# Why your trade mark licence may survive bankruptcy

**Jim Leshaw** and **Ari Newman** explain how a recent case has created uncertainty around the fate of trade mark licence agreements after being rejected in bankruptcy proceedings

Section 365 of the US Bankruptcy Code empowers a trustee or debtor in possession to reject so-called executory contracts that are burdensome to the bankrupt estate. Courts usually define an executory contract as one where material performance remains on both sides of a licence agreement; such a contract may be rejected in bankruptcy. Under section 365(g) of the code, the rejection of an executory contract constitutes a breach of such a contract immediately before the date of the filing of the bankruptcy petition. Section 365(n) details the effect of rejection of "an executory contract under which the debtor is a licensor of a right to intellectual property", but the term intellectual property is defined narrowly to include trade secrets, patents and copyrights, and not trade marks, trade names and service marks. Congress's failure to include trade marks, trade names and service marks in this definition has left courts without clear legislative direction as to how trade mark licence agreements should be treated upon their rejection by a licensor.

The US Court of Appeals for the Seventh Circuit's decision in *Sunbeam Products v Chicago American Manufacturing* (July 2012) aims to resolve some of the uncertainty, at least within the Seventh Circuit. In that decision, the court held that a trade mark licensee could continue to use a licensed trade mark despite rejection of the trade mark licence by a bankruptcy trustee. But uncertainties remain.

## One-minute read


In a recent bankruptcy decision, a US court of appeals held that a trade mark licensee could continue to use a licensed trade mark despite rejection of the licence by a bankruptcy trustee. The decision creates a split among the federal circuit courts of appeal as to whether a non-debtor licensee's right to use trade marks terminates upon the licensor's rejection of the licence. The ruling represents an uncertain shift towards addressing the rights of trade mark licensees in bankruptcy. Companies must understand the US Bankruptcy Code's treatment of IP licences in order to identify potential issues.

## Define your licence

Whether a trustee or debtor in possession can reject a licence agreement in bankruptcy will depend on whether the agreement falls within the definition of an executory contract – in other words, whether material obligations remain between the parties to the licence agreement. More often than not, licence agreements contain provisions that support a finding of executoriness, thus making them capable of rejection in bankruptcy. For example, a licence agreement may require that the licensor agree not to sue the licensee for infringement, agree to indemnify the licensee from infringement suits and to otherwise protect the licensed trade mark. Similarly, a licence agreement will often require a licensee to use intellectual property only in accordance with the terms of the licensing agreement (including geographic restrictions), to pay royalties to the licensor, to maintain appropriate insurance, and to comply with recording or accounting obligations.

In instances, however, where one party to the licence agreement no longer has any continuing obligations, some courts are more likely to find that the agreement is not (or, at least, is no longer) executory and thus not capable of being rejected. For example, a court held that where an author granted exclusive rights to two books to a publisher the licence agreement was not executory because the author had no further material obligations after transferring the intellectual property. More recently, the Third Circuit Court of Appeals held that an exclusive licence agreement was not executory because the licensor substantially performed under the agreement and no longer had any ongoing material obligations to the licensee. In contrast, the Eighth Circuit Court of Appeals, in a decision issued on August 30 2012, held that a bankrupt licensor could reject an exclusive licence agreement for the use of brands and trade marks several years after the grant of the licence because some material obligations between the parties remained unperformed.

As these examples establish, determining whether a licence agreement is executory, especially exclusive licences, is not always predictable and requires a detailed analysis of the relevant agreement and surrounding facts.

### Rejection of IP licence agreements

Upon rejection of an executory contract under which the debtor is a licensor of an IP right, the bankruptcy code says that the licensee may (i) treat the licence agreement as terminated, or (ii) may retain the right to use the intellectual property so long as the licensee continues to perform by paying royalties to the licensor. In other words, section 365(n) authorises a licensee to continue to use licensed intellectual property even after the underlying licence is rejected by the licensor. Section 365(n) was added to the Bankruptcy Code in 1985 as a swift and direct response to the Fourth Circuit's decision in *Lubrizol Enterprises v Richmond Metal Finishers, (In re Richmond Metal Finishers)*. In *Lubrizol*, the debtor rejected a non-exclusive licence agreement, which granted the licensee the right to use a patented metal coating process. The licensee argued for the continued use of the licensed technology despite the debtor's rejection of the underlying licence agreement. Ruling in favour of the licensor, the Fourth Circuit held that upon rejection of the licence agreement, the licensee's right to use the licensed intellectual property was terminated and that the licensee's sole remedy was for contract damages in the form a pre-petition claim against the debtor's estate.

