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Sunbeam Products – Offering a Ray of Light for Trademark Licensees When Licensors File for Bankruptcy

On July 9, 2012, the United States Court of Appeals for the Seventh Circuit issued a significant decision holding that a trademark licensee could continue to use a licensed trademark notwithstanding a bankruptcy trustee's rejection of the trademark license under Section 365(a) of Chapter 11 of the U.S. Bankruptcy Code (*Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, Docket Number 11-3920 (7th Cir. Jul. 9, 2012)). The decision, authored by Chief Judge Easterbrook, runs counter to the longstanding and widely-held view that a trademark licensee is at significant risk of losing its license in the event of a licensor's bankruptcy.

Prior to *Sunbeam*, it was widely understood under *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), that trademark licenses were vulnerable in the event of a licensor's bankruptcy, in part because trademark licensees could not avail themselves to the protections of Section 365(n) of the Bankruptcy Code. *Sunbeam* now appears to provide trademark licensees, at least within the jurisdiction of the Seventh Circuit, with protections against such risk that did not previously exist. However, given that *Sunbeam* expressly rejects *Lubrizol*'s holding as it would apply to trademarks, there is now a split in federal circuit court authority suggesting that the questions addressed by *Sunbeam* and *Lubrizol* may become ripe for review by the United States Supreme Court. Until such time, practitioners will need to carefully observe whether other federal courts will follow *Sunbeam* or *Lubrizol*. In that regard, practitioners representing trademark licensees should continue to employ traditional strategies for mitigating the risks associated with licensors entering bankruptcy, including having the licensee (a) acquire the licensed marks if possible, (b) take a security interest in the licensed marks, (c) allocate payments under the license in a manner that would create a disincentive for the trustee to reject the license and (d) request that the licensor place the licensed marks in a special purpose entity isolated from any bankruptcy filing.

A more detailed discussion of the facts and holding of the *Sunbeam* decision is provided below.

Background

In 2008, Lakewood Engineering & Manufacturing Co. ("**Lakewood**") contracted the manufacture of its box fans to Chicago American Manufacturing, LLC ("**CAM**"). The contract authorized CAM to practice Lakewood's patents and put Lakewood's trademarks on the completed fans. However, CAM would not be in privity of contract with Lakewood's retailers: instead, Lakewood would take orders from the retailers and would instruct CAM to ship directly to them. Aware that Lakewood was in financial distress, CAM contracted for the right to sell the 2009 inventory of Lakewood fans for CAM's account if Lakewood did not purchase them.

In February 2009, Lakewood's creditors filed an involuntary bankruptcy proceeding against it. During the proceeding, Lakewood's court-appointed trustee sold Lakewood's assets, including Lakewood's patents and trademarks, to Sunbeam Products ("**Sunbeam**"). However, Sunbeam did not want to acquire any of the Lakewood-branded fans that CAM had in its inventory but which still represented assets of Lakewood's estate, nor did it want CAM to sell the fans in competition with Sunbeam's products. Therefore, Lakewood's trustee rejected the executory portion of the CAM contract under Section 365(a). After CAM continued to manufacture and sell Lakewood-branded fans, Sunbeam filed an adversary proceeding in bankruptcy court.

The bankruptcy court concluded that CAM was permitted under the contract to continue manufacturing and selling the Lakewood-branded fans throughout the 2009 selling season but did not decide whether the contract's rejection had the effect of terminating CAM's right to use Lakewood's trademarks. Rather,

the bankruptcy court allowed CAM to continue to use such trademarks on equitable grounds given that CAM invested substantial resources in making the Lakewood-branded fans. Sunbeam appealed the bankruptcy court's decision to the Seventh Circuit, contending that CAM had to stop making and selling fans once Lakewood stopped having requirements for them. The Seventh Circuit did not disagree with the bankruptcy court's reading of the contract, but determined that the effect of the trustee's rejection of the contract required review.

Seventh Circuit Opinion

Relying on the Supreme Court's recent decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2605 (2012), the Seventh Circuit first rejected the bankruptcy court's reliance on equity over an analysis of the applicable provisions of the Bankruptcy Code to determine whether CAM could continue to use Lakewood's trademarks following the trustee's rejection of the CAM contract. For the Seventh Circuit, the relevant question was whether the Fourth Circuit's decision in *Lubrizol* correctly applied Section 365(g) to determine the consequences of rejection under Section 365(a). *Lubrizol* held that, when an intellectual property license is rejected under Section 365(a), the licensee loses the ability to use the licensed intellectual property. Three years after the *Lubrizol* decision, Congress added Sections 365(n) and 101(35A) to the Bankruptcy Code, allowing licensees to continue using licensed intellectual property after rejection, provided they meet certain conditions. However, Congress did not include trademarks in the term "intellectual property", as defined in Section 101(35A) of the Bankruptcy Code. According to the court, contrary to what other bankruptcy courts have inferred this omission does not mean that Congress codified *Lubrizol* with respect to trademarks, rather the omission was "just an omission" and "[t]he limited definition [of intellectual property] in Section 101(35A) means that Section 365(n) does not affect trademarks one way or the other."[1] The court also noted that the legislative history of Section 365(n) states that the omission of trademarks from the definition of intellectual property in Section 101(35A) "was designed to allow more time for study, not to approve *Lubrizol*."[2]

On the question of what consequences follow from the rejection of an executory contract under Section 365(a), the court concluded that Section 365(g) provides that the rejection should be treated as nothing more than a breach of the contract, allowing the non-breaching party's rights to remain in place and providing the non-breaching party with a claim for damages. In other words, according to the court, rejection under Section 365(a) does not subject the debtor to an order of specific performance. Finding that a licensor's breach does not terminate a licensee's right to use intellectual property outside of bankruptcy, the court concluded that nothing in Section 365(g) changes that result in bankruptcy, and held that CAM should receive the benefit of its bargain, *i.e.*, the assurance of being able to sell Lakewood-branded fans for its own account if Lakewood defaulted.

The court noted that bankruptcy law does allow for the elimination of rights under a contract in some cases, e.g., by providing a bankruptcy trustee with avoiding powers, such as those provided under Sections 544 through 551 of the Bankruptcy Code. The court clarified that such powers, however, should not be confused with the rejection powers under Section 365(a) which does not abrogate contractual rights. Given that the trustee never sought to rescind the CAM contract by bringing an avoidance action, but rather attempted to reject it under Section 365(a), the court found that such rejection did not preclude CAM from continuing to enjoy its right to use the Lakewood trademarks under the contract.

[1] *Sunbeam Products*, No. 11-3920, slip op. at 3, 4 (7th Cir. Jul. 9, 2012).

[2] *Id.* at 4 (citing *In re Exide Technologies*, 607 F.3d 957, 966-67 (3d Cir. 2010) (Ambro, J., concurring) approvingly).

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Intellectual Property		
Frank J. Azzopardi	212 450 6277	frank.azzopardi@davispolk.com
David R. Bauer	212 450 4995	david.bauer@davispolk.com
Randy Samson	212 450 4360	randy.samson@davispolk.com
Bankruptcy		
Donald S. Bernstein	212 450 4092	donald.bernstein@davispolk.com
Giorgio Bovenzi	212 450 4260	giorgio.bovenzi@davispolk.com
Timothy Graulich	212 450 4639	timothy.graulich@davispolk.com
Marshall S. Huebner	212 450 4099	marshall.huebner@davispolk.com
Brian M. Resnick	212 450 4213	brian.resnick@davispolk.com
Damian S. Schaible	212 450 4580	damian.schaible@davispolk.com