about Lakewood's financial distress, CAM also contracted for the right to sell for its own account the entire run of Lakewood-branded fans if Lakewood failed to purchase them.

Only months into the contract, Lakewood's creditors forced it into an involuntary chapter 7 bankruptcy. The chapter 7 trustee, hoping to maximize the value of Lakewood's assets, rejected Lakewood's contract with CAM under section 365 of the Bankruptcy Code and sold Lakewood's operating assets (including the patents and trademarks licensed to CAM) to Jarden Consumer Solutions. Despite rejection of the contract and sale of the licensed patents and trademarks to Jarden, CAM continued to make and sell the Lakewood-branded fans. The chapter 7 trustee and Jarden sued CAM in bankruptcy court for infringement.

The bankruptcy court concluded that while Congress did not explicitly extend section 365(n)'s protections to trademarks, it did anticipate "equitable treatment" of trademark licensees. On these grounds, the bankruptcy court held that rejection of the contract did not terminate CAM's trademark license.

The Seventh Circuit Court of Appeals affirmed the bankruptcy court's ruling on different grounds. Writing for the panel on appeal, Chief Judge Frank Easterbrook concluded that the omission of trademarks from the definition of "intellectual property" does not indicate Congress' approval of *Lubrizol* with respect to trademarks. Rather, the omission was intended to allow Congress more time to study rejection issues as they relate to trademarks. Accordingly, the court concluded that Congress did not intend to codify *Lubrizol* with respect to trademarks.

Second, and perhaps most significantly, the court refused to follow the reasoning of *Lubrizol* with respect to the consequences of a rejection under section 356(g). The court concluded that in *Lubrizol* the Fourth Circuit confused rejection of a contract with avoidance powers. Section 365(g) provides merely that rejection "constitutes a breach of contract" and says nothing about terminating the non-breaching party's rights or rescinding the contract altogether. In most cases, the non-breaching party's rights remain intact. Because rejection did nothing to terminate CAM's rights to use the trademark under its contract with Lakewood, the Seventh Circuit affirmed the bankruptcy court's ruling.

<u>Effect of *Sunbeam* Decision</u>

Trademarks are a distinct form of intellectual property, inasmuch as they serve to identify the source of particular goods or services. Because of the unique nature of trademarks, Congress concluded, back in 1988, that further study would be required before it would include trademarks in section 365(n). Congress seemed to recognize, at some level, that the *Lubrizol* rule might make sense with respect to trademarks. The *Sunbeam* decision effectively took the leap Congress was unwilling to take. *Sunbeam* thus opens the door to a host of potential developments.

It is possible, in light of the split between the Fourth and Seventh Circuits as to the consequences of a rejection under 356(g), that the Supreme Court will address the issue. Moreover, Congress may take a renewed interest in trademark-license rejection and finally address the exclusion of trademarks from the definition of the term "intellectual property" in section 365(n). Absent review by the Supreme Court or legislation by Congress, courts outside the Fourth and Seventh Circuits will continue to wrestle with how to apply the bankruptcy laws to trademark licenses. Indeed, it is not entirely clear how the Fourth Circuit will apply those laws in the context of a trademark license.

Sunbeam also raises other significant issues, including the following:

- The *Sunbeam* court concluded that CAM could continue to use Lakewood's trademark for the limited run of goods covered by the agreement in that case. Did the facts make the law in *Sunbeam*, in a manner unfair to bankrupt licensors and successors in interest? What is *Sunbeam*'s impact on trademark assets in bankruptcy that are subject to long-term licenses? Will any buyers of trademarks emerge in a bankruptcy sale if the trademarks are subject to long-term use rights under a rejected licensing agreement?

- Does the trademark licensee maintain other rights under the rejected licensing agreement, such as exclusivity?
- Section 365(n) requires the licensee of a rejected intellectual property license to continue to pay royalties post-rejection as required under the license, to the extent the licensee continues to use the intellectual property. Section 365(n), however, does not apply to trademark licenses. Must a trademark licensee continue to pay royalties post-rejection, or does rejection constitute a material breach excusing performance, including the payment of royalties to the bankrupt licensor?

Courts will have to address these and other issues opened by the *Sunbeam* decision. The only certainty, for now at least, is that *Sunbeam* is a significant victory within the Seventh Circuit for trademark licensees whose licenses are rejected in bankruptcy.

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