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Expert Analysis

Rejection Revisited: 7th Circuit Holds Rejection Does Not Terminate Right to Use trademarks

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In the recent decision in *Sunbeam Products v. Chicago American Manufacturing*, the 7th U.S. Circuit Court of Appeals held that the rejection of a trademark agreement by the debtor-licensor in its bankruptcy case did not abrogate the licensee's license to sell products branded with the debtor's trademark.[1] The appeals court affirmed the decision of the lower court, the U.S. Bankruptcy Court for the Northern District of Illinois, which held in favor of the licensee.[2] This is the first appellate decision to directly reject the holding of the much criticized landmark *Lubrizol* case decided 27 years earlier.

In 1985, the 4th Circuit, in *Lubrizol Enterprises v. Richmond Metal Finishers,* held that when a debtor-licensor rejected an intellectual property licensing agreement, the licensee's only remedy was a monetary damages claim and not specific performance of the right to retain the use of the intellectual property under the license agreement.[3]

Responding to the predicament of licensees stripped of the intellectual property, in 1988 Congress enacted Section 365(n) of the Bankruptcy Code to afford certain protections to licensees upon rejection of a license agreement by a debtor-licensor. The licensee may either treat the license as rejected and assert a claim for damages or elect to retain certain rights under the license, including the continued use of the intellectual property.

Because the term "intellectual property" as used in the Bankruptcy Code does not include trademarks, the *Sunbeam* court could not rely upon Section 365(n) but instead had to determine the effect of rejection on the use of the trademark license. The 7th Circuit decision creates not only a split among the appellate courts (which could be taken up by the U.S. Supreme Court), but also a dialogue about whether the enactment of Section 365(n) was necessary to achieve the desired result.

BACKGROUND

Lakewood Engineering & Manufacturing Co. made and sold a variety of consumer products, including fans, which were covered by its patents and trademarks. Lakewood contracted the manufacture of its fans to Chicago American Manufacturing, authorizing CAM to practice Lakewood's patents and put its trademarks on the completed fans.

Subsequently, an involuntary petition was filed against Lakewood, and the bankruptcy trustee sold the business assets, including trademarks and patents, to Sunbeam Products, doing business as Jarden Consumer Solutions.

Jarden did not want the Lakewood-branded fans that CAM had in inventory, nor did it want CAM to sell those fans in competition with Jarden's products. The trustee rejected the CAM contract under Section 365(a) of the Bankruptcy Code, which provides for assumption or rejection of contracts if obligations remain on both sides.

When CAM continued to make and sell Lakewood-branded fans, Jarden commenced an adversary proceeding against CAM, alleging patent and trademark infringement. A dispute arose about whether CAM was acting within the scope of the intellectual property license granted by Lakewood pre-petition and whether that license had terminated upon the trustee's rejection of the underlying contract.

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The Bankruptcy Court concluded that CAM was entitled to make as many fans as Lakewood estimated it would need for the season and sell them bearing Lakewood's marks. The court did not determine whether rejection terminated CAM's right to use the trademarks. The Bankruptcy Court allowed CAM to use the trademarks on the basis of equitable grounds since it had invested resources in manufacturing the fans. Jarden claimed that CAM had to cease production and sales once Lakewood's requirements ceased.

There was a direct appeal to the 7th Circuit, which had to determine the effect of the trustee's rejection. While the 7th Circuit affirmed the lower court's holding, it disagreed with the equitable basis of the holding and analyzed whether under Section 365(g) of the Bankruptcy Code, rejection of the supply agreement affected the licensee's continuing right to use the trademarks.

Previously, the 4th Circuit in *Lubrizol* held that when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks and patents. Congress enacted Section 365(n) to the Bankruptcy Code three years after *Lubrizol* to allow licensees the right to continue using the intellectual property after rejection, provided that they met certain conditions. The 7th Circuit reviewed whether the court in *Lubrizol* correctly understood the consequences of rejection under the Bankruptcy Code.

7TH CIRCUIT'S ANALYSIS OF THE EFFECT OF REJECTION

The term "intellectual property" as defined under the Bankruptcy Code includes patents, copyrights and trade secrets, but not trademarks.[4] The legislative history notes indicate that that omission was intended to allow Congress more time to study trademarks. Because of the omission, the 7th Circuit reasoned that trademarks are unaffected by Section 365(n) of the Bankruptcy Code.

The 7th Circuit dismissed arguments based in equity, following the Supreme Court's recent decision on another section of the Bankruptcy Code, where it applied well-established principles of statutory construction.[5]

The 7th Circuit noted that "arguments based on views about the purposes behind the Code, and wise public policy, cannot be used to supersede the Code's provisions." After the trustee's rejection of an intellectual property licensee granted by the debtor, the licensee's "rights depend on what the Bankruptcy Code provides rather than on notions of equity."[6]

The 7th Circuit looked at the concurring opinion of 3rd Circuit Judge Thomas Ambro in *In re Exide Technologies*, the only other appellate case somewhat on point.[7] Judge Ambro concluded that, had the contract at hand been eligible for rejection under Section 365(a), the licensee could have continued using the trademarks.[8]

