SUNBEAM PRODUCTS: A Ray of Light For The Bankruptcy Treatment of Licenses Under Rejected Trademark Licenses?

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In *Sunbeam Products, Inc., v. Chicago American Manufacturing, LLC,*[1] the Seventh Circuit, in a Judge Easterbrook authored opinion, became the first Circuit Court to issue a reported opinion directly considering and rejecting the decades old holding of the Fourth Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,*[2] that a licensee's rights to use a licensed mark or intellectual property is necessarily lost upon debtor-licensor's rejection of an executory license agreement. In so holding, the *Sunbeam* court reasoned that the enactment of section 365(n) of the Bankruptcy Code is irrelevant to the treatment of trademark licenses in bankruptcy and that nothing in section 365(g) deprives a non-debtor contracting party of rights not in the nature of specific performance. Thus, according to the Seventh Circuit, the trademark licensee in *Sunbeam* was permitted to continue to use the licensed marks notwithstanding a debtor-licensor's rejection of the agreement containing the license.

The *Sunbeam* decision has the potential to inject significant uncertainty into the Bankruptcy Code's treatment of trademark licenses. But, its reach may extend well beyond that. The consequences of rejection of personal property leases, real property sub-leases and virtually any kind of contract in which a debtor allows another person to use its property may now need to be reevaluated.[3] Moreover, the decision's apparent premise – that a licensee's post-rejection enforcement of its contractual right to continue using a trademark is not in the nature of a specific performance remedy – also raises the question of just what kind of right it is. The answer to this question, in turn, may impact, among other things, whether the post-rejection right to use licensed property will survive a free and clear sale of the underlying information assets pursuant to section 363(f).

In 1984 when the Fourth Circuit decided *Lubrizol*, the Bankruptcy Code was silent on the rights of a licensee of intellectual property (then not yet a defined term in the Bankruptcy Code) to continue to use intellectual property after the debtor-licensor rejected a license agreement. There, the debtor sought to reject a license of its patents, which were its principal assets. In opposing rejection, the licensee argued, among other things, that the rejection should not limit its continued right to practice the patented technology. Reversing the district court, which had sided with the licensee, the Fourth Circuit ruled that section 365(g) afforded the licensee under a rejected license only a damages claim for breach and that the licensee could not rely on a specific performance remedy to continue using the technology. The court reasoned succinctly that "[a]llowing specific performance would obviously undercut the core purpose of rejection ...."[4]

Reacting to the licensing community's concerns over *Lubrizol*, Congress added section 365(n) to the Bankruptcy Code in 1988.[5] Section 365(n) provides generally that if the debtor rejects an executory contract under which it is a licensor of "intellectual property," then the licensee may elect to either (a) treat the license agreement as terminated or (b) retain its rights to the intellectual property covered by the license agreement. The Bankruptcy Code's definition of "intellectual property," however, excludes trademarks.[6]

Following the enactment of section 365(n), most bankruptcy courts unquestioningly applied *Lubrizol* to the treatment of executory trademark licenses, holding that licensees lost all rights to a trademark upon a debtor-licensor's rejection.[7] Indeed, while most academics were critical of *Lubrizol*, only a handful of courts actually questioned *Lubrizol's* approach to rejection in reported opinions and, until *Sunbeam,* none had directly rejected it as applied to intellectual property licenses.[8]

In 2010, though, Third Circuit's Judge Ambro filed a concurring opinion in *In re Exide Technologies, Inc.,*[9] to express his view that rejection of a trademark agreement did not necessarily mean the end of a trademark licensee's right to use the mark. Judge Ambro did not directly criticize *Lubrizol.* He, however, did write that bankruptcy courts retain "equitable powers" to protect trademark licensees upon rejection of a trademark license, which necessarily implies some disagreement with *Lubrizol*.

