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There's Something Happening Here: Recent Bankruptcy Developments May Give Trademark Licensees Reason to Hope

By Robert Eisenbach III

For years, the world of bankruptcy has been a scary place for trademark licensees. Long-standing case law held that a licensor-debtor's rejection of a license cut off the licensee's rights to the intellectual property, and Congress did not come to the rescue of trademark licensees as it did for licensees of other types of intellectual property. However, recent decisions from at least two courts of appeals suggest that trademark licensees may have more rights than previously thought when their licenses are rejected in a licensor's bankruptcy. This article examines these developments, but first we need to look at the treatment of executory contracts in bankruptcy generally, the protections for other intellectual property licenses, and the history of rejection and trademark licenses.

Executory Contracts in Bankruptcy

An executory contract is a contract between a debtor and another party under which both sides still have important performance obligations outstanding. A debtor in bankruptcy (or its bankruptcy trustee) has the option of assuming, rejecting, or assuming and assigning executory contracts, 11 U.S.C. §§365(a)(1) and (f), with its choice governed by the business judgment standard.

Generally, a debtor can assume an executory contract if it meets the requirements of Section 365(b) of the Bankruptcy Code, including curing defaults and providing adequate assurance of future performance. 11 U.S.C. § 365(b)(1) provides:

> If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of assumption of such contract or lease, the trustee
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default ….
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any ancillary pecuniary loss to such party resulting from such default; and
> (C) provides adequate assurance of future performance under such contract or lease.

If a debtor chooses to assume and assign an executory contract, the proposed assignee will be required to establish that it can provide adequate assurance of future performance. Alternatively, a debtor can choose to reject an executory contract; rejection constitutes a breach of such contract entitling the nondebtor counterparty to file a claim for rejection damages but without the benefit of specific performance. 11 U.S.C. § 365(g).

Intellectual Property Licenses and Section 365(n)

Prior to the enactment of Section 365(n) of the Bankruptcy Code, 11 U.S.C. § 365(n), licensees whose intellectual property licenses were rejected as executory contracts lost their rights under the license. This was the holding in *Lubrizol Enters., 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 *Lubrizol*, 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 patent licensee, lost its rights under the license.

In reaction to *Lubrizol* and the concerns about the decision's potential impact on patent and other technology licensees, Congress enacted the Intellectual Property

Bankruptcy Act of 1988, adding Section 365(n) to the Bankruptcy Code to give licensees special protections. Although you might expect intellectual property to include trademarks, when Section 365(n) was enacted a special, limited definition of "intellectual property" was also added to the Bankruptcy Code in Section 101(35A). This definition includes trade secrets, U.S. patents, patent applications, copyrights, plant variety, and mask works – but not trademarks.

With no Section 365(n) protection, and in the face of the *Lubrizol* decision, trademark licensees have long faced the serious risk of losing all license rights to a trademark if the licensor files for bankruptcy and rejects the trademark license as an executory contract. If the trademark owner decides that the license is now unfavorable and a better deal can be had under a new license agreement with someone else, the trademark owner likely will reject the existing trademark license agreement. Even the enforceability of phase-out provisions, allowing a licensee to continue to use a mark for a limited time period after the license is terminated, is unclear.

Recent decisions have attempted to fill the gap created by *Lubrizol*, Section 365(n), and the Bankruptcy Code's definition of "intellectual property," and offer trademark licensees rays of hope and caution to trademark licensors in bankruptcy. Three decisions in particular warrant further discussion.

The Third Circuit Treats a Trademark License as Non-Executory

In *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010), the United States Court of Appeals for the Third Circuit examined a series of agreements, determined to constitute one integrated agreement, pursuant to which Exide Technologies sold an industrial battery business, and licensed certain trademark rights, to EnerSys. Exide filed for bankruptcy in 2002, and the bankruptcy court granted Exide's motion to reject the agreement as an executory contract, a decision that was affirmed by the district court. On appeal, the Third Circuit held that under New York law, which governed the agreement, once a party has substantially performed, a later breach by that party does not excuse performance.

The Third Circuit held that EnerSys had substantially performed by paying the full purchase price and operating under the agreement for 10 years, as well as by assuming certain liabilities related to the business EnerSys purchased when it obtained the trademark license. As such, the agreement was no longer executory. The court also held that EnerSys's obligation not to use the trademark outside of the licensed business was not a material obligation because it was a condition subsequent and, in any event, did not relate to the agreement's purpose – the transfer of the industrial battery business in return for a $135 million payment. Likewise, the Third Circuit concluded that a quality standards provision was minor because it related only to the standards of the mark for each battery produced and not to the transfer of industrial battery business that was the agreement's purpose. An indemnity obligation that had subsequently expired, and a further assurances obligation where no remaining required cooperation was identified, were held not to outweigh the factors supporting a finding of substantial performance.