Congress was pushed into action only months after the *Lubrizol* decision was issued to address the potentially adverse results to licensees that could flow from that decision. For example, in accordance with the *Lubrizol* holding, a licensee that built its entire business or product line based upon the use of a licensor's intellectual property could stand to suffer crippling losses if the licensor filed bankruptcy, rejected the licence agreement and the licensee's rights to further use of the intellectual property was terminated.

Congress's section 365(n) fix, however, has failed to provide guidance for licensees of trade marks, trade names and service marks, each of which is not included in the bankruptcy code's definition of intellectual property. This omission has caused several bankruptcy courts to reject the extension of section 365(n) protections to trade mark licensees and, instead, relying on *Lubrizol*, those courts have held that a licensee's right to use trade marks is terminated upon rejection of the licence.

## Two options to reduce your risk

While it is not always possible to protect against a licensor's rejection of a trade mark licence, and each situation will be governed by its own facts, the following strategies may be worthy of consideration in appropriate circumstances:

- The licensed property can be placed in a trust or other bankruptcy remote entity that can then license the rights to the licensee. By structuring the licensing arrangement in this manner, a licensee may be able to reduce the risk that the licensor will become the subject of a bankruptcy case.
- Alternatively, a licensee can attempt to take a security interest in the licensed property to secure the licensor's obligations to the licensee. By taking a security interest, the licensee may be able to reduce the licensor's economic incentive to reject the licence agreement in bankruptcy.

These proposed approaches should only be considered under certain circumstances, however, and are not guaranteed to shield against rejection.

### The *Sunbeam* case

In *Sunbeam*, Lakewood Engineering & Manufacturing (LEM) contracted the manufacture of its box fans to Chicago American Manufacturing (CAM). Among other things, the contract authorised CAM to put LEM's trade marks on the completed fans.

Shortly thereafter, LEM was placed into bankruptcy and a trustee was appointed to administer LEM's assets. The trustee rejected the trade mark licence agreement with CAM and then later sold LEM's assets, including the trade marks that were previously licensed by CAM. Despite the rejection of the licence agreement, CAM continued to use the LEM trade marks, which caused the trustee to commence an infringement action against CAM (which was joined by the purchaser of LEM's assets) seeking to enjoin CAM's use of the LEM trade marks.

After a lengthy trial, the bankruptcy court concluded that CAM was permitted under the contract to continue to manufacture and sell the LEM-branded fans throughout the contract selling period. The bankruptcy court reached its decision on equitable grounds, explaining that CAM had invested substantial resources in making the LEM-branded fans. The purchaser took a direct appeal of the bankruptcy court's decision to the Seventh Circuit.

The Seventh Circuit affirmed the bankruptcy court's ruling, but rejected the lower court's reasoning. The Seventh Circuit pointed out that Supreme Court precedent dictates that rights depend, in the first instance, on what the federal statute – the Bankruptcy Code – provides, rather than on notions of equity.

The Seventh Circuit first dispensed with any reliance on the omission of trade marks in the Bankruptcy Code's definition of intellectual property by noting that the "limited definition in section 365(n) does not affect trade marks one way or the other". Having rejected the equity approach and dismissing any argument based on the omission of trade marks in the definition of intellectual property, the Seventh Circuit focused on the effect of rejection of an executory contract under section 365(g) of the Bankruptcy Code. The Seventh Circuit explained its reasoning under section 365(g), that a rejection under section 365(a) constitutes nothing more than a breach of the underlying contract and does not amount to termination or rescission of the rejected agreement. In its view, section 365(g) characterises rejection as a breach, and not a termination, so that the non-breaching party's rights remain in place as they would outside of bankruptcy. In the court's reasoning, rejection does not "vaporize the counterparty's rights", or the contract's continued existence, but instead "merely frees the estate from the obligation to perform".

**The decision is critical for licensors who may be considering filing for bankruptcy to reject an under-market or restrictive trade mark licence**

In short, rejecting the holding in *Lubrizol*, the Seventh Circuit held that the trustee's rejection of the licence agreement did not terminate CAM's rights to use the LEM trade mark.

### What now?

The *Sunbeam* decision marks a big shift, at least in the Seventh Circuit, for trade mark licensees. For over 25 years, trade mark licensees have operated with the risk that a bankruptcy filing by the licensor could result in the termination of their rights to use a licensed trade mark. The *Sunbeam* decision suggests that, at least in the Seventh Circuit, a licensee's right to use a licensed trade mark can continue – even if the licensor files bankruptcy and rejects the underlying licence agreement.

