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SUNBEAM OFFERS A RAY OF SUNSHINE FOR THE LICENSEE WHEN A LICENSOR REJECTS A TRADEMARK LICENSE AGREEMENT IN BANKRUPTCY

Alan N. Resnick*

ABSTRACT

*In 1985, industries that relied heavily on intellectual property licenses were dealt a severe blow when the Court of Appeals for the Fourth Circuit held that a licensee of patent rights could be deprived of the continued use of patent technology by reason of the licensor rejecting the license in bankruptcy. In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,¹ the appellate court characterized a nonexclusive patent license as an executory contract within the meaning of the Bankruptcy Code and approved rejection of the license by the licensor because it was advantageous to the licensor's Chapter 11 reorganization effort. The result, according to the Fourth Circuit, was that the licensee lost its right to use the intellectual property for which it had bargained, had no right to specific performance of the licensing agreement, and was left with nothing but a money-damages claim against the bankruptcy estate.²*

It did not take long for Congress to respond to Lubrizol by enacting the Intellectual Property Bankruptcy Protection Act of 1988, which added § 365(n) to the Bankruptcy Code. This section grants the licensee of intellectual property the option to treat a licensor's rejection as a termination of the license or, alternatively, to continue to use the intellectual property for the remaining term of the rejected license, including any term extension to which the licensee is otherwise entitled, in exchange for continued payments of royalties in accordance with the license agreement. Congress, however, defined "intellectual property" in the Bankruptcy Code so as to exclude trademarks, deliberately depriving trademark licensees of the protections afforded by § 365(n). Though Congress intended to return to the subject of trademark licensees in bankruptcy at a later time, Congress took

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1. 756 F.2d 1043, 1046-47 (4th Cir. 1985).

2. *Id.* at 1048.

no further legislative action to protect such licensees. Therefore, trademark licensees remained vulnerable.

As shocking as Lubrizol was to all licensees of intellectual property, and as disappointing as the exclusion of trademarks from the protections of § 365(n) was to trademark licensees, a recent decision by the Court of Appeals for the Seventh Circuit in the Sunbeam case³ is an unexpected cause for celebration by trademark licensees. The Seventh Circuit, twenty-seven years after the decision in Lubrizol, directly rejected the holding and reasoning of the Fourth Circuit and held, based on its analysis of bankruptcy law, that a trademark licensee cannot be deprived of the right to use a trademark under a license agreement despite rejection of the agreement in the bankruptcy case of the licensor. The United States Supreme Court declined to review the Sunbeam decision, thereby leaving a circuit split and many unanswered questions regarding the effect of a licensor's rejection of a trademark license agreement in bankruptcy.

I. INTRODUCTION

IT is common for a purchaser of a business to want to use the trade name and trademark long associated with the business so as to capture its goodwill and reputation. A seller that does not want to part with the trademark often grants the buyer a long-term license to use the seller's trademark. From the licensee's standpoint, the right to use the trademark under a licensing agreement can be among the most valuable assets purchased in the transaction. It is also common for the owner of a trademark to grant several entities exclusive or nonexclusive licenses to use the trademark in certain geographic areas or on certain products, unrelated to any sale of other assets, while retaining ownership of the trademark. In all of these scenarios, licensees often invest capital and build their businesses based on an expectation of uninterrupted use of the trademark.

When a company seeks protection under Chapter 11 of the Bankruptcy Code, the debtor in possession or trustee is granted extraordinary powers not available to companies outside of bankruptcy. One of those powers is the right to assume or reject executory contracts under § 365(a) of the Bankruptcy Code.⁴ Historically, at least since 1985 when the Court of Appeals for the Fourth Circuit decided *Lubrizol Enterprises, Inc., v. Richmond Metal Finishers, Inc.*, the power to reject executory contracts enabled trademark licensors in bankruptcy to effectively terminate the right of trademark licensees to use trademarks despite the contractual arrangements of the parties and the continuation of the licensees' willingness to pay royalties.⁵ Congress responded to *Lubrizol* by enacting legislation to protect licensees of intellectual property from the deprivation of

3. *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 376 (7th Cir. 2012).

4. See 11 U.S.C. § 365(a) (2012).

5. 756 F.2d 1043 (4th Cir. 1985).

their rights to continued use of licensed intellectual property when a licensor rejects the license in bankruptcy, but such protection was not afforded to trademark licensees.⁶ Most recently, however, the Court of Appeals for the Seventh Circuit rejected the holding and analysis of *Lubrizol* and held that rejection of a trademark license by a licensor in bankruptcy does not deprive the licensee of its right to continued use of the trademark for the duration of the license period, resulting in a circuit split over the consequences flowing from rejection of a trademark license agreement.⁷

This Article will discuss the issue of whether a trademark licensor may deprive a licensee of the use of the trademark by becoming a debtor in a bankruptcy case and rejecting the license as an executory contract. It begins in Part I with a general discussion of the powers of a trustee or debtor in possession to reject executory contracts under the Bankruptcy Code, the meaning of “executory contract,” and the consequences of a rejection. Part II of this Article focuses on the landmark decision in *Lubrizol*,⁸ in which the rejection of intellectual property licensing agreements resulted in the termination of the licensee’s right to use the intellectual property. Part III discusses Congress’s response to *Lubrizol*, the enactment of the Intellectual Property Bankruptcy Protection Act of 1988,⁹ which added § 365(n) to the Bankruptcy Code but did not include trademarks within the protection afforded to licensees. Part IV discusses transaction structures designed in the wake of *Lubrizol* and the 1988 Act in an attempt to reduce risk and potential harm to a trademark licensee in the event that the licensor rejects the trademark licensing agreement in bankruptcy. Part V discusses the Seventh Circuit’s decision in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,¹⁰ which rejected the holding of *Lubrizol* and protects the right of licensees to continue to use trademarks despite rejection by the licensor in bankruptcy. But the decision leaves several questions unanswered regarding its impact on the survival of the obligations of the parties after a rejection.

II. THE POWERS OF A TRUSTEE OR DEBTOR IN POSSESSION TO ASSUME OR REJECT EXECUTORY CONTRACTS UNDER THE BANKRUPTCY CODE

To help maximize the value of a bankruptcy estate for the benefit of creditors or to assist a company reorganizing under Chapter 11, a trustee in bankruptcy is granted extraordinary powers that are unavailable to the debtor outside of the bankruptcy system, including, among others, the

6. Intellectual Property Bankruptcy Protection Act of 1988, Pub. L. No. 100-56, 102 Stat. 2538, 2539 (codified in Title 11 of the United States Code).

7. *Sunbeam Prods.*, 686 F.3d at 376.

8. 756 F.2d. at 1046–47.

9. 102 Stat. at 2538–39.

10. 686 F.3d at 376.

power to avoid unperfected security interests,¹¹ to recover preferential payments to creditors made shortly before bankruptcy,¹² and to avoid pre-bankruptcy fraudulent transfers of the debtor's assets.¹³ Also included among these powers is the ability to assume or reject executory contracts and unexpired leases.¹⁴ The rationale for granting this power is that the trustee or debtor in possession should be able to take advantage of favorable, yet-to-be-performed contracts that benefit the bankruptcy estate while abandoning those unfavorable contracts that otherwise would burden the estate.¹⁵ Subject to certain exceptions,¹⁶ § 365(a) of the Bankruptcy Code provides that the trustee may assume or reject executory contracts and unexpired leases of the debtor.¹⁷ These extraordinary powers may also be exercised by a debtor in possession in a Chapter 11 case.¹⁸ Notwithstanding this broad power, a decision by the trustee or debtor in possession to assume or reject an executory contract is subject to bankruptcy court approval.¹⁹ The bankruptcy court's oversight, however, is highly deferential, generally applying the "business judgment" standard when determining the propriety of the assumption or rejection decision by the trustee or debtor in possession.²⁰

11. See 11 U.S.C. § 544(a) (2012).

12. *Id.* § 547.