The 7th Circuit agreed with Judge Ambro that *Lubrizol* was incorrect. It noted that outside the bankruptcy context a licensor's breach does not terminate a licensee's right to use intellectual property. The Bankruptcy Code, by classifying the debtor's rejection of an executory contract as a breach of Section 365(g), establishes that in bankruptcy, as outside that context, the other party's rights remain in place.[9]

Upon rejection of a contract, the debtor's unfulfilled obligations become damages — which are treated as a pre-petition obligation.[10] The counterparties' rights in a rejection scenario are not "vaporized." The 7th Circuit provided an example of rejection in the lease context: "A lessor that enters bankruptcy may not, by rejecting the lease, end the tenant's right to possession and thus reacquire 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."[11]

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Rejection of debtor's executory contract 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 estate from the obligation to perform and has absolutely no effect upon the contract's continued existence.[12]

Without agreeing or disagreeing with the *Lubrizol* court, other courts have similarly held that rejection doesn't vitiate a contract's continued existence; the contract is not canceled, repudiated, rescinded or in any other fashion terminated.

In *In re Flagstaff Realty Associates*, the 3rd Circuit held that that rejection of a lease does not alter the substantive rights of the parties to the lease.[13] The court noted that the primary function of rejection is to allow a debtor-lessor to escape the burden of providing continuing services to a tenant, but the tenant's leasehold interest remains intact; accordingly, the debtor-lessor's rejection does not relieve it of its obligation to accept an agreed-upon reduced rent provided for under the lease.

Rejection does not terminate state law rights in or to specific property.[14] "Rejection does not change the substantive rights of the parties to the contract, but merely means that the bankruptcy estate itself will not become a party to it."[15] Rejection isn't a termination of the contract, it is merely a breach that leaves the parties to their state's law remedies.[16]

IMPLICATIONS

This decision provides relief for trademark licensees, at least within the 7th Circuit, that in the event of the licensor's bankruptcy and rejection of the license agreement, the trademark licensee may nevertheless continue to use the licensed trademark. In the context of distressed asset sales, debtors may worry that the value of their trademarks is diminished if pre-existing licensees may continue to use them. Yet licensees must still be cautious that their intellectual property rights are not extinguished in a sale of assets "free and clear" under Section 363 of the Bankruptcy Code.

Trademark licensees outside the jurisdiction of the 7th Circuit may retain counsel to implement strategies to protect their rights in a bankruptcy (see box).

Possible legal strategies for licensees outside the 7th Circuit:

- Specifying in the license that upon rejection, the licensee has the continued right to use the mark through the license period.
- Creating a bankruptcy-remote special purpose entity that owns and licenses the trademark.
- Obtaining a security interest in the trademarks.
- Purchasing the trademarks.
- Structuring payments or requiring liquidated damages so that the debtor has little incentive to reject the contract.

Finally, *Sunbeam* puts into play a discussion over which rights may be retained under any rejected contract. The *Sunbeam* reasoning could apply to other provisions of rejected contracts, such as non-monetary remedies. For example, the rejection of an employment agreement or purchase agreement containing a non-compete provision may result in the ability of the non-debtor party to enforce the non-compete covenants of the rejecting debtor.

The *Sunbeam* analysis could also apply to foreign patents otherwise outside the protections of Section 365(n). By noting that rejection is not the same as termination, the decision raises arguments that Section 365(n) is not necessary because relief may be formulated under different grounds.

NOTES

[1] *Sunbeam Prods. v. Chicago Am. Mfg.*, 686 F.3d 372 (7th Cir. July 9, 2012).

[2] *In re Lakewood Eng'g & Mfg. Co.*, 459 B.R. 306 (Bankr. N.D. Ill. Sept. 29, 2011).

[3] *Lubrizol Enters. v. Richmond Metal Finishers,* 756 F.2d 1043 (4th Cir.1985).

[4] 11 U.S.C.A. § 101(35A).

[5] *See RadLAX Gateway Hotel LLC v. Amalgamated Bank,* 132 S. Ct. 2065 (May 29, 2012).

[6] *Sunbeam*, 2012 WL 2687939 at *2.

[7] *In re Exide Techs.,* 607 F.3d 957, 966–67 (3d Cir. 2010) (Ambro, J., concurring).

[8] *Id.* at 964–68.

[9] *Sunbeam*, 2012 WL 2687939 at *3.

[10] 11 U.S.C.A. § 365(g).

[11] *Sunbeam*, 2012 WL 2687939 at *3.

[12] *Id.* at *4 (citing *Thompkins v. Lil' Joe Records,* 476 F.3d 1294, 1306 (11th Cir. 2007).

[13] *In re Flagstaff Realty Assocs.*, 60 F.3d 1031 (3d Cir. 1995).

[14] *In re Drexel Burnham Lambert Group,* 138 B.R. 687, 709 (Bankr. S.D.N.Y. 1992). *See In re Hall,* 415 B.R. 911, 922 (M.D. Ga. 2009) ("rejection has absolutely no effect upon the contract's continued existence").

[15] *In re Ortiz,* 400 B.R. 755, 762 (C.D. Cal. 2009).

[16] *In re Cont'l Airlines,* 981 F.2d 1450 (5th Cir. 1993).

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