Seventh Circuit: Bankruptcy Code's Definition of 'Intellectual Property' Does Not Include Trademarks

Much has been written over the past 20-plus years, in court decisions and scholarly articles, about the omission of "trademarks" from the Bankruptcy Code's definition of "intellectual property." As a result of this omission, trademark licensees have not received the benefit of the Bankruptcy Code's § 365(n), which protects intellectual property licensees when their licensors file for bankruptcy. However, a recent decision by the Seventh Circuit provided a trademark licensee with protection when its licensor filed for bankruptcy and rejected the trademark license.

**Lubrizol**

Section 365(n) was added to the Bankruptcy Code in 1988, in response to the Fourth Circuit's decision in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985). In Lubrizol, the Fourth Circuit held that when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks and patents.

**Enactment of § 365(n)**
To address its concern that Lubrizol might inhibit the licensing of technology and other intellectual property, Congress enacted § 365(n) to provide licensees of intellectual property protection analogous to that provided to lessees of real property by § 365(h). That is, because of § 365(n), licensees of intellectual property have rights to continue using that intellectual property even after a bankrupt licensor rejects the license agreement (just as under § 365(h) a tenant can continue in possession of real property even after a bankrupt landlord rejects the tenant's lease). Trademarks, however, are not included in the Bankruptcy Code's definition of "intellectual property." Consequently, licensees of trademarks have not enjoyed the protection of § 365(n).

**Sunbeam**

In Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, __F.3d __, 103 USPQ2d 1421, 2012 WL 2687939 (7th Cir. July 9, 2012), the United States Court of Appeal for the Seventh Circuit held that a trademark licensee can continue to use the licensed trademarks of the bankrupt debtor/licensor, even when the bankruptcy trustee rejects the trademark license, and even though Bankruptcy Code § 365(n) does not provide the trademark licensee with the right to continue to use the debtor/licensor's trademarks.
The Sunbeam case began in 2008 when Lakewood Engineering & Manufacturing Co. (Lakewood) contracted with Chicago American Manufacturing (CAM) to manufacturer box fans for Lakewood, as the latter had been unable to profitably manufacture and sell box fans itself. In conjunction with CAM's manufacture of the box fans, the contract licensed CAM to use Lakewood's applicable patents and mark the completed box fans with Lakewood's trademarks.

Although the box fans were to be manufactured for and on behalf of Lakewood and its customers, CAM negotiated for the right to sell any excess inventory of the box fans for CAM's own account in the event that Lakewood was unable to purchase the entire amount of the initial production run (1.2 million box fans). The excess inventory was to be sold by CAM under the patent and trademark licenses granted by Lakewood in the manufacturing contract.

Just a few months after the contract was signed, a number of Lakewood's creditors filed an involuntary bankruptcy petition against it. The bankruptcy court appointed a trustee who decided to sell Lakewood's business, including the patents and trademarks that had been licensed to CAM, to
Sunbeam Products, Inc. (operating as Jarden Consumer Solutions). Sunbeam did not wish to acquire the Lakewood-branded box fans CAM had in inventory, nor did it want CAM to sell those box fans in competition with Sunbeam's own products. Therefore, the trustee rejected the executory portion of Lakewood's manufacturing contract with CAM under Bankruptcy Code § 365(a). When CAM continued to make and sell the Lakewood-branded box fans, Sunbeam brought suit in the bankruptcy court to stop CAM from doing so.

Bankruptcy Court Decision
Bankruptcy Judge Pamela Hollis held a trial and decided that CAM was permitted to continue using the Lakewood trademarks to make and sell as many box fans as Lakewood estimated it would have needed for the entire initial production run. Acknowledging that the Bankruptcy Code is silent on whether rejection of an intellectual property license under § 365(a) ends the licensee's right to use the licensed trademarks, the bankruptcy court nevertheless reached this conclusion on equitable grounds because CAM had invested substantial resources in gearing up to manufacture the Lakewood-branded box fans. In re Lakewood Engineering & Manufacturing Co., 459 B.R. 306, 333-38 (Bankr.N.D.Ill.2011).

Sunbeam appealed the bankruptcy judge's
decision directly to the Seventh Circuit.

**Seventh Circuit Decision**
The Seventh Circuit began its analysis of the case by reviewing the Fourth Circuit's Lubrizol decision and the subsequent addition of § 365(n) to the Bankruptcy Code. And, like other courts that have considered the issue, it concluded that § 365(n) does not affect trademarks one way or the other. The Seventh Circuit noted that no other court of appeals has agreed with the Lubrizol decision, or for that matter, has disagreed with it, and the only other appellate case in which the issue arose was decided on other grounds.

**Lubrizol Was Wrong**
Continuing its analysis, the Seventh Circuit found that the bankruptcy judge's decision to permit CAM to continue to use the licensed Lakewood trademarks on equitable grounds was untenable because of the inherently subjective nature of such an equitable standard. Nevertheless, the Seventh Circuit agreed with Judge Hollis' ultimate decision in view of its reading of Bankruptcy Code § 365(g), which specifies the consequences of a rejection under §365(a).