13. *Id.* § 548.

14. *Id.* § 365(a).

15. See, e.g., *In re Compass Van & Storage Corp.*, 65 B.R. 1007, 1010 (Bankr. E.D.N.Y. 1986).

16. 11 U.S.C. § 365(a). The exceptions relate to the trustee's right to assume, rather than reject, executory contracts. In certain situations an executory contract may not be assumed, including, among others, (i) where the debtor has defaulted in the performance of the contract and the debtor has neither cured the default nor provide adequate assurance that it will promptly cure the default, or has failed to provide compensation for any losses as a result of such default, or has failed to provide adequate assurance of future performance, *id.* § 365(b); (ii) where the contract is a pre-bankruptcy agreement to provide a loan or other financing to the debtor, *id.* § 365(c)(2); (iii) where applicable law excuses a party other than the debtor from accepting performance from or rendering performance to another entity without its consent, such as personal services contracts that are nonassignable as a matter of law, *id.* § 365(c)(1); or (iv) where the contract is not timely assumed, *id.* § 365(d).

17. *Id.* § 365(a); see generally 3 COLLIER ON BANKRUPTCY ¶ 365.01-.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012).

18. In a case under Chapter 11 of the Bankruptcy Code, a "debtor in possession" is the debtor, which is operated by its managers, if a trustee is not serving in the case. 11 U.S.C. § 1101(1). A trustee is not appointed in Chapter 11 cases unless there is cause to appoint one, such as if the debtor's managers are grossly incompetent or dishonest. See *id.* § 1104(a). In the vast majority of Chapter 11 cases, a trustee is not appointed and the debtor remains the debtor in possession. In general, a debtor in possession has all the rights and powers of a trustee. See *id.* § 1107(a). Accordingly, subject to limited exceptions, references in the Bankruptcy Code to the "trustee" include the debtor in possession when the bankruptcy case is a case under Chapter 11 of the Bankruptcy Code. For ease of reference, this Article uses the term "debtor" when referring to a debtor in possession or the trustee with respect to the power to assume or reject executory contracts.

19. *Id.* § 365(a).

20. See, e.g., *In re Pomona Valley Med. Grp.*, 476 F.3d 665, 670 (9th Cir. 2007); *Orion Pictures Corp. v. Showtime Networks*, 4 F.3d 1095, 1099 (2d Cir. 1993).

A. THE EFFECTS OF ASSUMPTION AND REJECTION

To fully appreciate the power of assumption or rejection, it is necessary to understand the consequences of rejecting or assuming an executory contract. If a debtor assumes an executory contract in bankruptcy, the bankruptcy estate adopts it as its own, which means it accepts responsibility to fully perform its obligations under the contract.²¹ If the debtor breaches following assumption or formally rejects the contract after assuming it, any resulting claims (including any right to monetary damages resulting from a post-assumption breach) are entitled to payment as an administrative expense in the bankruptcy case.²² Under § 507(a)(2) of the Bankruptcy Code, administrative expense claims are entitled to priority in payment over other unsecured creditors,²³ including priority over most other unsecured claims that are also entitled to some degree of priority, such as employee wage claims²⁴ and priority tax claims.²⁵ Moreover, in a Chapter 11 case, except to the extent that an administrative expense claimant agrees otherwise, a plan cannot be confirmed unless it proposes to pay administrative claims in full on the effective date of the plan.²⁶

Conversely, where the debtor rejects an executory contract, such rejection constitutes a breach of the contract by the debtor.²⁷ The breach is treated under the Bankruptcy Code as though it occurred immediately before the date of the commencement of the bankruptcy case.²⁸ Under § 502(g)(1) of the Bankruptcy Code, the nondebtor party to the rejected contract is entitled to a prepetition claim against the estate for damages incurred as a result of the breach.²⁹ Courts have held that rejection terminates any right that the nondebtor party would have had under applicable nonbankruptcy law to obtain specific performance, thereby limiting the nondebtor party to the assertion of a money-damages claim against the bankruptcy estate.³⁰ Unlike a claim for breach of a contract previously assumed by a debtor, however, a claim flowing from a debtor's rejection of an executory contract not previously assumed is not entitled to administrative priority.³¹ As a result, unless the claim is otherwise secured by collateral or independently entitled to priority under the Bankruptcy Code, the nondebtor party to the rejected contract will share pro rata with the debtor's other general unsecured creditors.³² To the extent that

21. See 11 U.S.C. § 365(b)(1)(c).

22. See *id.* §§ 503(b), 365(g)(2); see also, e.g., *Adventure Res. v. Holland*, 137 F.3d 786, 793 (4th Cir. 1998).

23. 11 U.S.C. §§ 507(a)(2), 726(a), 1129(a)(9)(A).

24. *Id.* § 507(a)(4).

25. *Id.* § 507(a)(8).

26. *Id.* § 1129(a)(9)(A).

27. *Id.* § 365(g).

28. *Id.* § 365(g)(1).

29. *Id.* § 502(g)(1).

30. See, e.g., *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); *Midway Motor Lodge v. Innkeepers' Telemanagement & Equip. Corp.*, 54 F.3d 406, 407 (7th Cir. 1995).

31. See 3 COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 365.10[1].

32. 11 U.S.C. § 726(b).

the claim remains unpaid after all distributions are made in the bankruptcy case or under a Chapter 11 plan of reorganization, such claim is discharged.³³

To illustrate the consequences of rejection, suppose that a debtor is a party to a pre-bankruptcy contract for the purchase of certain goods for a total price of \$100,000. The goods are to be delivered approximately ninety days after the contract was formed and payment of the purchase price is due thirty days after the delivery date. Before the delivery date, the debtor files a Chapter 11 petition and discovers that the market price for such goods fell sharply. In fact, the debtor could buy the same type of goods of the same quality on the market from one of the seller's competitors for only \$60,000. If the debtor rejects this contract and buys the goods from the seller's competitor, the rejection would be treated as a breach of the agreement immediately before the filing of the petition.³⁴ This breach would give the seller under the contract an unsecured, non-priority prepetition claim against the bankruptcy estate for whatever damages it suffers.³⁵ Because the first seller would presumably be able to mitigate damage by reselling its goods on the market for \$60,000, the seller would be left with a \$40,000 damage claim against the bankruptcy estate. If, based on the value of the property of the estate, unsecured creditors are entitled to receive payment equal to only ten percent of their unsecured claims in the bankruptcy case, the seller would receive only \$4,000 and the balance of the debt would be discharged. Thus, by rejecting the contract, the debtor in possession would pay only \$4,000 for the opportunity to be relieved from its obligation to purchase the goods from the original seller, despite the fact that under non-bankruptcy law the original seller would be entitled to a \$40,000 money judgment against the debtor.

B. WHAT IS AN EXECUTORY CONTRACT?

The right to assume or reject under § 365(a) applies only to those contracts that are executory on the date when the bankruptcy case is commenced.³⁶ The term "executory contract" is not defined in the Bankruptcy Code.³⁷ However, the prevailing definition used by most courts is one commonly known as the "Countryman definition," named after the late Professor Vern Countryman of Harvard Law School. As discussed below, Professor Countryman developed his definition of executory contracts taking into consideration the consequences of assumption and rejection.