Judge Ambro declined to adopt the view of several lower courts that, by omitting trademarks from the Bankruptcy Code's definition of intellectual property, Congress necessarily intended the *Lubrizol* holding to apply to trademarks. He reasoned that no negative inference should be drawn because the legislative history expressed Congress's view that protection for trademark licensees required "more extensive study" due to the unique nature of "trademark, trade name and service mark licensing relationships [which] depend to a large extent on control of the quality of the products or services sold by the licensee."[10] Congress expressly

stated that it was postponing legislative action "in this area and to allow the development of equitable treatment of this situation by bankruptcy courts."[11] Rejection, Judge Ambro explained, "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence."[12]

Sunbeam picks up where Judge Ambro left off in *Exide*. The debtor in *Sunbeam*, "Lakewood," licensed the right to practice its patents and use its trademarks for the manufacture and sale of box fans under the "Lakewood" brand to "CAM."[13] Once forced into a chapter 7 bankruptcy liquidation, after a time, Lakewood's trustee rejected the agreement and subsequently sold its assets, including the patents and trademarks subject to the agreement, to Sunbeam Products. When CAM continued to make and sell Lakewood-branded box fans, the trustee and Sunbeam brought an action against CAM for an injunction and damages. Following a trial, the bankruptcy court found for CAM "on equitable grounds," holding that its post-rejection use of the trademark was permissible.[14] The appeal was then certified for direct review by the Seventh Circuit.

The Seventh Circuit initially blessed the bankruptcy court's conclusion (which relied almost exclusively on Judge Ambro's *Exide* concurrence) that the enactment of section 365(n) had not been a tacit approval of *Lubrizol*. As the Seventh Circuit explained, "[t]he limited definition [of 'intellectual property'] in § 101(35A) means that § 365(n) does not affect trademarks one way or the other."[15]

Judge Easterbrook, however, was unwilling to follow the next notion accepted by the bankruptcy court and Judge Ambro – that bankruptcy courts could rely solely on equitable principles to determine whether a trademark licensee should retain rights after rejection. This, he wrote, was "untenable" because it left too much room for subjective balancing and unpredictability.[16]

Instead, according to Judge Easterbrook, parsing section 365(g) of the Bankruptcy Code was required to determine what relief is available to a trademark licensee post-rejection. Section 365(g), stripped to its core language, provides that rejection "constitutes a breach of such contract."[17] The Seventh Circuit held that, by classifying a rejection as breach, section 365(g) establishes "that in bankruptcy, as outside of it, the other party's rights remain in place."[18] The rejection "merely frees the estate from the obligation to perform," but "has absolutely no effect upon the contract's continued existence."[19] Thus, even though a debtor may not be subjected to an order of specific performance on a rejected contract, the rights of the other party are not "vaporized."[20] Accordingly, the Seventh Circuit affirmed, holding that "the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights" in the trademarks.[21]

Although the *Sunbeam* court's construction of section 365(n) is sound, an inherent tension is left unresolved by its analysis of section 365(g) and the consequences of rejection. The court recognized that "[a]fter rejecting a contract, a debtor is not subject to an order of specific performance."[22] What it did not answer (and what is sure to puzzle academics, jurists and litigants alike) is how the right that may be retained by the licensee to continuing using a licensed trademark after rejection of the license is anything other than specific performance of the rejected contract.[23]

Consider, for example, a debtor-franchisor that rejects the franchise agreement of its franchisee, which includes the territorially exclusive license to operate a restaurant under its mark and name within a five mile radius of its present location for the next 15 years. Under the *Sunbeam* construct of rejection, on the one hand, the licensee retains the right to continue using the franchisor's trademark, trade name and trade dress, notwithstanding the debtor-licensor's rejection of the franchise agreement. On the other hand, rejection makes the debtor-licensor immune from obligations that would subject it to specific performance. Accordingly, the debtor-franchisor need not provide its former franchisee with employee training, advertise on its behalf or supply the super-secret special sauce.

This situation is almost certainly unsatisfactory for the debtor-franchisor if it is reorganizing or selling its business as a going concern. Its presumably valuable mark, name and dress are now in the hands of an unregulated former franchisee. Assume for our example that the debtor decides to purchase advertising and post signs near its former franchisee's store alleging that the former franchisee is no longer affiliated with the debtor and is operating a franchise-branded restaurant without authorization. Former franchisee, which considers itself entitled to operate under the brand in reliance on *Sunbeam* and *Exide*, then sues to the debtor to compel it to abide by the terms of the now rejected license agreement and stop interfering with former franchisee's right to use the mark.

