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Trademarks And Bankruptcy: Seventh Circuit Provides Lifeline For Trademark Licensees Confronting Licensor Bankruptcy

Boris I. Mankovetskiy and Lucas F. Hammonds

SILLS CUMMIS & GROSS P.C.

The Bankruptcy Code provides certain protections to intellectual property licensees. Specifically, section 365(n) of the Bankruptcy Code grants intellectual property licensees the ability to retain rights under license agreements rejected by bankrupt licensors under section 365(a). This protection does not extend to trademarks. As a result, licensees face difficulty in retaining the use of trademarks when licensors reject the underlying agreements in bankruptcy. *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), a recent opinion by the United States Court of Appeals for the Seventh Circuit, offers hope for trademark licensees. This article discusses strategies for retaining the use of trademarks in the event of rejection in light of *Sunbeam*.

Treatment Of Contracts Under Section 365 Of The Bankruptcy Code

Section 365(a) provides that a debtor

Boris I. Mankovetskiy

Lucas F. Hammonds

may assume or reject any "executory contract" to which it is a party. An "executory contract" is typically defined as a contract under which the obligations of both parties are so far underperformed that the failure of either party to complete performance would be a material breach excusing performance by the counterparty. If a debtor assumes a contract under section 365(a), it will continue to be bound by the contract and is required by section 365(b)(1) to cure any defaults. If a debtor rejects a contract, it is relieved of its contractual obligations. Rejection constitutes a breach of the rejected contract, as provided by section 365(g).

Intellectual Property Licenses And Section 365(n)

Section 365(n) of the Bankruptcy Code protects intellectual property licensees in the event that their license agreements are rejected under section 365(a). Under section 365(n), if a licensor rejects an intellectual property license agreement and the rejection amounts to a breach entitling the licensee to treat the contract as terminated according to "its own terms, non-bankruptcy law, or an agreement with another entity[,]" the licensee has the option to treat the agreement as terminated and file a claim for the resulting damages. The licensee may alternatively elect to retain its rights under the agreement to the intellectual property for the duration of the agreement and any period that it may be extended under non-bankruptcy law.

Section 365(n) was enacted in the wake of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), in which the United States Court of Appeals for the Fourth Circuit held that the rejection of a technology licensing agreement to use metal coating process technology deprived the licensee of all rights to the process. According to the Fourth Circuit, section 365(g) entitled the licensee to "treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of [that] type of contract."

Section 365(n), which explicitly supersedes *Lubrizol* with respect to intellectual property licenses, is a powerful tool for licensees. However, its applicability is limited by the definition of "intellectual property" under section 101(35A), which does not include trademarks, making matters difficult for licensees wishing to retain the use of trademarks under rejected license agreements.

***Boris I. Mankovetskiy** is a Member of the Sills Cummis & Gross Creditors' Rights and Bankruptcy Reorganization Practice Group. **Lucas F. Hammonds** is an Associate in the Group. The views and opinions expressed in this article are those of the authors and do not necessarily reflect those of Sills Cummis & Gross P.C.*

Please email the authors at bmankovetskiy@sillscummis.com or lhammonds@sillscummis.com with questions about this article.

Strategies For Retaining The Use Of A Trademark

The simplest way to retain the use of a trademark, while also preserving the existing business relationship with the licensor, is by consensual agreement. However, not every licensor is willing to negotiate or agree to reasonable terms, especially if the licensor believes rejection of the agreement will be beneficial. In that event, a licensee has several arguments at its disposal. Prior to *Sunbeam*, the best of these arguments were: (i) the license agreement is not an executory contract and therefore cannot be rejected under section 365(a), and (ii) despite the omission of trademarks from the definition of intellectual property under section 101(35A), the protections of section 365(n) should extend to the trademark at issue if it is integral to intellectual property protected under that section.

Support for the former argument is found in *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010). In *Exide*, the licensee had a license to use a trademark in the industrial battery business. The licensor sought to reject the license agreement, but the United States Court of Appeals for the Third Circuit held that the agreement was not executory because the licensee had substantially performed by paying the full purchase price for the trademark and other property in a sale by the licensor over 10 years earlier and by operating under the terms of the agreement since that time.

