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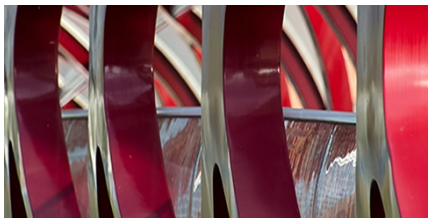

News & Types: Corporate, Finance & Acquisitions Update

7th Circuit Creates Conflict Among Federal Courts Regarding Ability of Bankrupt Trademark Licensor to Reject License Agreement; U.S. Supreme Court May Need to Decide

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Practices: Commercial, Competition & Trade

In a recent important decision, the 7th Circuit Court of Appeals held that a trademark licensor could not use its bankruptcy to deny the rights of a licensee to use the trademark pursuant to a pre-bankruptcy agreement. (*Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 7th Circuit Court of Appeals, No. 11-3920, decided July 9, 2012) This decision creates a conflict among the federal circuits, which often means the U.S. Supreme Court must eventually decide the issue.

As background, in 1985 the 4th Circuit Court of Appeals held that, when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. (*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* 756 F.2d 2043 (4th Circuit Court of Appeals 1985)). The decision was heavily criticized, since it permitted an intellectual property licensor to get out of a license agreement through bankruptcy. Even the 4th Circuit acknowledged, when issuing the opinion, that permitting rejection of an intellectual property license could have a "chilling effect" on the willingness of potential licensees to contract with licensors in financial difficulty.

Three years later, Congress amended the Bankruptcy Code to overturn *Lubrizol*. Congress added Section 365(n) of the Bankruptcy Code to permit an intellectual property licensee, faced with a bankrupt licensor's attempt to reject the contract, to either treat the contract as terminated or to retain rights under the contract. But, in a notable omission, the definition of "intellectual property" in Section 365(n) did not include trademark rights. At the time, the Senate report that accompanied the Bankruptcy Code amendment stated that the omission of trademarks was not because Congress felt trademark licensees should not be protected. Rather, it was because trademark licenses depend on quality control of the products sold by the licensee and this was an area beyond the scope of the amendment. The Senate report went on to say that Congress intended to allow development of "equitable treatment" of this situation by bankruptcy courts.

This placed the courts in an obvious dilemma. Do the courts follow *Lubrizol* in permitting a bankrupt trademark licensor to reject a trademark license agreement, since, at least with respect to trademarks, Congress let the *Lubrizol* case stand? Or do the courts use "equitable treatment" to decide on a case by case basis, based on the Senate report?

Earlier we reported on a case that dealt with the effect of this omission. (*In re: Exide Technologies,* 3rd Circuit Court of Appeals, No. 08-1872, filed June 2, 2010) In the *Exide Technologies* case, a bankrupt trademark licensor tried to take back the trademark it had licensed in 1991, nearly twenty years prior to the case. The court in *Exide Technologies* found that the trademark license agreement was not "executory" (i.e., not yet performed) because the trademark licensee had substantially performed the contract. So the trademark licensor did not succeed in getting its trademark back through the bankruptcy. Since the contract was not "executory", the court was not bound by *Lubrizol*, which dealt with executory contracts. In a concurring opinion, Judge Ambro, citing the Senate report, asserted that the court could have used its equitable power to achieve the same result to not permit a bankrupt trademark licensor to reject a trademark license agreement.

Enter Judge Easterbrook of the 7th Circuit, who wrote the opinion in the *Sunbeam Products* decision. In *Sunbeam Products*, Lakewood Engineering & Manufacturing Co. made and sold a variety of consumer products, including box fans. Since it was losing money on these, in 2008 it contracted with Chicago American Manufacturing, LLC (CAM) to manufacture the box fans using the Lakewood trademarks. CAM was clearly concerned about Lakewood's financial condition. So, as part of its agreement, Lakewood authorized CAM to sell the fans on CAM's own account if Lakewood did not purchase them, even though the fans used the Lakewood trademarks.

Sure enough, three months into the contract, several of Lakewood's creditors filed an involuntary bankruptcy petition against it. The court appointed a trustee, which sold the assets of Lakewood to Sunbeam Products (doing business as Jarden Consumer Solutions). The assets included the patents and trademarks. Since Sunbeam did not want the fans CAM had manufactured and also did not want CAM to sell the fans directly in competition with Sunbeam, Sunbeam caused the trustee to reject Lakewood's contract with CAM. Had the rejection been effective and CAM been unable to use the Lakewood trademarks, CAM would be in the disastrous position of holding an inventory of fans it could not sell, as well as losing money on unrecovered production costs for fans it could no longer make.

The bankruptcy judge, after trial, followed the reasoning of Judge Ambro in the *Exide Technologies* case and decided that CAM could continue to use the Lakewood trademarks to manufacture and sell the box fans "on equitable grounds." This seemed to be the easier and more obvious course, since the bankruptcy judge could cite the Senate report and rely on Judge Ambro's earlier concurring opinion in support. It also seemed to be the "right" decision in not penalizing CAM for contracting with a financially distressed licensor.

Judge Easterbrook would have none of it. He agreed with the bankruptcy judge's decision, but not the reasoning behind it. Said Judge Easterbrook,

> "What the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be 'inequitable'. . . . There are hundreds of bankruptcy judges, who have many different ideas about what is

> equitable in any given situation. . . . Rights depend, however, on what the Code provides rather on notions of equity."

Judge Easterbrook went on to directly attack the result in *Lubrizol*. He noted that no other court of appeals has agreed with *Lubrizol*. He then analyzed what the situation would have been outside bankruptcy. If, apart from bankruptcy, Lakewood had breached its agreement, "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." The Bankruptcy Code provides that rejection of a contract is a breach by the bankrupt party. It does not destroy the remedies of the other, non-bankrupt, party. It only limits these to damages, which are dealt with in the bankruptcy proceeding. But the rights of the other party are not "vaporized." Judge Easterbrook compared this situation to a bankrupt lessor's rejection of a lease, which does not end the tenant's right to possession. So the Lakewood trustee's rejection of the contract with CAM did not abrogate CAM's contractual rights, just as, in a non-bankruptcy context, Lakewood's breach would not abrogate CAM's contractual rights.

In the end, Judge Easterbrook's opinion directly and explicitly contradicted Lubrizol. The facts did not permit him to avoid Lubrizol by calling the contract non-executory, as the Exide Technologies court did. But he also did not want to use the notion of "equity" cited in the Senate report to avoid Lubrizol, as the bankruptcy judge did.

> "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." [En banc refers to a hearing that includes all the judges of the circuit, not just the three judges deciding the case.]

By creating a "conflict among the circuits", Judge Easterbrook has invited the U.S. Supreme Court to eventually decide on the issue in an appropriate case. The other alternative (which the court hinted at in noting that no other court of appeals has agreed with Lubrizol) is that the Lubrizol case will be abandoned as an outlier and not followed by any other court of appeals.

One of the recent drivers to M&A activity has been the value of intellectual property rights, including valuable trademarks. The value and certainty of rights provided for by contract, even in a bankruptcy context, is important to protect valuable intellectual property rights. So the Sunbeam decision, if followed by other circuits, will be helpful to add consistency and certainty for acquirers of intellectual property as well as lawyers who assist clients in the buying and selling of intellectual property rights.