In a 1973 article, Professor Countryman analyzed in great depth the

33. *Id.* §§ 727(b), 1141(d).

34. *See id.* § 365(g).

35. *See id.* § 502(g).

36. *Id.* § 365(a); *see also* COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 365.02[2][e].

37. *See generally* COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 365.02[2][e].

subject of executory contracts in bankruptcy.³⁸ He began his analysis by looking at the three types of unperformed contracts that exist outside of bankruptcy: (i) contracts under which the nondebtor party has performed all of its material obligations, but the debtor has not; (ii) contracts under which the debtor has fully performed, but the nondebtor party has not; and (iii) contracts under which both the debtor and the nondebtor party have material obligations not yet performed at the time of bankruptcy.³⁹ Beginning with the premise that in bankruptcy the term “executory contract” should be defined “in the light of the purpose for which the trustee is given the option to assume or reject”⁴⁰ that the definition “should not extend to situations where the only effect of its exercise would be to prejudice other creditors of the estate.”⁴¹ Professor Countryman reasoned that the only contracts that should be treated as executory contracts for bankruptcy purposes are the third type: contracts in which, at the time the bankruptcy case was commenced, both the debtor and the nondebtor party have material unperformed obligations remaining so that a breach by either party would relieve the other of the obligation to perform.⁴²

With respect to the first type of contract—where the nondebtor party has completed performance but the debtor has not—Professor Countryman reasoned that the trustee or debtor in possession should not be able to assume the contract because to do so would provide no benefit to the estate and would only serve to give preference to the claims of the nondebtor party to the contract over other creditors of the estate.⁴³ As a practical matter, these contracts are in the nature of accounts payable because there is nothing left but the debtor’s duty to render its performance. There is no logical reason for a trustee or debtor to assume an account payable because “[t]he estate has whatever benefit it can obtain from the other party’s performance” without the need to assume it.⁴⁴ The only consequence of assumption in that circumstance would be to give the nondebtor party an administrative expense claim for the full amount of its damages at the expense of other creditors if the debtor fails to perform, and no reasonable trustee or debtor would opt to do that. And rejecting an account payable would have no legal effect because, with or without rejection, the nondebtor party has fully performed its obligations under the contract and would be entitled to a prepetition unsecured claim for the full amount of its damages. Thus, Professor Countryman concluded that “[t]he trustee’s option to assume or reject should not extend to such contracts.”⁴⁵ Consistent with this analysis, promissory notes and

38. See Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439 (1973).

39. *Id.* at 451–65.

40. *Id.* at 450.

41. *Id.* at 451.

42. *Id.* 457–60.

43. *Id.* at 451–52.

44. *Id.* at 451.

45. *Id.*

loan agreements under which there is no outstanding obligation other than the debtor's obligation to pay money are not executory contracts and may not be assumed or rejected.

With respect to the second type of contract—where the debtor has completed performance but the nondebtor party to the contract has not—Professor Countryman likewise concluded that the trustee should not be able to reject such contracts because doing so would provide no benefit to the estate.⁴⁶ These contracts are in the nature of fully-earned accounts receivable owned by the debtor. Upon the filing of a bankruptcy petition, a bankruptcy estate is created,⁴⁷ which consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.”⁴⁸ Property of the estate includes the debtor's contractual rights to further performance due from a nondebtor party under a contract.⁴⁹ Thus, assumption of an executory contract where the debtor has fully performed adds nothing to the estate because the further performance by the nondebtor party to which the debtor is entitled under the contract is already property of the estate.⁵⁰ The trustee may simply enforce the debtor's right to payment on its accounts receivable without the need to assume the contract. Professor Countryman also wrote that the trustee should not be permitted to reject the contract because, as discussed above, rejection constitutes a breach of the contract by the debtor, which, in light of the debtor's full performance, would make no sense.⁵¹

For these reasons, Professor Countryman concluded that the only contracts that should be subject to assumption or rejection by the trustee or debtor in possession are those in which material performance remained outstanding on both sides such that a breach by one party would excuse the other party's performance under applicable nonbankruptcy law.⁵² In that situation, the trustee or debtor would determine whether the contract is a beneficial one that should be performed by the debtor and enforced against the nondebtor party, in which case it should be assumed.⁵³ To illustrate, if the contract price for goods in the above hypothetical was \$100,000, the market price of such goods has risen to \$140,000, and the delivery date and payment date have not yet occurred, the trustee or debtor would assume the contract so that the bankruptcy estate would realize the benefit of this good bargain by paying \$100,000 in exchange

46. *Id.* at 458.

47. 11 U.S.C. § 541(a).

48. *Id.* § 541(a)(1).

49. *See generally* 5 COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 541.07[3].

50. *See id.*

51. Countryman, *supra* note 38, at 459 n.81.

52. *Id.* at 460–62. Professor Countryman defined material performance consistent with the Restatement (Second) of Contracts: “[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” *Id.* at 460; accord RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981).

53. *See* Countryman, *supra* note 38, at 461.

for goods now worth \$140,000.⁵⁴ But if the market price of the goods has fallen to \$60,000, the trustee or debtor should reject the contract, giving the seller nothing but a \$40,000 prebankruptcy unsecured claim against the bankruptcy estate while relieving the trustee or debtor of the obligation to purchase the goods under that contract. As Professor Countryman has noted, “Whether in a given case the trustee will assume or reject depends, presumably, on his comparative appraisal of the value of the remaining performance by the other party and the cost to the estate of the unperformed obligation of the bankrupt.”⁵⁵

Though the Countryman definition has been adopted by the vast majority of courts that have addressed the issue, and no circuit has rejected it outright,⁵⁶ a few courts have used a different test that has been characterized as a more functional alternative for determining whether a contract is executory for purposes of applying § 365 of the Bankruptcy Code.⁵⁷ These courts have suggested that the Countryman definition is too restrictive and should also include contracts in which material unperformed obligations exist on only one side, so long as assumption or rejection would benefit the estate.⁵⁸

C. THE SHOT HEARD AROUND THE IP WORLD: *LUBRIZOL ENTERPRISES, INC. v. RICHMOND METAL FINISHERS, INC.*⁵⁹

In 1985, a decision of the Fourth Circuit Court of Appeals seemingly shattered the reliability of technology licenses.⁶⁰ A few years before that decision, Richmond Metal Finishers, Inc. (RMF) developed a metal-coating process technology on which it wanted to capitalize.⁶¹ In 1982, RMF

54. *See id.*

55. *Id.*

56. COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 365.02[2][b].

57. *See, e.g., In re Gen. Dev. Corp.*, 84 F.3d 1364, 1374 (11th Cir. 1996); *In re Jolly*, 574 F.2d 349, 351 (6th Cir. 1978) (adopting the functional approach in a case under the Bankruptcy Act); *Stevens v. CSA, Inc.*, 271 B.R. 410, 413 (D. Mass. 2001) (explaining that courts in the First Circuit use both the Countryman standard and the functional analysis approach to evaluate executory contracts); *Cohen v. Drexel Burnham Lambert Grp., Inc.* 138 B.R. 687, 703 n.24 (Bankr. S.D.N.Y. 1992).

