Crowell

CLIENT ALERT

Sunbeam: Seventh Circuit Says That Rejection in Bankruptcy Does Not Vaporize a Trademark Licensee's Rights

July 13, 2012

In characteristically clear prose by Chief Judge Frank Easterbrook, the U.S. Court of Appeals for the Seventh Circuit held on July 9 that a debtor-licensor's rejection in bankruptcy of an intellectual property license does not abrogate the non-debtor licensee's right to use the licensed trademarks. *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC*, No. 11-3920 (7th Cir. July 9, 2012). The decision is noteworthy because the case involves the effect of rejection on a licensee's rights to the use of both patents and trademarks, and the result as to trademarks creates a split among federal judicial circuits.

In 2008, Lakewood contracted with Chicago American Manufacturing ("CAM") to manufacture Lakewood's box fans. The contract authorized CAM to practice Lakewood's patents to manufacture box fans and to put Lakewood's trademarks on completed fans. Given Lakewood's poor financial situation, Lakewood provided CAM payment assurance by authorizing CAM to sell the fans for its own account if Lakewood did not purchase them. Three months into the contract, some of Lakewood's creditors filed an involuntary bankruptcy petition against it. The bankruptcy trustee later sold Lakewood's assets, including the licensed patents and trademarks, to Sunbeam. Sunbeam did not want to buy the Lakewood-branded fans in CAM's inventory and it also did not want CAM to sell those fans to former Lakewood customers. The trustee therefore rejected Lakewood's contract with CAM. When CAM continued to make and sell Lakewood-branded fans, Sunbeam filed suit to determine the effect of the trustee's rejection of CAM's contract.

Section 365(n) of the Bankruptcy Code allows licensees the option to retain their rights to the "intellectual property" after the license agreement is rejected. The Bankruptcy Code defines "intellectual property" to include patents, copyrights, and trade secrets. 11 U.S.C. § 101(35A). Thus, in accordance with Section 365(n), CAM clearly could elect to practice Lakewood's patents.

The Code's definition of "intellectual property" does not mention trademarks, however. As a result, a question arose regarding whether CAM could also continue using Lakewood's trademarks following the trustee's rejection of the license agreement. The Seventh Circuit concluded in *Sunbeam* that because Section 365(n) does not affect trademarks, CAM could continue using Lakewood's trademarks – just as it would be able to, outside of bankruptcy, if the licensor had breached the license agreement. The court said that rejection "constitutes a breach" of the contract under Section 365(g), and that the non-debtor party's contract rights "remain in place" and are not "vaporized." Rather, the effect of rejection is merely to require that the non-debtor party's claim for damages as a result of the breach be "treated as a pre-petition obligation, which may be written down in common with other debts of the same class" (instead of being asserted as a post-bankruptcy administrative claim entitled to full payment). Consequently, the court held, the trustee's rejection did not abrogate CAM's contractual rights to use the licensed trademarks.

The Seventh Circuit noted that its holding conflicted with *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol*, which was the impetus for Congress' enactment of Section 365(n), the Fourth Circuit held that when a debtor or trustee rejects a license agreement, the licensee loses the ability to use any licensed copyrights, trademarks,

and patents. Noting that scholars "uniformly criticize" *Lubrizol* for confusing rejection with the use of bankruptcy avoidance powers, the Seventh Circuit observed that the Fourth Circuit in *Lubrizol* "devoted scant attention to the question whether rejection cancels a contract," focusing instead on "the right way to identify executory contracts to which the rejection power applies."

The Seventh Circuit's *Sunbeam* decision is the first circuit court decision that squarely rejects *Lubrizol*. *Sunbeam*'s reasoning is likely to be persuasive in other jurisdictions, given scholars' criticism of *Lubrizol*. *See, e.g., In re Exide Technologies*, 607 F.3d 957, 964-68 (3d Cir. 2010) (Ambro, J., concurring) (Judge Ambro concluded that, if the contract at issue there had been executory, the licensee could have continued using the trademarks). However, *Lubrizol* remains binding in the Fourth Circuit, and it is presently uncertain whether other circuits will follow *Lubrizol* or *Sunbeam*. Until a consensus emerges, or until the Supreme Court resolves the circuit split, the ability of trademark licensees to continue using a debtor's trademarks post-bankruptcy may vary depending on where the debtor-licensor files for bankruptcy protection.

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For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Mark D. Plevin
Partner – San Francisco, Washington, D.C.
Phone: +1.415.365.7446, +1.202.624.2801
Email: mplevin@crowell.com