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On July 9, 2012, the U.S. Court of Appeals for the Seventh Circuit issued its decision in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC,* and in doing so handed a major victory to trademark licensees whose licenses are rejected in bankruptcy by trademark owners. View the full opinion. However, before discussing the details of the opinion, it's important to put it in context first. And for that, we need to journey back to the 1980s.

A history of rejection

Back in 1985, the U.S. Court of Appeals for the Fourth Circuit issued a decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985). The Fourth Circuit held that Lubrizol, a nonexclusive patent licensee whose patent license was rejected as an executory contract in the bankruptcy case of Lubrizol's licensor, debtor Richmond Metal Finishers, could not "rely on provisions within its agreement with [the debtor] for continued use of the technology." According to the *Lubrizol* court, when Congress enacted Section 365(g) of the Bankruptcy Code, governing the effect of rejection of an executory contract, "the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party," and no specific performance remedy. The Fourth Circuit held that, as a result, when the debtor rejected the contract, Lubrizol, as the patent licensee, lost its rights under the license.

Congress protects certain IP licensees

In reaction to the *Lubrizol* decision and the concerns of the decision's potential impact on patent and other technology licensees, in 1988 Congress added Section 365(n) to the Bankruptcy Code, expressly permitting licensees of intellectual property to elect to retain their rights to the intellectual property. However, Congress also added to the Bankruptcy Code its own definition of "intellectual property" for Section 365(n) purposes, and decided not to include trademarks in Section 101(35A)'s definition. As a result, trademark licensees have none of the protections of Section 365(n). Read more on Section 365(n) and its protections for licensees.

Back to the future

With that history in mind, it's time to come back to the future, or at least the present. *Lubrizol's* decision that a licensee cannot rely on the provisions of its license agreement for continued use of the intellectual property, together with the fact that Section 365(n)'s protections do not extend to trademark licenses, has for years left trademark licensees at great risk of losing all trademark rights if the license is rejected. That is, it seemed that way until just the past couple of years.

- A 2010 decision from the U.S. Court of Appeals for the Third Circuit in the *In re: Exide Technologies* case held that when a trademark license was provided in connection with the sale of a business, and that sale had been substantially performed, the trademark license was no longer executory, could not be rejected, and the licensee could continue to use the trademarks.
- In a concurring opinion in *Exide Technologies,* Judge Ambro went further, concluding that rejection of a trademark license should not deprive the licensee of all rights. In enacting Section 365(n) but leaving trademarks outside the definition of "intellectual property," Congress did not intend that *Lubrizol's* result apply to trademark licenses and instead courts should use equitable powers to protect licensees.
- Last year, in the case that led to the Seventh Circuit's decision here, the bankruptcy court in *In re Lakewood Engineering & Manufacturing Co., Inc,* 459 B.R. 306 (Bankr. N.D. Ill. 2011), decided to "step into the breach," follow Judge Ambro's reasoning, and begin the "development of equitable treatment" of trademark licensees that it concluded Congress had anticipated would occur. In so doing, it held that despite rejection of a manufacturing and supply agreement that included a trademark license, the licensee could continue to sell trademarked goods as it had been licensed to do.

The Seventh Circuit's decision

The bankruptcy court's decision was taken up on appeal to the Seventh Circuit. In its July 9, 2012 opinion, written by Chief Judge Frank H. Easterbrook, the Seventh Circuit disagreed with the bankruptcy court's analysis but ultimately affirmed its decision. In its opinion, however, the Seventh Circuit took aim directly at the *Lubrizol* decision and reasoning.

The facts of the *Sunbeam* case are fairly straightforward. Lakewood Engineering & Manufacturing Co. made various consumer products, including box fans, which were covered by its patents and trademarks. Lakewood contracted with Chicago American Manufacturing ("CAM") to make its fans for 2009, granting CAM a license to the relevant patents and trademarks. In recognition of both the investment CAM would have to make to manufacture the fans and Lakewood's own distressed financial condition, the agreement authorized CAM to sell directly any of the 2009 production of box fans that Lakewood did not purchase. A few months after the agreement was signed, Lakewood was forced into involuntary bankruptcy and a trustee was appointed. The trustee sold Lakewood's assets, including the patents and trademarks, to Sunbeam Consumer Products, which wanted to sell its own fans and not have to compete with CAM's sales. The trustee rejected the CAM agreement and, when CAM continued to sell the remaining fans, Sunbeam sued CAM for infringement.

The issue on appeal was the effect of the trustee's rejection of the CAM agreement, and specifically the trademark license, on CAM's ability to sell the fans. The Seventh Circuit's focus on the *Lubrizol* decision was apparent:

Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), holds that, when an intellectual-property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. Three years after *Lubrizol,* Congress added §365(n) to the Bankruptcy Code. It allows licensees to continue using the intellectual property after rejection, provided they meet certain conditions. The bankruptcy judge held that §365(n) allowed CAM to practice Lakewood's patents when making box fans for the 2009 season. That ruling is no longer contested. But "intellectual property" is a defined term in the Bankruptcy Code: 11 U.S.C. §101(35A) provides that "intellectual property" includes patents, copyrights, and trade secrets. It does not mention trademarks. 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.