58. *See In re Arrow Air, Inc.*, 60 B.R. 117, 121–22 (Bankr. S.D. Fla. 1986), where the court wrote:

The legislative history of § 365, and the statute itself, establish that it is not always the case that there must be outstanding obligations on the part of both parties to the contract in order for a contract to be deemed executory The express language of § 365 reflects that Congress did not adopt a specific definition of an “executory contract” which would require mutual obligations, in spite of its clear opportunity to do so. The legislative history to that section evidences that Congress considered mutual obligations to be indicative of an executory contract in some, but not all, cases. . . . [E]ven though there may be material obligations outstanding on the part of only one of the parties to the contract, it may nevertheless be deemed executory under the functional approach if its assumption or rejection would ultimately benefit the estate and its creditors.

59. 756 F.2d 1043 (4th Cir. 1985).

60. *See id.*

61. *In re Richmond Metal Finishers, Inc. (Richmond II)*, 38 B.R. 341, 342 (E.D. Va. 1984), *rev'd sub nom., Lubrizol*, 756 F.2d 1043.

entered into a sixteen-year contract with Lubrizol Enterprises, Inc., under which Lubrizol, as licensee, would have a non-exclusive license to use the technology.⁶² The contract provided that Lubrizol was prohibited from using the technology for one year after the execution of the agreement.⁶³ In consideration for the license, Lubrizol agreed to make royalty payments on product sales resulting from the use of the technology and to forgive certain indebtedness owed by RMF to Lubrizol.⁶⁴ Lubrizol also had certain ongoing accounting, reporting, and confidentiality obligations under the agreement.⁶⁵ In addition to its licensing obligations, RMF was obligated under the licensing agreement to (i) notify Lubrizol of any patent infringement suit and defend Lubrizol in any such suit, (ii) notify Lubrizol of any other use or license of the technology, and (iii) indemnify Lubrizol for certain losses arising out of the licensing agreement.⁶⁶

RMF filed for protection under Chapter 11 of the Bankruptcy Code in August 1983.⁶⁷ At the time RMF filed for bankruptcy, no royalties had been paid or credited and the one-year period in which Lubrizol was prohibited from using the technology had just expired.⁶⁸ The licensed technology was a principal asset of RMF's business, and attempts to sell or license the technology to third parties were hindered by the existing Lubrizol license.⁶⁹ RMF wanted to have the ability to sell or license the technology to others free from the restrictive provisions in the Lubrizol agreement.⁷⁰ For that reason, RMF moved to reject the licensing agreement under § 365 of the Bankruptcy Code shortly after it filed its bankruptcy petition.⁷¹ At the hearing on the motion to reject, RMF presented evidence that to properly fund RMF's Chapter 11 plan, the "sound business decision" was to reject the licensing agreement.⁷² Lubrizol opposed the debtor's motion, arguing that (i) the licensing agreement was not executory and, therefore, was not subject to rejection under § 365 of the Bankruptcy Code and (ii) even if the licensing agreement was executory, the debtor should not be permitted to reject the agreement because rejection would not preclude Lubrizol from continuing to use the technology going forward and, as a result, rejection would not benefit the estate.⁷³

On the first issue, the bankruptcy court determined that the licensing agreement was executory for § 365 purposes.⁷⁴ The court reasoned that Lubrizol's continuing obligation to make royalty payments under the

62. *In re Richmond Metal Finishers, Inc. (Richmond I)*, 34 B.R. 521, 522 (Bankr. E.D. Va. 1983), *rev'd*, *Richmond II*, 38 B.R. 341 (E.D. Va. 1984).

63. *Richmond II*, 38 B.R. at 342.

64. *Richmond I*, 34 B.R. at 522.

65. *Lubrizol*, 756 F.2d at 1046.

66. *Richmond I*, 34 B.R. at 522.

67. *Id.*

68. *Richmond II*, 38 B.R. at 342.

69. *Id.*

70. *Id.*

71. *Richmond I*, 34 B.R. at 522.

72. *Id.*

73. *Id.* at 523, 526.

74. *Id.* at 526.

agreement was material, as were RMF's ongoing obligations to notify and defend against patent infringement suits and to indemnify Lubrizol for certain losses under the licensing agreement, thus rendering the contract executory.⁷⁵

The bankruptcy court next addressed the issue of whether rejection would provide a benefit to the estate.⁷⁶ Applying the business judgment rule, the bankruptcy court held that rejecting the agreement would benefit the estate by permitting the debtor to substitute a new sale or licensing arrangement that would be more advantageous to the estate and to creditors.⁷⁷ The bankruptcy court rejected Lubrizol's argument that the debtor could not reject under § 365 because the licensing agreement "represents a future stream of income and, therefore, rejection will not benefit the estate."⁷⁸ Noting that the so-called "burdensome test" was "not the appropriate [test] to be applied," the bankruptcy court found that "rejection may and should be approved where a contract, while not actually burdensome to the debtor nonetheless prevents the debtor from entering a more advantageous arrangement."⁷⁹ Having found the licensing agreement executory and the business judgment test satisfied, the court granted the debtor's motion to reject the licensing agreement.⁸⁰

On appeal to the district court, the bankruptcy court's decision was reversed.⁸¹ In holding that the licensing agreement could not be rejected,

75. *Id.* at 524. The bankruptcy court cited *In re Select-A-Seat*, 625 F.2d 290 (9th Cir. 1980), to support its conclusion that the license agreement was an executory contract. *Richmond I*, 34 B.R. at 524. The bankruptcy court also rejected Lubrizol's argument that the licensing agreement was not executory as to RMF because its obligations under the agreement were contingent. *Id.* Relying on *In re Smith Jones, Inc.*, 26 B.R. 289, 292 (Bankr. D. Minn. 1982), and *In re O.P.M. Leasing Services, Inc.*, 23 B.R. 104, 117 (Bankr. S.D.N.Y. 1982), the bankruptcy court found that "even obligations that may never arise may form the basis of classifying a contract as executory." *Richmond I*, 34 B.R. at 524-25. The bankruptcy court also found support from Professor Countryman himself who stated, "The usual patent license, by which the patentee-licensor authorizes the licensee to exercise some part of the patentee's exclusive right to make, use and vend the patented item in return for payment of royalties, ordinarily takes the form of an executory contract." *Id.* at 525 (quoting Countryman, *supra* note 38, at 301).

It should be noted, however, that not all intellectual property licenses are executory contracts. In *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), a purchaser of substantially all of an industrial battery business also obtained, as part of the sale transaction, an exclusive, perpetual, royalty-free license to use the seller's trademark. *Id.* at 961. When the seller-licensor filed a Chapter 11 petition many years later and attempted to reject the license in order to prevent the licensee from using the trademark, the Court of Appeals held that all of the licensee's material obligations under the agreement were substantially performed as of the date when the bankruptcy petition was filed and, therefore, if the licensee breached any remaining obligations, the licensor would not be relieved of its obligation to perform under the license agreement. *Id.* at 963-64. Therefore, the agreement was not an executory contract under the Countryman definition and it could not be rejected. *But see In re Interstate Bakeries Corp.*, 690 F.3d 1069, 1075, (8th Cir. 2012) *vacating as moot* No. 11-1850, 2013 U.S. App. LEXIS 12463 (8th Cir. 2013) (en banc).

76. *Richmond I*, 34 B.R. at 524.

77. *Id.* at 526.

78. *Id.*

79. *Id.* (citing *In re Smith Jones, Inc.*, 26 B.R. 289, 293 (Bankr. D. Minn. 1982)).