It is important to remember, however, that the Seventh Circuit's decision is not binding precedent in other circuits and, in fact, will likely not even be persuasive in the Fourth Circuit where the *Lubrizol* decision remains binding precedent.

The Seventh Circuit's decision is critical for licensors who may be considering filing for bankruptcy to reject an under-market or restrictive trade mark licence agreement. While a licensor may still be able to achieve that objective in the Fourth Circuit, the *Sunbeam* decision, for now, ensures that in the Seventh Circuit a licensee's rights to use the trade mark will continue despite rejection by the licensor.

**The location of a licensor's bankruptcy filing has become increasingly important to licensees**

Given the split among the circuits, the location of a licensor's bankruptcy filing becomes increasingly important to licensees. Such factors could affect the value a licensee may attribute to a trade mark and may, in certain instances, be a reason to forgo entering into the licensing arrangement altogether.

## Uncertainties remain

The *Sunbeam* decision leaves uncertainty on several issues.

### Free and clear sales

The parties in *Sunbeam* stipulated that the trustee's sale of LEM's assets would not prejudice CAM's trade mark rights, to the extent any rights remained after rejection. The court, therefore, did not address whether a debtor can sell its assets free and clear of a licensee's residual interest, if any, after a debtor's rejection of a trade mark licence under section 365(a).

In an analogous situation involving a tenant's leasehold interest, the Seventh Circuit in *Qualitech* permitted a debtor's sale of real estate free and clear of the tenant's leasehold, stripping the tenant of its leasehold rights under section 365(h) of the bankruptcy code, which rights are substantively similar to the rights afforded licensees of intellectual property under section 365(n). *Sunbeam* thus leaves open whether the reasoning employed by the Seventh Circuit in *Qualitech* would also apply to the residual rights of a licensee to use intellectual property (or trade marks) after rejection upon a sale of the IP free and clear under section 363(f). If, indeed, a licensee's rights can be cut off by section 363(f), it remains unclear what must be provided to the licensee as adequate protection, upon the licensee's demand.

### Specific performance

Citing Supreme Court precedent in *NLRB v Bildisco & Bildisco* (1984), the *Sunbeam* court stated that "[a]fter rejecting a contract, a debtor is not subject to an order of specific performance". The Seventh Circuit thus concluded that the licensee's continued use of the trade mark after rejection by the licensor does not amount to an order of specific performance against the debtor. The Fourth Circuit in *Lubrizol*, however, denied a licensee's continued use of intellectual property upon the debtor's rejection of the licence agreement on the basis that permitting the licensee's continued use would amount to compelling the debtor to specifically perform under the rejected agreement. The *Sunbeam* court fails to adequately address this issue and does not explain how the rights retained by the licensee in continuing to use a licensed trade mark after rejection of the underlying licence agreement is something other than enforcing specific performance of the rejected contract.

### Statutory issue

The *Sunbeam* court's interpretation of section 365(g) and its application to trade marks is arguably in conflict with the statutory scheme of section 365 because it places the utility and purpose of section 365(n) in question. If section 365(g) alone establishes that rejection of an intellectual property licence has no effect on a licensee's ability to further use licensed intellectual property, then section 365(n) appears superfluous. Indeed, in conflict with basic notions of statutory construction, the Seventh Circuit's decision could be read to render not only section 365(n) superfluous, but also sections 365(h) (providing that certain tenants can retain their right of possession upon landlord's lease rejection) and (i) (providing that certain purchasers of real property and timeshare interests to retain their right of possession upon rejection of the purchase or timeshare agreement) superfluous as well.

### What rights remain?

In addition to these issues, there remain questions about what types of non-monetary rights may be retained by a licensee or licensor upon rejection by the debtor counterparty. The *Sunbeam* court clarifies that a licensee may continue to use licensed trade marks even after rejection by the licensor, but exactly what rights remain in place for the non-debtor party under a rejected agreement still remains unclear. The reasoning in *Sunbeam* also suggests that, outside the trade mark context, certain non-monetary provisions of rejected executory contracts may still be enforceable by the non-debtor party, such as non-compete or confidentiality provisions in employment or consulting agreements, but the extent and exact nature of those rights also remains unclear.

The *Sunbeam* case is likely to attract considerable attention from judges, practitioners and academics in the months to come. Given that attention and the now clear split between at least two federal circuit courts of appeal, the Supreme Court may take the opportunity to review and provide much needed clarity on some of these open issues. Until then, however, we can expect the courts to continue to reach different conclusions.

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