However, the circumstances of *Exide* were atypical. The licensee in *Exide* purchased the trademark license in a transaction that involved the purchase of a bundle of assets from the licensor that included physical manufacturing plants, equipment and inventory. The license agreement was one of 23 agreements entered into by the parties to effectuate the transaction. Due to the transaction's structure, the consideration for the license was delivered up front, and the licensee's few remaining material obligations were satisfied by the time the licensor sought to reject the agreement. In a more typical transaction, a licensee might have continuing material obligations that render the agreement executory for the purposes of assumption or rejection under section 365(a).

Moreover, *Lewis Brothers Bakeries Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 2012 U.S. App. LEXIS 18403 (8th Cir. Aug. 30, 2012), a recent decision from the United States Court of Appeals for the Eighth Circuit, has further limited *Exide*'s application. *Lewis Brothers* involved a factually similar scenario in which the license agreement was part of an integrated agreement for the sale of certain business operations to the licensee. The transaction was treated as a completed sale, and the parties acted accordingly for over a decade. The court distinguished *Exide* on the grounds that the requirement of the licensee in *Lewis Brothers* to maintain quality standards under the agreement was a material obligation and that failure to do so would be a material breach according to the agreement's own terms. The parties in *Exide* had not considered or discussed any such standards. The *Lewis Brothers* court also held that the licensor's obligations with respect to (i) notice and forbearance regarding the trademarks, (ii) maintaining and defending the marks, and (iii) other infringement-related obligations were material. It therefore concluded that the agreement was an executory contract and could be rejected. As a result, the argument that a license agreement is not an executory contract has become even more difficult.

Support for the argument that the protections of section 365(n) should extend to the trademark at issue if it is integral to intellectual property protected under that section is found in section 365(n)'s language protecting any agreement "supplementary" to the intellectual property license agreement and certain remarks by the United States Bankruptcy Court for the Southern District of Florida in *In re Ron Matusalem & Matusa of Florida, Inc*., 158 B.R. 514 (Bankr. S.D. Fla. 1993). In *Matusalem*, the court suggested (i) that, in cases where the value of an intellectual property license is tied to a related trademark, the legislative history of section 365(n) indicates that courts may look to equity to protect the trademark license in addition to the intellectual property license, and (ii) that the definition of "work of authorship" under title 17 of the United States Code might be broad enough to encompass at least some trademarks. Unfortunately for licensees, *Matusalem,* like *Exide*, was a unique case, and was ultimately decided on other grounds. *Matusalem* involved a decades-long family feud dating back to 1872. The court viewed the bankruptcy case as a vendetta filed for the purpose of hurting the licensee, even at the licensor's own expense, not a legitimate attempt at reorganization. The court therefore ruled that the debtor could not reject the agreement in question because there was no business justification for doing so. Other courts have nearly uniformly held that, despite the inequitable result, licensees may not continue to use trademarks merely because they are relevant to protected intellectual property rights.

Sunbeam provides a lifeline for trademark licensees by directly contradicting *Lubrizol*'s holding that section 365(g) of the Bankruptcy Code limits licensees to money damages in the event of rejection of a license agreement and the licensee cannot retain its rights under the rejected agreement. The *Sunbeam* court held that the omission of trademarks from the definition of intellectual property under section 101(35A) "means that § 365(n) does not affect trademarks one way or the other." The court further held that *Lubrizol*'s interpretation of section 365(g) was mistaken. By classifying a rejection as a breach, section 365(g) "establishes that in bankruptcy, as outside of it, the other party's rights remain in place." Rejection is not the equivalent of rescission. According to the *Sunbeam* court, although rejection frees the debtor from the obligation to perform under the rejected agreement, it has no effect on the agreement's continued existence. This view is supported by Judge Ambro's concurring opinion in *Exide*, in which he concluded that the licensee could have continued using the trademarks even if the contract in question had been executory and eligible for rejection under section 365(a).

Conclusion

Sunbeam creates a circuit split with respect to the effect of section 365(g) in the event of rejection of a contract under section 365(a). In contrast to *Lubrizol*, *Sunbeam* supports the position that the rejection of a license agreement in bankruptcy has the same effect as a breach of the agreement outside of bankruptcy. It therefore also supports the argument by a trademark licensee that it may continue the use of a trademark after rejection of the license agreement, provided that the licensee could continue the use of the trademark outside of bankruptcy in the event of breach by the licensor.