80. *Id.*

81. *Richmond II*, 38 B.R. 341, 345 (E.D. Va. 1984), *rev'd sub nom.* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1984).

the district court first determined that, contrary to the bankruptcy court's finding, the licensing agreement was not an executory contract.⁸² Analogizing the licensing agreement to a sale of land where the seller retained a purchase money deed of trust, the court found that RMF's notification and defense obligations were insufficient to make the contract executory:

There, as here, the subject of the contract has been conveyed and possession has been taken by the vendee. There, as here, the vendee has the obligation of making payment for the conveyance as provided in the contract. There, as here, the vendor has the benefit of receiving the periodic payments and has the obligation of defending the vendee's title. . . .

. . . .
The obligations of the vendor of real estate to defend the purchaser's title is no more onerous than the obligation of the vendor of technology to defend the vendee's right to exploit it.

. . . .
Applying this analysis and on the reasoning, (though not necessarily on the conclusion) of Professor Countryman, I find the contract to be essentially nonexecutory.⁸³

Further, the district court wrote that even if the licensing agreement was executory, RMF could not reject the contract because rejection provided no benefit to the estate.⁸⁴ Most notably, the district court was of the view that rejection would neither affect Lubrizol's ability to continue exercising its property rights under the licensing agreement nor relieve its obligations to continue paying royalties.⁸⁵ Despite rejection, the court reasoned that a licensee's right to use licensed technology does not terminate.⁸⁶ As a result, the district court concluded, rejection would only serve to relieve RMF of its defense obligations.⁸⁷ Because RMF's business judgment rationale for rejection was the refusal of third parties to license the technology so long as the Lubrizol license remained in effect, but rejection of the license agreement would not deprive Lubrizol of the continued use of the technology, rejection would have "at best, a marginal effect upon the technology's marketability."⁸⁸ Accordingly, the district court found no basis for the debtor's business judgment and determined rejection was not appropriate.⁸⁹

On appeal, the Court of Appeals for the Fourth Circuit reversed the judgment of the district court and directed entry of an order consistent with the bankruptcy court's decision.⁹⁰ First, the Fourth Circuit agreed

82. *Id.*

83. *Id.* at 343-45 (emphasis omitted).

84. *Id.* at 345.

85. *Id.* at 344.

86. *Id.* at 343-45.

87. *Id.* at 344.

88. *Id.* at 344-45.

89. *Id.* at 345.

90. *Lubrizol Enters., Inc., v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1044 (4th Cir. 1985).

with the bankruptcy court that the licensing agreement was an executory contract.⁹¹ Relying on an earlier decision where it adopted the Countryman test for determining whether a contract was executory for § 365 purposes,⁹² the Fourth Circuit concluded that the continuing obligations of RMF to notify Lubrizol of further licensing of the technology, to reduce Lubrizol's royalty rate to meet any favorable grants to subsequent licensees, to notify and defend Lubrizol against suits, and to indemnify Lubrizol for certain losses under the licensing agreement were material obligations still outstanding such that the contract was executory as to RMF.⁹³ Likewise, the court found Lubrizol's obligation to make royalty payments, to comply with various accounting and reporting requirements under the licensing agreement, and to keep the licensed technology in confidence for a number of years were sufficiently material to make the contract executory as to Lubrizol as well.⁹⁴ Thus, there were material obligations remaining on both sides when the bankruptcy case commenced.

On the question of whether rejection would benefit the estate, the Fourth Circuit again agreed with the bankruptcy court's finding.⁹⁵ Turning to the business judgment test, the Fourth Circuit evaluated "whether the decision of the debtor that rejection [would] be advantageous [was] so manifestly [unreasonable] that it could not be based on sound business judgment, but only on bad faith, or whim or caprice."⁹⁶ In reversing the district court, the Fourth Circuit found error in two respects. First, the district court improperly substituted its business judgment for the debtor's and, second, the district court misconstrued the law when it concluded that the debtor's rejection of the licensing agreement would not deprive Lubrizol of its right to continue using the licensed technology.⁹⁷

As to Lubrizol's right to continue using the licensed technology, the Fourth Circuit rejected the district court's holding as a "misapprehension of controlling law":

[W]e can only conclude that the district court was under a misapprehension of controlling law in thinking that by rejecting the agreement the debtor could not deprive Lubrizol of all rights to the process. Under 11 U.S.C. § 365(g), Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be

91. *Id.* at 1044–45.

92. *Id.* at 1045 (citing *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984)).

93. *Id.*

94. *Id.* at 1046.

95. *Id.* at 1047.

96. *Id.*

97. *Id.* at 1047–48. The Fourth Circuit found no evidence in the record from which the district court could have determined that the debtor's decision was the result of anything other than its sound business judgment. In the absence of such evidence, the Fourth Circuit found, "the business judgment rule required that the debtor's factual evaluation be accepted by the court." *Id.* at 1047.

available upon breach of this type of contract.⁹⁸

Viewing Lubrizol's continued use of the licensed technology after the debtor's rejection as akin to specific enforcement under the licensing agreement, the Fourth Circuit looked to the legislative history of § 365(g) and found that the nondebtor party to a rejected contract was limited to a money-damages claim against the bankruptcy estate.⁹⁹ Allowing Lubrizol to obtain specific performance after the debtor rejected the licensing agreement, the Fourth Circuit concluded, "would obviously undercut the core purpose of rejection under § 365(a), and that consequence cannot therefore be read into congressional intent."¹⁰⁰

The Fourth Circuit was not unaware of the potential harm that could flow from its decision.¹⁰¹ The court acknowledged that its decision would create "serious burdens" on contracting parties and "have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty"¹⁰² but felt that it could not consider such equitable considerations in the face of clear Congressional intent.¹⁰³ The court wrote that Congress was aware of the consequences flowing to a nondebtor party from a debtor's rejection of an executory contract and how to protect against it, as was evidenced by § 365(h) of the Bankruptcy Code, which allows tenants of real property to remain in possession notwithstanding a debtor-landlord's rejection of a real property lease.¹⁰⁴ Because Congress had not provided comparable treatment for technology licensees, in a grave understatement, the Fourth Circuit cautioned that Lubrizol would have to "share the general hazards created by § 365 for all business entities dealing with potential bankrupts."¹⁰⁵ The hazard for Lubrizol would be the loss of its right to use its licensed intellectual property.

D. THE INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT OF 1988: CONGRESS'S RESPONSE TO *LUBRIZOL*

In 1988, the Intellectual Property Bankruptcy Protection Act was enacted for the purpose of legislatively overruling the *Lubrizol* decision and eliminating the threat to technology licensees when licensors become debtors in bankruptcy.¹⁰⁶

The purpose of the bill is to amend § 365 of the Bankruptcy Code to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of

98. *Id.* at 1048.

99. *Id.*

100. *Id.*

101. *See id.*

102. *Id.*

103. *Id.*

104. *Id.*; see 11 U.S.C. § 365(h); COLLIER ON BANKRUPTCY, *supra* note 17, ¶ 365.11.

