

Seventh Circuit Strengthens Protection for IP Licenses in Bankruptcy

On July 9, 2012, the United States Court of Appeals for the Seventh Circuit significantly strengthened the potential ability of licensees to trademarks, international intellectual property, and other rights to continue to enjoy the benefits of their licenses despite a licensor's bankruptcy. In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, a trademark licensee sought to continue to use licensed trademarks despite the bankruptcy trustee's rejection of the license. Relying on the basic consequences of contract rejection rather than on any special provisions of the Bankruptcy Code, the Seventh Circuit said the licensee could continue to use the licensed trademarks.

In *Sunbeam*, the debtor had entered into an agreement with Chicago American Manufacturing that allowed the company to make and sell fans under the debtor's patents and to brand them with the debtor's trademarks. The debtor was placed into involuntary bankruptcy and the bankruptcy trustee sold the debtor's business to Sunbeam Products, rejecting Chicago American's agreement under 11 U.S.C. § 365(a). Chicago American continued to make fans bearing debtor's trademarks, and Sunbeam brought an adversary proceeding to stop it.

Section 365(n) of the Bankruptcy Code allows a licensee to continue to exercise rights in "intellectual property" provided the licensee meets certain conditions. Congress enacted § 365(n) in response to a decision from the Fourth Circuit, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), which held that, were a license to patents, copyrights or trademarks rejected in bankruptcy, the licensee would lose the right to use the licensed intellectual property. However, when enacting § 365(n), Congress omitted trademarks from the definition of "intellectual property" in the Bankruptcy Code. *See* 11 U.S.C. § 101(35A). Therefore, both the bankruptcy court and the Seventh Circuit found the protections of § 365(n) did not apply to Chicago American's use of the debtor's trademarks.

The bankruptcy court nonetheless allowed Chicago American to continue to make the fans using debtor's trademarks. The bankruptcy court's logic was that, because Chicago American had invested substantial resources to make the fans, the company could continue to use the debtor's trademarks "on equitable grounds." The Seventh Circuit disapproved the bankruptcy court's reliance on equity, but not the result.

The Seventh Circuit instead examined the nature and consequences of contract rejection as set forth in § 365(g) of the Bankruptcy Code and decided that Chicago American could continue to use the debtor's trademarks. And for purposes of its analysis, "all that matter[ed] is the opening proposition [of § 365(g)]: that rejection 'constitutes a breach of such contract.'" Looking at what happens when licensors breach outside of bankruptcy, the court found that a licensor's breach does not terminate the licensee's right to use intellectual property. That is, by classifying rejection as breach, § 365(g) establishes that in bankruptcy, as outside of bankruptcy, the non-breaching party's rights remain in place.

Neither the Fourth Circuit's *Lubrizol* opinion nor the adoption of § 365(n) led the Seventh Circuit to a different result. The Seventh Circuit rejected *Lubrizol's* holding and logic, and joined scholars in criticizing *Lubrizol* for confusing rejection, which is a breach, with avoidance, which is a nullification. As for the omission of trademarks from the definition of "intellectual property" and the protection § 365(n) provides, the Seventh Circuit noted that the "omission is just an omission" and that the limited definition of "intellectual property" "does not affect trademarks one way or the other." To support that conclusion, the Court cited the legislative history of § 365(n), which noted the omission was designed to allow more time for study, and not to approve *Lubrizol*.

The Seventh Circuit's *Sunbeam Products* opinion is an important development that has the potential to significantly strengthen the rights of licensees to intellectual property licenses. The immediate benefit will be in areas where § 365(n) may be read as providing little or no protection for licensees, such as in trademark licenses, U.S. law governed licenses where the licensor has filed bankruptcy in a foreign jurisdiction, and licenses of non-U.S. patents and copyrights. For more information regarding the potential impact of *Sunbeam Products*, please contact [James M. Wilton](#), [Stephen Moeller-Sally](#), [Mark W. Bellomy](#), [James S. DeGraw](#), or your regular Ropes & Gray contact.