How is this not a demand for specific performance? Unfortunately, neither the Seventh Circuit in *Sunbeam* nor the Fourth Circuit *Lubrizol* explored where the line resides between the remedy of "specific performance," which both agree is extinguished upon rejection, and other types of rights derivative of the contract that might somehow survive rejection. Does it depend on whether the rights obtained by the licensee under the license were somehow substantial enough to constitute some form of property interest? If so, *Sunbeam* hardly seems like a case that would warrant deeming the licensee to have retained post-rejection licensing rights. The agreement containing the trademark license was a contingent one of limited duration and allowed the licensee to use the mark only for the limited purposes and products identified in the agreement. Indeed, although *Sunbeam* rejects the notion of relying on equitable principles as "untenable," the concept that has replaced it – drawing a potentially arbitrary line between what is and is not specific performance of a rejected contract – fares no better when measured in terms of whether it fosters fairness and predictability.

The full impact of the *Sunbeam* decision will not be felt for some time, but it seems apparent that its effects could be far reaching. At a minimum, the decision, could lead courts to revisit their reliance on *Lubrizol* in cases where they are called upon to evaluate a trademark licensee's rights after the debtor-licensor rejected the parties' agreement. Similarly, it is foreseeable that the *Sunbeam* holding may come into play in decisions concerning the rejection of broader agreements in which trademark licenses are but one embedded piece, such as franchise agreements like the hypothetical one above. A potential consequence of this uncertainty is that the bankruptcy reorganization prospects of businesses that depend on a franchising or other information licensing model will be harmed.

The decision also could have reach outside of trademark licensing, particularly in areas where the Bankruptcy Code does not provide express protections to the nondebtor party to a rejected agreement. For example, although section 365(h) protects the option of a debtor's real property lessee to retain its tenancy notwithstanding the debtor's rejection of the lease, there is no corresponding protection for personal property lessees or, arguably, for a debtor-lessee's sub-tenants. One can imagine a scenario where the debtor's business involves the manufacture and leasing of satellites and after entering bankruptcy the debtor attempts to reject an unfavorable contract containing a satellite lease to one of its customers. *Sunbeam* suggests that the satellite-lessee might enjoy total freedom to continue using the satellite for the remaining term of the license. One struggles to see how this result and others that might be required by this concept of rejection foster bankruptcy's rehabilitative purpose.

Sunbeam also raises, but does not answer, the question of whether a debtor can ever truly sell its assets "free and clear" of whatever residual interest remains after rejection of a trademark license.[24] In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, the Seventh Circuit held that section 363(f) of the Bankruptcy Code, which allows a debtor to sell assets free and clear of all interests, trumps section 365(h), which would allow a debtor's tenant to retain its tenancy notwithstanding the debtor's rejection of the lease.[25] *Sunbeam* leaves open whether the *Qualitech* reasoning would apply to a residual right of a licensee to continue using a trademark after rejection of the licenses and after an attempt to sell the trademark free and clear of under section 363(f). And, if the licensee's right to continue using a trademark is like other interests that can be cleansed from assets using section 363(f), how does a debtor provide the former licensee of that mark with adequate protection required by section 363(e) if demanded? The "interest" here must be something more than a claim (otherwise, section 365(g) would have applied). But, what is it exactly? For these answers, we must fend for ourselves.

Perhaps, the clear Circuit split now in place will propel the Supreme Court to take up one or more of these questions for review. Until that happens, one suspects that we will be struggling for some time to learn how the winds will blow on the newly reshaped landscape for post-rejection rights of trademark licensees and other contract parties. One thing is certain: creative advocates will have plenty of opportunities to fan the air of bankruptcy courts with arguments built on this uncertainty.

(Endnotes)

1 --- F.3d ----, 2012 WL 2687939 (7th Cir. July 9, 2012).

2 756 F.2d 1043, 1044 (4th Cir. 1985).