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

106. Intellectual Property Bankruptcy Act of 1988, Pub. L. No. 100-506, 102 Stat. 2538 (codified in Title 11 of the United States Code); see S. REP. NO. 100-505, at 2-3 (1988).

the rejection of the license pursuant to § 365 in the event of the licensor's bankruptcy. Certain recent court decisions interpreting § 365 have imposed a burden on American technological development that was never intended by Congress in enacting § 365. The adoption of this bill will immediately remove that burden and its attendant threat to the development of American Technology and will further clarify that Congress never intended for § 365 to be so applied.¹⁰⁷

As reflected in the senate report relating to the legislation, Congress viewed the *Lubrizol* decision as a misreading of § 365 of the Bankruptcy Code.¹⁰⁸ The Intellectual Property Bankruptcy Protection Act was designed to correct this misreading by adding to § 365 of the Bankruptcy Code a subsection (n), which provides that upon rejection by the licensor, the licensee of intellectual property may elect to either treat the contract as terminated by the rejection or retain its rights to the use of the intellectual property, including exclusivity provisions, for the duration of the license period, including any period for which the license could be extended under the agreement.¹⁰⁹ In particular, subsection (1) of § 365(n) provides:

If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.¹¹⁰

If a licensee elects to keep its rights under the licensing contract under § 365(n)(1), the trustee must allow the licensee to continue exercising its

107. S. REP. NO. 100-505, at 1-2.

108. See S. REP. NO. 100-505, at 3 ("Congress never anticipated that the presence of executory obligations in an intellectual property license would subject the licensee to the risk that, upon bankruptcy of the licensor, the licensee would lose not only any future affirmative performance required of the licensor under the license, but also any right of the licensee to continue to use the intellectual property as originally agreed in the license agreement.").

109. *Id.* at 5-6.

110. 11 U.S.C. § 365(n)(1).

rights under the agreement, but with certain limitations.¹¹¹ Although a licensee electing to retain its rights under a licensing agreement retains its right to specifically enforce exclusivity provisions, it loses the right to seek specific performance with respect to all other covenants under the licensing agreement.¹¹² As explained in the legislative history of § 365(n), this limitation “recognizes that continued affirmative performance of an intellectual property license may be impractical; for instance, a trustee will generally be unable to perform covenants calling for continued research to improve licensed intellectual property.”¹¹³

It is not surprising that the licensee that elects to retain its rights under a rejected license is not released of all of its obligations under the license agreement.¹¹⁴ Most notably, in exchange for its continued use of the license, the licensee must continue to make all royalty payments under the licensing agreement. The licensee is also deemed to have waived any set-off rights it may have against the debtor so that royalty payments may not be reduced by any damages suffered by the debtor’s nonperformance of covenants.¹¹⁵ Similarly, the licensee is deemed to have waived any right to seek administrative expense priority under § 503(b) of the Bankruptcy Code with respect to any claim it may have against the debtor licensor.¹¹⁶ These provisions represent a compromise between the debtor’s and licensee’s respective needs: the licensee retains its right to use the licensed intellectual property, which may be essential to the continuation of its business, while the debtor, no longer able to relicense or sell the intellectual property after rejection, receives the royalty payments—free of the burden of offsets or administrative priority claims—needed to effectuate its reorganization.¹¹⁷

Rejection of a licensing agreement does not free the trustee or debtor of all of its performance obligations under a licensing agreement. To make the election to retain the use of the licensed intellectual property meaningful, on written request, the trustee or debtor in possession must, to the extent provided in the license agreement, provide the licensee with any intellectual property, including an embodiment, held by the trustee or debtor in possession and must not interfere with the licensee’s rights to the intellectual property, including the right to obtain it from a third party.¹¹⁸

While the Intellectual Property Bankruptcy Protection Act of 1988 legislatively overruled the Fourth Circuit’s *Lubrizol* decision with respect to the license of patented technology at issue, the Act did not extend protection to all intellectual property. Section 365(n), by its terms, applies to

111. *Id.* § 365(n)(2).

112. *Id.* § 365(n)(1)(B).

113. S. REP. NO. 100-505, at 8.

114. 11 U.S.C. § 365 (n)(2)(B).

115. *Id.* § 365(n)(2)(C)(i).

116. *Id.* § 365(n)(2)(C)(ii).

117. *See* S. REP. NO. 100-505, at 10.

118. 11 U.S.C. § 365(n)(3).

licensees to “executory contract[s] under which the debtor is a licensor of a right to intellectual property.”¹¹⁹ However, the Act also added a definition of “intellectual property” to the Bankruptcy Code, which does not include all types of property that are generally known in the business and legal worlds as “intellectual property.” In particular, “intellectual property” is defined in § 101 of the Bankruptcy Code to mean:

- (A) trade secret;
- (B) invention, process, design, or plant protected under Title 35;
- (C) patent application;
- (D) plant variety;
- (E) work of authorship protected under Title 17; or
- (F) mask work protected under Chapter 9 of Title 17; to the extent protected by applicable nonbankruptcy law.¹²⁰

Conspicuous in their absence are any mention of trademarks, trade names, and service marks. As explained in the legislative history of the 1988 Act, while Congress was concerned about the rights of licensees under trademark, trade name, and service mark license agreements under the *Lubrizol* line of reasoning, Congress opted not to address these types of intellectual property at that time because “such contracts raise[d] issues beyond the scope of th[e] legislation.”¹²¹ Particularly, Congress thought this area required more extensive study because “trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee.”¹²² For example, if a franchisor of restaurants becomes a debtor in a Chapter 11 case, it may want to reject a certain franchise agreement under § 365(a) and terminate its franchise relationship with a poorly-managed, unprofitable restaurant. Since such franchisees are often given trademark licenses so they can use the trade name and trademark of the franchisor on their restaurants, menus, napkins, and related products, if a franchisee with a rejected franchise agreement could continue to use the trademarks but be relieved of the obligation to comply with quality control covenants, the result would be a lowering or elimination of quality standards while the trademark of the licensor would continue to be used by the franchisee. This concern led Congress to “postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.”¹²³ However, in the quarter century since the enactment of the 1988 Act, Congress has yet to address the rights of licensees when a debtor in bankruptcy rejects a licensing agreement for trademarks, trade names, and service marks.

Of course, under the reasoning of *Lubrizol*, rejection of a trademark license by a licensor in bankruptcy could result in the loss of the licensee’s

119. *Id.* § 365(n)(1).

120. *Id.* § 101(35A).

121. S. REP. NO. 100-505, at 5.

122. *Id.*

123. *Id.*

right to use the trademark.¹²⁴ Ironically, the likelihood that bankruptcy courts would deprive a licensee of the right to use a trademark under a rejected license was actually enhanced after the enactment of the 1988 Act. Several courts have found that, relying on what they perceived as a negative inference of the legislation, the exclusion of trademarks from the definition of “intellectual property” meant that Congress intended that *Lubrizol’s* holding would continue to govern trademark license rejections.¹²⁵

E. TRANSACTIONAL STRUCTURES DESIGNED TO MINIMIZE THE RISKS
TO A LICENSEE FLOWING FROM REJECTION OF A
TRADEMARK LICENSE

Given the reliance of trademark licensees on long-term licensing arrangements, the magnitude of the investment, and the uncertainty of the long-term financial viability of any licensor, it is not surprising that in the wake of *Lubrizol* and Congress’s failure to extend the protections of § 365(n) to trademarks, licensees and their attorneys have devised transactional steps and complex structures designed to offer some degree of protection to trademark licensees from the adverse effects of a licensor’s rejection of the license agreement in bankruptcy. For example, rather than structure the transaction as a licensing arrangement, the initial transaction could be structured as a sale or absolute assignment of the intellectual property. If a licensing arrangement is required, the transaction could include the trademark owner first transferring title to the trademark to a trust or “bankruptcy-remote” entity, which becomes the licensor. These entities, which typically have no assets other than the intellectual property, have no debts, and have independent directors and corporate governance documents designed to reduce the likelihood that a bankruptcy petition will be filed, that the licensor will ever become a debtor under the Bankruptcy Code, and that the license therefore, will ever be rejected. Another option is for the licensor to grant the licensee a security interest in its assets, including the trademark itself. Rejection of an executory contract does not deprive the nondebtor party from the benefit of a security interest securing the debtor’s obligations under the agreement.¹²⁶ Therefore, rejection of a trademark license would not terminate the licensee’s security interest in the trademark. Although the security interest will not eliminate the licensor’s power to reject the license, it will result in the licensee having a secured claim for any damages that

124. See, e.g., *Harrell v. Colonial Holdings, Inc.*, 923 F. Supp. 2d 813 (E.D. Va. 2013).

125. 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 . . . [therefore,] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] 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 trademarks stops on rejection.”).