In doing so, the Seventh Circuit criticized the Fourth Circuit's Lubrizol decision as misunderstanding the effect § 365(g) on
rejected intellectual property licenses
("Lubrizol itself 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.") Simply put, Judge
Hollis got it right when she determined that §§
101(35A) and 365(g) left open the question of
whether rejection of an intellectual property
license ends the licensee's right to use
trademarks.

**Rejection Is Not Tantamount to Recission**

To reach its conclusion, the Seventh Circuit
focused on the opening proposition of §
365(g): that
rejection of an executory contract "constitutes
a breach of such contract." Outside of
bankruptcy, the court noted, a licensor's
breach of a license does not automatically
terminate a licensee's right to use intellectual
property; rather, it creates a cause of action in
favor of the licensee. As the court put it,
"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."

**Analogy to Real Property Lease Rejection**

Drawing an analogy, the court considered
how rejection under § 365 works for leases:
"A lessee that enters bankruptcy may reject
the lease and pay damages for abandoning
the premises, but rejection does not abrogate the lease (which would absolve the debtor of the need to pay damages). Similarly a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price. The bankrupt lessor might substitute damages for an obligation to make repairs, but not rescind the lease altogether."

In other words, nothing about the rejection process under § 365 implies that any rights of the other contracting party have been "vaporized."

The Seventh Circuit concluded by explicitly clarifying that rejection of a contract containing an intellectual property license under § 365(a) is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed. Rather, rejection merely frees the debtor/licensor's estate from the obligation to perform under the license and has absolutely no effect upon the contract's continued existence and the trademark licensee's continued right to use the licensed trademark under the terms of the license. Therefore, CAM was permitted to continue making and selling box fans using the licensed Lakewood trademarks.

Ramifications of Sunbeam
1. How broadly can Sunbeam be read?

Does it apply to all trademark licenses, or just situations with facts akin to the Sunbeam facts (a limited license granted to sell-off a fixed amount of inventory)?

Based on the Seventh Circuit's logic, we suspect it can be read broadly; based on our analysis, we think it should be read broadly. The Seventh Circuit's decision was rooted in basic contract law, as interpreted within the framework of the Bankruptcy Code. There is nothing in the decision to suggest that the court would have reached a different conclusion had the underlying trademark license permitted CAM to sell an unlimited quantity of box fans using Lakewood's trademarks. For that matter, there is nothing in the decision to suggest that any other terms typically found in trademark licenses, such as market channel and/or geographic exclusivity provisions, or time limitations, would have changed the court's opinion. Only time will tell how far Sunbeam will be stretched; however, it is clear is that debtor-licensors are not as likely to receive as high a value for their trademark portfolios in jurisdictions that follow Sunbeam as they would in jurisdictions that follow Lubrizol.

2. Does Sunbeam have applicability outside of trademark licenses?
We think it should. In addition to trademarks, other forms of intellectual property are not identified in the Bankruptcy Code's definition of "intellectual property," including trade names, rights of publicity and foreign patents, industrial designs and copyrights. Because the Seventh Circuit's decision relied upon fundamental contract law, and the underlying nature of the licensed intellectual property was not a determinative factor, it seems likely that licensees will use Sunbeam as a tool to protect licenses for all forms of intellectual property excluded from § 365(n).

3. Can a purchaser of licensed intellectual property buy it "free and clear" of a licensee's rights after Sunbeam?

Interestingly, the Seventh Circuit's decision in Precision Industries, Inc. v. Qualitech SBQ, LLC, 327 F.3d 537 (7th Cir. 2003), permitted a debtor-landlord to sell property under § 363 free and clear of the tenant's leasehold interest. There has been debate over whether Qualitech's reasoning should carry over to intellectual property licenses. Sunbeam, it could be argued, stands for the proposition that a licensee's rights cannot be so abrogated. On the other hand, if a buyer can buy free and clear of a lease why can't it also buy free and clear of a license? Time will tell.

4. If Sunbeam becomes the prevailing view,
will § 365(n) matter anymore?

It must. To ignore § 365(n) would be tantamount to allowing licensees to retain rights without meeting the obligations of that subsection, such as paying royalties and waiving setoffs. This cannot be the result.

Conclusion
Trademark licensees (and licensees of other forms of intellectual property that are not included in the Code's definition) will surely cite for the proposition that rejection of their license agreements in bankruptcy does not terminate their licenses, and that they are permitted to continue using the licensed intellectual property postrejection. But, as noted above, that use surely cannot (at least, should not) be for free.

We think, at the end of the proverbial day, courts will effectively (perhaps through competing analytical frameworks) treat licensees as if they are covered by § 365(n); perhaps Congress will (should) amend the Code accordingly.

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