3 In certain provisions of the Bankruptcy Code Congress has enacted specific rules governing the consequences of rejection. *See, e.g.,* 11 U.S.C. §§ 365(h) (debtor's rejection of unexpired lease of real property under which the debtor is the lessor) & (n) (debtor's rejection of license agreement involving "intellectual property" as defined in 11 U.S.C. 101(35A)).

4 *Lubrizol,* 756 F.2d at 1048.

5 Intellectual Property Bankruptcy Protection Act of 1988, Pub. L. No. 100-506, 102 Stat. 2538 (1988).

6 11 U.S.C. § 101(35A).

7 *See*, *e.g.*, *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [so,] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [the] trademark . . . ."); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, Lubrizol controls and the Franchisees' right to use the trademark stops on rejection."); *In re Centura Software Corp.*, 281 B.R. 660, 674-75 (Bankr. N.D. Cal. 2002) ("Because Section 365(n) plainly excludes trademarks, the court holds that [the licensee] is not entitled to retain any rights in [the licensed trademark] under the rejected ... [t]rademark [a]greement."); *In re Chipwich, Inc.*, 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985) ("[B]y rejecting the [trademark] licenses[,] the debtor will deprive [the licensee] of its right to use the . . . trademark for its products.").

8 *See Sunbeam,* 2012 WL 2687939, at *4 (citing academic criticism of *Lubrizol*). *See also, e.g., In re The Ground Round, Inc.,* 482 F.3d 15, (1st Cir. 2007) (declining to take an overall view on the consequences of rejection but noting broad criticism of *Lubrizol* approach); *Licensing by Paolo, Inc. v. Sinatra (In re Gucci),* 126 F.3d 380, 394 & n.1 (2d Cir. 1994) (declining to declare the effect of rejection of a trademark license but suggesting that to treat a rejection as extinguishing a license means that "§ 365 rejection operates as a kind of avoiding power that brings back into the estate a license of the debtor's trade name or trademark").

9 607 F.3d 957, 964-68 (3d Cir. 2010). The holding of this case, in which Judge Ambro fully joined, was that the contract that contained the trademark license was no longer executory and therefore incapable of being rejected.

10 *Id.* (quoting S. Rep. No. 100-505, at 5, reprinted in 1988 U.S.C.C.A.N. at 3204).

11 *Id.*

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

13 *Sunbeam Products*, 2012 WL 2687939, at *1. The underlying agreement was a supply contract, pursuant to which the debtor outsourced the manufacturing of Lakewood-branded fans to CAM. The Lakewood-brand trademark license at issue was one that sprung into existence for a limited period of time to allow CAM to use remaining parts and supplies on hand to manufacture and sell for its own account Lakewood-branded fans whenever the debtor failed to meet its minimum purchase requirements under the agreement.

14 *Szilagyi v. Chcago American Mfg., LLC (In re Lakewood Engin. & Mfg. Co., Inc.),* 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011).

15 *Sunbeam Products*, 2012 WL 2687939, at *1.

16 *Id.* at *3.

17 *Id.* at *3. (quoting 11 U.S.C. § 365(g)).

18 *Id.*

19 *Id.* at *4 (quoting *Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007)).

20 *Id.* at *3.

21 *Id.* at *4.

22 *Id.* at *3 (citing *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 531 (1984); *Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equip. Corp.,* 54 F.3d 406, 407 (7th Cir. 1995)).

23 *Compare* Raymond T. Nimmer & Jeff Dodd, Modern Licensing Law § 11:29 (Oct. 2011) (explaining that under applicable non-bankruptcy law intellectual property licensees may be entitled to "specific performance" in the event of a licensor's breach because "[i]informational assets protected by intellectual property rights are often unique in the sense that they cannot be obtained [from] anyone other than . . . the rights-owner (licensor)").

24 The parties stipulated that the bankruptcy trustee's sale of the trademarks would not prejudice CAM's position.

25 327 F.3d 537 (7th Cir. 2003). *Qualitech's* holding has not been universally accepted. *See, e.g., In re Haskell, L.P.,* 321 B.R. 1, 10 (Bankr. D. Mass. 2005) (rejecting reliance on *Qualitech* as authority to allow debtor to sell free and clear of a leasehold interest because it would allow the debtor to do indirectly what section 365(h) prohibited it from doing directly).

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