126. See, e.g., *Leasing Servs. Corp. v. First Tenn. Bank*, 826 F.2d 434, 437 (6th Cir. 1987).

result from the rejection, which would give the licensee the right to receive full payment for all such damages up to the value of the collateral, including the value of the trademark subject to the security interest, rather than receiving only a fraction of its claim as an unsecured creditor.¹²⁷ This enhanced position is likely to act as a disincentive to the licensor that otherwise may be inclined to reject the license agreement.¹²⁸

These transactional options do not necessarily give perfect protection, and they may not be feasible or cost efficient in a particular situation. From the standpoint of trademark licensees, a more preferable development would be a legislative solution that provides the kind of protection offered to other intellectual property licensees under § 365(n) or a judicial solution that assures licensees of the right to continued use of a trademark under a licensing agreement despite rejection by the licensor in bankruptcy.

F. A RECENT VICTORY FOR TRADEMARK LICENSEES IN THE SEVENTH CIRCUIT: THE SUNBEAM PRODUCTS DECISION

The first major appellate decision to determine the effect of rejection by a licensor of an intellectual property licensing agreement after *Lubrizol* and the passage of the Intellectual Property Bankruptcy Protection Act of 1988 was the decision of the Court of Appeals for the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*.¹²⁹ Sunbeam involved the Lakewood Engineering & Manufacturing Company, which manufactured and sold various consumer products, including box fans.¹³⁰ Losing money on every fan, Lakewood decided to outsource the manufacture of some of its products, including its box fans, to third parties.¹³¹ As a result, Lakewood entered into an outsourcing agreement with Chicago American Manufacturing (“CAM”), under which CAM would manufacture Lakewood’s box fans.¹³² Under the terms of the outsourcing agreement, Lakewood would supply the fan motor and cord at no cost to CAM, and CAM, in turn, would provide the other raw materials and assemble the fans.¹³³ Lakewood would then purchase the fans at a set price directly from CAM and then resell them to its customers.¹³⁴

127. *Id.* at 436.

128. For a more fulsome discussion of these structural devices and transactional options designed to minimize the risks flowing from rejection of an intellectual property license, see Richard M. Cieri & Michelle M. Morgan, *Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee’s Intellectual Property and Technology Investment*, 55 *Bus. Law.* 1649, 1691 (2000).

129. 686 F.3d 372, 376 (7th Cir. 2012).

130. *Id.* at 375. “Prior to 2008, Lakewood was one of the three largest manufacturers of box fans in the United States.” *In re Lakewood Eng’g & Mfg.*, 459 B.R. 306, 312 (Bankr. N.D. Ill. 2011).

131. *Sunbeam*, 686 F.3d at 374.

132. *Lakewood*, 459 B.R. at 313.

133. *Id.*

134. *Id.*

Concerned about Lakewood's financial status, in late 2008 CAM sought to replace the outsourcing agreement with a supply agreement that would allow CAM to license the Lakewood trademark and sell the box fans it had manufactured directly to third parties in the event Lakewood was unable to purchase the fans CAM manufactured.¹³⁵ Under the supply agreement, CAM was to manufacture a set number of fans each month in accordance with a forecast schedule, and Lakewood was to order all of its actual requirements of box fans within thirty days after each forecasted month solely from CAM.¹³⁶ If Lakewood failed to purchase all fans manufactured under the forecast schedule within thirty days after the month for which those fans were forecasted as required by Lakewood, CAM would have been entitled under the supply agreement to sell any fans not purchased by Lakewood "in Lakewood's packaging and under Lakewood's name, to any customer whatsoever, including, but not limited to, any customers of Lakewood."¹³⁷ The parties entered into the supply agreement in December 2008.¹³⁸ Two months after signing the contract, however, Lakewood's profits did not improve, and several of Lakewood's creditors filed an involuntary petition against the company under Chapter 7 of the Bankruptcy Code.¹³⁹ The order for relief under Chapter 7 was entered, and a trustee was appointed to liquidate Lakewood's assets in 2009.¹⁴⁰

When the trustee sought to effectuate a sale of the company's assets, he filed a motion to reject the supply contract with CAM because of his concern that it would negatively impact the sale process.¹⁴¹ Although CAM did not oppose the motion, it took the position that the rejection did not affect its continuing right to sell fans under the supply agreement.¹⁴²

Shortly after rejection, the trustee entered into a purchase agreement with Sunbeam Products, Inc., doing business as Jarden Consumer Products, under which Jarden purchased Lakewood's assets, including its patents and trademarks.¹⁴³ Jarden, however, did not want to buy the fans in CAM's inventory, nor did it want CAM selling the fans in competition with Jarden.¹⁴⁴ Despite Jarden's objections, however, CAM continued to sell the Lakewood-branded fans, resulting in Jarden's commencement of an adversary proceeding in the bankruptcy court against CAM alleging patent and trademark infringement.¹⁴⁵

Entering judgment in favor of CAM, the bankruptcy court held that the trustee's rejection of the supply agreement did not terminate either

135. *Id.* at 316.

136. *Id.* at 317-18.

137. *Id.* at 333.

138. *Id.* 335.

139. *Id.* at 320.

140. *Id.* at 322.

141. *Id.* at 323.

142. *Id.* at 323, 325.

143. *Id.* at 326.

144. *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 374 (7th Cir. 2012).

145. *Lakewood*, 459 B.R. at 310.

the patent or trademark licenses granted to CAM under that agreement.¹⁴⁶ With respect to the patents, the bankruptcy court held that § 365(n) of the Bankruptcy Code protected CAM's right to continue to use the intellectual property despite the rejection.¹⁴⁷ The bankruptcy court also held that, despite the fact that § 365(n) does not apply to trademark licenses, CAM was entitled to continue using the trademarks and to make and sell as many fans as Lakewood had estimated it would need for the entire 2009 selling season.¹⁴⁸

The bankruptcy court explicitly rejected the Fourth Circuit's decision in *Lubrizol*. Finding no controlling authority on point in the Seventh Circuit, the bankruptcy court found persuasive a concurring opinion rendered by Judge Thomas L. Ambro in a recent Third Circuit case, *In re Exide Technologies*.¹⁴⁹ In *Exide*, the bankruptcy court approved rejection under § 365(a) of the Bankruptcy Code of an integrated agreement for the sale of Exide's industrial battery business, which included a perpetual, exclusive, royalty-free license granting the buyer the right to use the Exide trademark in connection with the business.¹⁵⁰ Based on the reasoning of *Lubrizol* and a negative inference from § 365(n), the bankruptcy court held that rejection of the agreement terminated the licensee's right to use the licensed trademark.¹⁵¹ "[A] trademark license is terminated upon rejection and the licensee is left only with a claim for damages."¹⁵²

The district court affirmed the decision in *Exide*, but the Court of Appeals for the Third Circuit reversed, holding that the agreement was not an executory contract under the Countryman standard because all obligations of the licensee had been substantially performed and, therefore, the license could not be rejected.¹⁵³ In a concurring opinion in *Exide*, Judge Ambro agreed with the majority's decision, but added that even if the agreement were an executory contract, rejection would not necessarily result in termination of the licensee's right to use the trademark.¹⁵⁴ Judge Ambro pointed to the legislative history of § 365(n) indicating that trademarks were excluded from the definition of "intellectual property" because trademarks needed more extensive study, and "it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts."¹⁵⁵ Judge Ambro found this statement in the legislative history to be justification for bankruptcy courts to use their equitable powers to give the debtor a fresh start without stripping a licensee of its fairly-procured trademark

146. *Id.* at 347.

