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Courts Divide Over Intellectual Property Licensee's Rights When Bankrupt Licensor Rejects License

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Intellectual property licensees should carefully consider their options and the effect of a licensor's potential bankruptcy filing before entering into a license agreement.

Suppose that a company licenses a trademark — or some other form of intellectual property — from a company that owns a trademark (the "licensor"), the licensor files for bankruptcy protection, and the bankruptcy trustee exercises its rights under the Bankruptcy Code to "reject" (*i.e.*, breach) the trademark license. What are the licensee's rights and what is the licensee permitted to do?

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This issue was addressed recently by the U.S. Court of Appeals for the Seventh Circuit, which reached a different conclusion from that reached nearly 30 years ago by the U.S. Court of Appeals for the Fourth Circuit, leading to a split between the circuits. Just recently, the U.S. Supreme Court had the opportunity to resolve this split between the circuit courts, but declined to do so. As a result, it is important that intellectual property ("IP") licensees carefully consider their options and the effect of a licensor's potential bankruptcy filing before entering into a license agreement.

LUBRIZOL AND CONGRESSIONAL ACTION

In 1985, in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, the Fourth Circuit held that when a debtor licensor rejected an IP license, the licensee lost the ability to use the licensed copyrights, trademarks, and patents. Under *Lubrizol*, a licensee in this position could assert a claim for damages against the licensor's bankruptcy estate for the rejection of the license, but it had to immediately cease use of the trademarks on goods or services. That limited remedy left those IP licensees who had invested significant capital to develop their business in reliance upon another entity's IP at substantial risk.

In 1998, three years after *Lubrizol*, Congress amended the Bankruptcy Code to address this harsh result and added § 365(n) to the Bankruptcy Code to permit licensees to continue to use intellectual property after rejection, provided that they meet certain conditions. However, while the Bankruptcy Code provides that "intellectual property" includes patents, copyrights, and trade secrets, it does not mention "trademarks."

Since that 1988 amendment to the Bankruptcy Code, some bankruptcy courts have inferred that Congress intended to include trademarks in § 365(n) to avoid the application of the harsh rule in *Lubrizol* as it did with other types of intellectual property. The Seventh Circuit Court of Appeal recently analyzed this issue in *Sunbeam Products, Inc. v. Chicago American Mfg., LLC*.

THE *SUNBEAM* RULING

The *Sunbeam* case involved a debtor licensor named Lakewood Engineering & Manufacturing Co., which made and sold a variety of consumer

related products including fans for which it owned patents and trademarks. Lakewood entered into a contract with Chicago American Manufacturing ("CAM") that authorized CAM to manufacture fans covered by Lakewood's patent and to utilize trademarks on the completed products. Lakewood was to take orders from its retailers and CAM would then ship directly to those retailers pursuant to Lakewood's instructions.

Three months into the CAM contract, several of Lakewood's creditors filed an involuntary bankruptcy petition against it. The bankruptcy court appointed a bankruptcy trustee, who sold Lakewood's business to Sunbeam Products, doing business as Jarden Consumer Solutions. These purchased assets included Lakewood's patents and trademarks. Lakewood's bankruptcy trustee then exercised its rights under the Bankruptcy Code to reject the contract that Lakewood had entered into with CAM for the manufacture and distribution of the fans. When CAM continued to make and distribute Lakewood-branded fans, Jarden brought an action in the bankruptcy court to stop CAM's use of the trademarks.

The bankruptcy court ruled in favor of CAM, and the dispute reached the Seventh Circuit on appeal.

In its decision, the Seventh Circuit ruled that Bankruptcy Code § 365(n) did not affect trademarks one way or the other, because trademarks were not included in the Bankruptcy Code's definition of "intellectual property." Rather than relying on § 365(n) to resolve the dispute between Jarden and CAM, the Seventh Circuit referred to Bankruptcy Code § 365(g), which provides, among other things, that the rejection of an executory contract (such as an IP license) "constitutes a breach" of that contract.

In the Seventh Circuit's opinion, because a rejection constitutes a breach under § 365(g), the non-breaching party's rights are reserved under the agreement. Thus, the circuit court held that the trustee's rejection of Lakewood's contract with CAM "did not abrogate CAM's contractual rights" to continue to utilize Lakewood's trademarks and it affirmed the bankruptcy court's judgment in CAM's favor, permitting CAM to continue using the trademarks under the Lakewood contract.

Despite the apparent conflict between the Fourth and Seventh Circuits on this important issue, the U.S. Supreme Court refused to grant *certiorari* in *Sunbeam*, leaving the current split in the Fourth and Seventh Circuits.

CONCLUSION

As a consequence, in the Seventh Circuit, and perhaps in other circuits that might follow its reasoning, a licensee of trademarks and other IP would seem to be able to continue to use that IP under § 365(g) after a licensor rejects the license agreement in bankruptcy. Similarly, a licensee in this situation could also treat the rejection as a breach and thus rely on all of its contractual remedies, including but not limited to the right to recovery and the right to seek damages (although, as a practical matter, a damage claim is certainly likely to yield less than full payment from a bankrupt licensor).

In the Fourth Circuit, and perhaps in other circuits that might follow its reasoning, a licensee of trademarks may be required to cease using the trademarks under § 365(n), since that section is silent as to continued use of trademarks.

The bottom line for trademark and other intellectual property licensees is that they must carefully consider their options when entering into an intellectual property license, in order to protect themselves in the event of a subsequent bankruptcy filing by the licensor. Simply put, before making a significant capital investment based on the use of a third party's IP, the licensee must assess the licensor's business and analyze the impact that a potential bankruptcy filing by the licensor would have on the licensee's ability to obtain the benefit of its bargain. Such licenses also must carefully incorporate appropriate protections where possible.