ALERTS

Seventh Circuit Protects Nondebtor Licensee of Rejected Trademark License

July 12, 2012

The U.S. Court of Appeals for the Seventh Circuit held on July 9 that the nondebtor licensee of a rejected trademark license may continue to use the trademark (*Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, ___ F.3d ___, 2012 WL 2687939 (7th Cir. July 9, 2012) (Easterbrook, Ch. J.)). The court's clear, concise and no-nonsense opinion explained that Bankruptcy Code ("Code") § 365(g) deems a trustee's rejection to be a "breach" of the contract, enabling "the other party's rights [to] remain in place." *Id.*, at *3. In short, "nothing about [the rejection] process implies that any rights of the contracting party have been vaporized." *Id.*

Relevance

Owners of intellectual property prefer to enter into license agreements, authorizing a licensee to use the intellectual property in exchange for fees or royalties. The owner's bankruptcy, however, can have a significant impact because the license may constitute the cornerstone of the licensee's business.

Congress enacted the "Intellectual Property Bankruptcy Protection Act" (Code § 365(n)) on Oct. 18, 1988 to protect an intellectual property licensee by permitting it to retain rights under its license agreement despite the rejection of that agreement by the licensor's bankruptcy trustee or by the debtor-licensor as chapter 11 debtor-in-possession. Among other things, Congress responded to the Fourth Circuit's holding in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In that case, the chapter 11 debtor-in-possession, as

licensor, obtained leave to reject a technology licensing agreement under Code § 365(a) as a matter of business judgment. The court deprived the licensee of the right to use the licensed technology after rejection, however, limiting the licensee to a monetary damage claim with no right to specific performance. Despite the licensee's claim of unfair prejudice, the court suggested that the licensee's remedy lay with Congress. But the later 1988 legislation did *not* apply to licenses of trademarks, trade names or service marks (Senate Report, p.t. III. D, at 5, accompanying S. 1626, 100th Cong., 2d Sess., 134 Cong. Rec. H 9484 (1988) H.R. Rep. No. 1012, 100th Cong., 2d Sess. 8 (1988)). Because it rejects the holding of *Lubrizol*, the Seventh Circuit's *Sunbeam* decision admittedly "creates a conflict among the circuits." *Id.*, at *4. And because the entire Seventh Circuit declined "a hearing *en banc*," the appellant in *Sunbeam* may very well seek review by the Supreme Court of the United States.

Facts

The debtor licensor authorized the licensee "to practice [the licensor's] patents and put its trademarks on the completed [products], . . . authorizing [the licensee] to sell [products] for its own account if [the licensor] did not purchase them." *Id.*, at *1. After the licensor became the subject of a bankruptcy case, Sunbeam bought the debtor's assets, including its patents and trademarks, but did not want the licensee "to sell [the debtor-licensor's products] in competition with [its own] products." *Id.* When the licensee continued "to make and sell" the licensor's products, Sunbeam sued in the bankruptcy court, agreeing to share its recovery with the licensor's trustee who had rejected the debtor's contract with the licensee.

The Bankruptcy Court's Ruling

The bankruptcy court, after trial, held that the licensee was entitled to continue making and selling the licensor-debtor's products bearing the debtor's trademarks. *Id.* Finding that Code § 365(n) did not answer "the question whether rejection of an intellectual property license ends the licensee's right to use trademarks," the bankruptcy judge authorized the licensee to continue using the trademarks "on equitable grounds" because the licensee had invested "substantial resources in making" the products. *Id.*, at *2.

The Appeal

Sunbeam appealed directly to the Court of Appeals following certification by the district court. *Id.*, at *1. The sole issue on appeal was "the effect of the trustee's rejection . . . ." *Id.*

The Code's Omission of Trademarks: "Just an Omission"

Code § 101(35A), where defining "intellectual property," "does not mention trademarks," said the Seventh Circuit. *Id.* Rejecting speculation by "some bankruptcy judges" as to whether the Fourth Circuit's *Lubrizol* decision applied to trademark licenses, the Seventh Circuit said that "an omission is just an omission . . . . § 365(n) [that the later 1988 legislation] does not affect trademarks one way or the other." *Id.* According to the relevant legislative history, moreover, Congress merely wanted "more time for study" when it made the omission, but "not to approve *Lubrizol*." *Id.*

The Court of Appeals rejected the bankruptcy court's equitable analysis in *Sunbeam*. "There are hundreds of bankruptcy judges, who have many different ideas about what is equitable in any given situation. Some may think that equity favors licensees' reliance interests; others may believe that equity favors the creditors, who can realize more of their claims if the debtor can terminate IP licenses. Rights depend, however, on what the Code provides rather than on notions of equity." *Id.*, at *2. Although the bankruptcy judge's reasoning was "untenable," the Seventh Circuit still affirmed because it found *Lubrizol*'s holding "mistaken." *Id.*, at *2.

Analysis: Consequences of Contract Rejection

Homing in on the precise language of Code § 365(g), the court found that "rejection takes effect immediately before the [bankruptcy] petition's filing," and "that rejection 'constitutes a breach of such contract.'" *Id.*, at *3. The court then used the Code's terms to frame its analysis: "Outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property." *Id.* Had the licensor in *Sunbeam* breached its contract prior to bankruptcy, it could not have ended the licensee's "right to sell the [products] 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 . . . . 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. . . . 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." *Id.*

The trustee may have had other avoiding powers (fraudulent transfer; preference), but "never contended that [the licensor's] contract with [the licensee] is subject to rescission." *Id.*, at *4. Moreover, contract rejection does not constitute rescission avoiding the contract and reinstating the parties to their prior position. Rather, it "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence". *Id.*, quoting *Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007). As the court noted, "*Lubrizol* . . . 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." *Id.* Scholars have uniformly criticized *Lubrizol*, "concluding that it confuses rejection with the use of an avoiding power." *Id.*, citing *Douglas G. Baird, Elements of Bankruptcy*, 130-40 & n.10 (4th e.d. 2006).

* * *

The refreshing clarity of *Sunbeam* is welcome. For more than 25 years, courts and litigants have argued over the consequences of contract rejection. If the Supreme Court grants certiorari here, it will have one more "easy case" to resolve, "clearly and predictably using well established principles of statutory construction." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2093 (2012).

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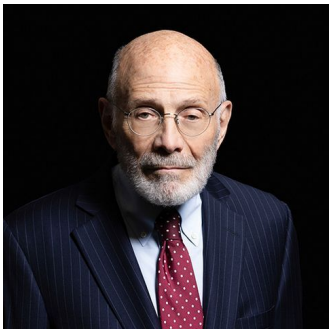

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