147. *Id.* at 341–43.

148. *Id.* at 345–46.

149. 607 F.3d 957, 964–68 (3d Cir. 2010).

150. *Id.* at 961.

151. *In re Exide Tech*, 340 B.R. 222, 250 (Bankr. D. Del. 2006), *vacated*, 607 F.3d 957 (2010).

152. *Id.* at 250 n.40.

153. *Id.* at 964.

154. *Id.* at 964–65.

155. S. REP. NO. 100-505, at 5 (1988) (emphasis added).

rights¹⁵⁶:

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.¹⁵⁷

Following Judge Ambro's reasoning in *Exide*, the bankruptcy court in *Sunbeam* opted to “not follow, in lockstep fashion, those few trial courts to have decided that the non-binding *Lubrizol* holding is the only possible outcome,” and it found on equitable grounds that CAM was entitled to continue using the Lakewood trademark to sell the forecasted fans that Lakewood failed to purchase under the supply agreement.¹⁵⁸

Jarden appealed the bankruptcy court's decision in *Sunbeam* directly to the court of appeals under a direct appeal procedure reserved for, among others, situations involving a matter of public importance or in which there is no controlling decision of the court of appeals or Supreme Court as to a question of law.¹⁵⁹ The Seventh Circuit affirmed the decision of the bankruptcy court, holding that rejection of the trademark license did not deprive the licensee, CAM, of the right to continued use the trademark.¹⁶⁰ However, the Seventh Circuit rejected the reasoning of the bankruptcy court and Judge Ambro's concurring opinion in *Exide*, which justified allowing CAM to retain its right to use the trademark based on equitable grounds.¹⁶¹ Judge Frank H. Easterbrook, who wrote the Seventh Circuit's opinion, explained his disapproval of bankruptcy judges making these determinations based on equitable principles:

What the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be ‘inequitable.’ . . . There are hundreds of bankruptcy judges, who have many different ideas about what is equitable in any given situation. Some may think that equity favors licensees' reliance interests; others may believe that equity favors the creditors, who can realize more of their claims if the debtor can terminate IP licenses. Rights depend . . . on what the Code provides rather than on notions of equity.¹⁶²

Taking a more textual approach in applying the Bankruptcy Code, the Seventh Circuit based its conclusion on § 365(g) of the Bankruptcy Code, which provides that rejection constitutes a breach by the debtor licensor.¹⁶³ Focusing on what would happen outside of bankruptcy if the licen-

156. *In re Exide Tech.*, 607 F.3d at 967.

157. *Id.* at 967–68.

158. *In re Lakewood Eng'g & Mfg.*, 459 B.R. 306, 345 (Bankr. N.D. Ill. 2011).

159. 28 U.S.C. § 158(d)(2) (2006); *Sunbeam Prods. Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 372–73 (7th Cir. 2012).

160. *Sunbeam*, 686 F.3d at 373.

161. *Id.* at 375.

162. *Id.* at 375–76.

163. *Id.* at 376–77.

sor breached the license agreement, the court found that the licensee's right to use the trademark would continue despite the licensor's breach.¹⁶⁴ "[O]utside of bankruptcy, Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties any more than a borrower could end the lender's right to collect by declaring that the debt will not be paid"¹⁶⁵:

After rejecting a contract, a debtor is not subject to an order of specific performance. . . . 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.*¹⁶⁶

Commenting that scholars uniformly criticized *Lubrizol* because it confused rejection of a contract with the use of an avoiding power,¹⁶⁷ the Seventh Circuit indicated that it too was unpersuaded by the landmark Fourth Circuit decision.¹⁶⁸ It criticized *Lubrizol* for devoting "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."¹⁶⁹

Though the Seventh Circuit's decision goes a long way in protecting the rights of trademark licensees, the full impact of *Sunbeam* is unclear because of the many unanswered questions that remain for courts that follow it. In particular, if the license agreement gives the licensee the exclusive right to use a trademark, what effect will rejection have on such exclusivity rights? Since rejection constitutes a breach by the debtor-licensor, is the licensee relieved of its obligations under the agreement? Is the licensee under a rejected license agreement, as a condition to continued use of the trademark, required to continue to make royalty payments under the agreement? Will the licensee be required to comply with other covenants, such as those relating to quality control, after the license agreement is rejected? Since the licensee's remedies are limited to filing a claim against the bankruptcy estate for any monetary damages caused by the licensor's rejection, and the licensee has no right to seek specific performance of the agreement, is the debtor-licensor or any successor to the licensor relieved of any contractual obligations to defend the trademark and protect it against infringement?

164. *Id.* at 377.

165. *Id.*

166. *Id.* (emphasis added).

167. The court cited various scholars. See DOUGLAS G. BAIRD, *ELEMENTS OF BANKRUPTCY* 130–40, 139 n.10 (Foundation Press 4th ed. 2006); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO. L. REV. 845, 916–19 (1988); Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 AM. BANKR. INST. L. REV. 463, 470–72 (1997).

168. *Sunbeam*, 686 F.3d at 377–78.

169. *Id.* at 377.

It remains to be seen how courts will resolve these questions and the extent to which they will look to § 365(n) for guidance or analogous application. In any event, despite Judge Easterbrook's disapproval of bankruptcy judges basing their decisions on what they think is the equitable result, the lack of legislative direction in this complex area resulting from Congress's failure to address the effects of rejection of trademark licenses in almost twenty-five years since the Intellectual Property Bankruptcy Protection Act of 1988 was enacted may leave judges with no alternative but to resolve these questions by weighing the equities of the parties under the particular circumstances.

III. CONCLUSION

The split in the circuits on whether a licensee has the right to continue to use a trademark after the licensor rejects the license agreement in bankruptcy can only be resolved by Congress or the United States Supreme Court. Unfortunately, it is unlikely that such resolution will come in the near term, especially since the Supreme Court denied a writ of certiorari in *Sunbeam*.¹⁷⁰

The circuit split and the unanswered questions raised by the decision in *Sunbeam* cry out for a legislative solution. Congress has already made the policy determination in 1988 that licensees of intellectual property should not lose the right to continued use of technology by reason of a licensor's rejection in bankruptcy—a decision that affords the intellectual property rights of such licensors greater weight than the general reorganization policy underlying the Bankruptcy Code. The time is long overdue for Congress to complete its task of refining and implementing a clear policy relating to the rights of licensees of a rejected trademark license agreement.

170. *Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 133 S. Ct. 790, 790 (2012).