Chief Judge Easterbrook's opinion noted that the bankruptcy court had permitted CAM to continue using the trademarks on equitable grounds, but rejected that approach as going beyond what the Bankruptcy Code permits. The Seventh Circuit then directly addressed the *Lubrizol* decision:

Although the bankruptcy judge's ground of decision is untenable, that does not necessarily require reversal. We need to determine whether *Lubrizol* correctly understood §365(g), which specifies the consequences of a rejection under §365(a). No other court of appeals has agreed with *Lubrizol*—or for that matter disagreed with it. *Exide,* the only other appellate case in which the subject came up, was resolved on the ground that the contract was not executory and therefore could not be rejected. (*Lubrizol* has been cited in other appellate opinions, none of which concerns the effect of rejection on intellectual-property licenses.) Judge Ambro, who filed a concurring opinion in *Exide,* concluded that, had the contract been eligible for rejection under §365(a), the licensee could have continued using the trademarks. 607 F.3d at 964–68. Like Judge Ambro, we too think *Lubrizol* mistaken.

After observing that outside of bankruptcy a licensor's breach does not terminate a licensee's right to use intellectual property, and Section 365(g) provides that rejection is breach, the Seventh Circuit turned to the impact of Section 365(g) and rejection in bankruptcy:

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. See *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 531 (1984); *Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equipment Corp.,* 54 F.3d 406, 407 (7th Cir. 1995). 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. Consider how rejection 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.
The Court then distinguished rejection from avoidance powers, which might lead to rescission or termination of an agreement, observing that "rejection 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." *Thompkins v. Lil' Joe Records, Inc.,* 476 F.3d 1294, 1306 (11th Cir. 2007). It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence'. *Ibid.* (internal citations omitted)." Read more background on the Thompkins decision.

The Seventh Circuit referenced scholarly criticism of the *Lubrizol* decision before turning back to the Fourth Circuit's opinion:

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.
Lubrizol does not persuade us. This opinion, which creates a conflict among the circuits, was circulated to all active judges under Circuit Rule 40(e). No judge favored a hearing en banc. Because the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights, this adversary proceeding properly ended with a judgment in CAM's favor.

A significant decision

The Seventh Circuit's opinion in the *Sunbeam* case not only creates a circuit split that could potentially lead the Supreme Court to address the issue, but more significantly represents the first court of appeals decision in 27 years to challenge *Lubrizol's* view of how rejection impacts an intellectual property license. Although binding only in the Seventh Circuit (much like, in theory, *Lubrizol* was binding only in the Fourth Circuit), the *Sunbeam* decision has the potential to impact licensee rights in cases across the country. Licensees, and especially trademark licensees, will be arguing that rejection does not terminate their license rights. Debtors and purchasers of trademarks may well argue otherwise. If followed by other courts, the *Sunbeam* decision and its potential interplay with Section 365(n) raises a number of questions, including:

- Aside from the right to use the licensed trademarks, does the licensee keep other rights under its agreement, such as exclusivity if applicable?
- How long does the right to the trademarks continue, the full term of the license agreement plus any extensions, or some shorter period?
- If royalties are required under a trademark license, must the trademark licensee continue to pay them post-rejection to use the licensed trademarks, as an IP licensee covered by Section 365(n) is required to do, or can the trademark licensee argue that rejection is a material breach excusing that performance?
- Since under *Sunbeam* rejection does not terminate trademark license rights, does the same analysis apply to intellectual property other than trademarks, including those covered by Section 365(n)?
- Are licensees of patents, copyrights, or trade secrets, otherwise protected by Section 365(n), required to follow Section 365(n)'s statutory scheme to retain their rights, or can they rely on the *Sunbeam* decision's analysis of the effect of rejection as an alternative approach?
- How will purchasers of trademarks and other assets react to the potential continued use of the marks by licensees under rejected trademark licenses?

Conclusion

As these questions suggest, the full impact of the Seventh Circuit's *Sunbeam* decision is yet to be determined. It remains to be seen how other circuits—and bankruptcy courts in important venues such as Delaware and the Southern District of New York—will react. Given the circuit split now created, it's possible the Supreme Court could address the issue, either in *Sunbeam* or a later case. In the meantime, however, a long-standing and often accepted view of the impact of rejection on intellectual property licenses, and especially on trademark licenses, has been upended. It will likely take courts, licensors, and licensees some time to sort through how the new, post-*Sunbeam* state of the law will play out. This could get interesting—stay tuned.

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