Judge Ambro wrote a concurring opinion to address the bankruptcy court's conclusion that rejection of a trademark license left EnerSys without the right to use the Exide mark. He analyzed the history of Section 365(n), disagreed that the exclusion of trademarks from its reach created a negative inference that rejection of a trademark license should be tantamount to termination, and stated that courts should be able to prevent the extinguishment of all rights upon rejection. As Judge Ambro wrote in his conclusion:

> Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not – as occurred in this case – use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.

Eighth Circuit Holds Trademark License Executory

In *In re Interstate Bakeries Corp.*, 690 F.3d 1069 (8th Cir. 2012), a case with facts that appear very similar to *Exide*, the United States Court of Appeals for the Eighth Circuit examined whether a perpetual, royalty-free, assignable, transferable, and exclusive license to use brands and trademarks belonging to Interstate Brands Corporation (IBC), which subsequently filed for bankruptcy, was an executory contract that could be rejected. Although the relevant aspects of the license agreement appeared to be, at first blush, nearly identical to those in *Exide*, the Eighth Circuit found the agreement in *Interstate Bakeries* to be materially different from the one in *Exide* and held that the agreement was executory – a victory for trademark licensors.

Prior to bankruptcy, IBC entered into a $20 million asset purchase agreement and license agreement with Lewis Brothers Bakeries (LBB) whereby IBC sold to LBB certain baking and business operations in the Chicago area. Following IBC's bankruptcy, LBB sought a declaratory judgment that the license agreement was not an executory contract. The bankruptcy court and district court both found that the agreement executory, with unperformed obligations on both sides. The Eighth Circuit affirmed, finding LBB's obligation to maintain quality standards and IBC's obligations of notice and forbearance with regard to the trademarks material and unperformed. The court distinguished *Exide* because there, "the parties had not even contemplated or discussed any quality standards. . . . Here, it cannot be argued the parties did not contemplate any quality standards, as it is an explicit provision of the License Agreement. Moreover, the plain language of the agreement provides a breach of the quality provision would be material."

As of this writing, a petition for rehearing *en banc* in the *Interstate Bakeries* case is pending but not yet decided.

The Seventh Circuit Rejects *Lubrizol's* Holding

In another 2012 decision, in *Sunbeam Prods., Inc. v. Chicago Am. Manuf., LLC*, 686 F.3d 372 (7th Cir. 2012), the United States Court of Appeals for the Seventh Circuit issued a decision hailed as a major victory for trademark licensees. The facts of *Sunbeam* are 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 an 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 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 in *Exide*, and begin the "development of equitable treatment" of trademark licensees that it concluded Congress had anticipated would occur. 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.

On appeal, 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 1985 Fourth Circuit Lubrizol decision and reasoning.

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:

> 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.

The Court turned to the Third Circuit's *Exide* decision, and specifically Judge Ambro's concurring opinion:

> *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, the Seventh Circuit explained that under Section 365(g), rejection is considered a breach but without the possibility of specific performance:

> 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 Seventh Circuit then described the impact of Section 365(g) and rejection in bankruptcy. "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."

Turning to an analogous situation, the court summarized what happens when a lease is rejected:

> 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 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.' 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.)

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.

Intriguing but Unanswered Questions Raised by Sunbeam

The Seventh Circuit's opinion represents the first court of appeals decision in 27 years to challenge *Lubrizol's* view of how rejection impacts an intellectual property license under Section 365(g). The U.S. Supreme Court denied review, leaving in place the circuit split *Sunbeam* created. *Sunbeam* and its potential interplay with Section 365(n) raises a number of interesting 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?
- Would a liquidated damages provision in favor of the licensee, payable on breach, cut against the licensee's right under *Sunbeam* to continue to use the licensed trademarks?
- 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 intellectual property 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, including payment of royalties, 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

After years in the proverbial bankruptcy desert, trademark licensees got a glimmer of hope from *Exide* and *Sunbeam*. If followed, these two decisions could mark a significant turning point in the treatment of trademark licenses in bankruptcy. Trademark licensees can now argue under *Exide* that a license, especially if part of a completed purchase and sale, is not an executory contract, although they will have to contend with the Eighth Circuit's *Interstate Bakeries* decision. Outside the Fourth Circuit, licensees can advance the *Sunbeam* decision and argue that rejection of an executory trademark license does not cut off the right to use the trademark. On the other hand, trademark owners will continue to argue that *Lubrizol* was correct and the effect of rejection is to deprive a licensee from further ability to use the trademark, at least other than in the Seventh Circuit. Pending future decisions, and absent a Supreme Court decision or amendments to the Bankruptcy Code to address trademark licenses, it remains to be seen whether these new developments for trademark licensees ultimately will prove to be real – or just a mirage.

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