Do You Have a License for That? Rejection of Trademark Licenses in Bankruptcy

Tennessee Bankruptcy Newsletter

This article provides an analysis of whether a licensee retains the right to use trademarks following rejection of an intellectual property license. The analysis centers on Section 365(n) of the Bankruptcy Code as well as a recent 7th Circuit opinion interpreting the applicability of that provision to trademarks. In short, while there does not appear to be unanimity among the Circuits, there is growing authority for the proposition that the right to use trademarks does not necessarily terminate upon rejection of the license.

Applicability of Section 365(n) to Trademarks.

Section 365(n)(1) of the Bankruptcy Code provides that if the Trustee (or debtor-in-possession, as the case may be) elects to reject an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee may elect to either treat the license as terminated or retain its rights under the license for the duration of the contract.

Interpretation of Section 365(n) is complicated when the terminated license is a license of trademarks. The Bankruptcy Code at Section 101(35)(A) defines intellectual property to include property such as trade secrets, patents, patent applications, and works of authorship but does not include trademarks. Therefore, the question becomes whether trademark licensees are entitled to make a Section 365(n) election to continue using the trademark, and if not, whether the right to use trademarks can survive rejection on other grounds.

A Brief History of Section 365(n).

Prior to the enactment of Section 365(n), Courts asked to rule on rejection of a license agreement had no statutory basis to consider the effect of rejection on nondebtor licensees. The only remedy available to nondebtor licensees was a claim for rejection damages. This arguably led to an inequitable result for nondebtor licensees who may have invested large amounts of time and money in reliance on the rejected license.
The issue was squarely addressed by the 4th Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol*, the 4th Circuit held that when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents.

In reaction to *Lubrizol* and to correct the inequity resulting from rejection of license agreements, Congress added Section 365(n) to the Bankruptcy Code. As described above, Section 365(n) allows licensees to continue using intellectual property after rejection, provided they meet certain conditions. However, as also stated above, Courts have struggled with whether or not trademark licenses fall within the protection of Section 356(n) since trademarks are not included in the Bankruptcy Code’s definition of intellectual property.

**Is the License Agreement Executory?**

In order for a license to be rejected, it must be executory. Therefore, before any analysis about whether a licensee can retain the right to use trademarks post-rejection, a Court must determine whether or not the underlying agreement is executory.

The primary case analyzing this issue is *In re Exide Technologies*, 607 F.3d 957 (3rd Cir 2010). In *Exide*, the 3rd Circuit determined that under the facts of that case the agreement at issue was not executory.

Specifically, *Exide* sought to reject certain agreements with EnerSys related to the sale of certain assets. One of the agreements was a Trademark and Trade Name License Agreement. Under that agreement, *Exide* granted EnerSys as a “perpetual, exclusive, royalty-free license to use the *Exide* trademark in the industrial battery business.” *Id.* at 961. *Exide* sought to reject the agreement in its Chapter 11 case.

The Bankruptcy Court granted the motion to reject the agreement. The District Court affirmed. As mentioned above, the 3rd Circuit vacated the District Court’s order and remanded for further proceedings consistent with its opinion. The 3rd Circuit determined that in order to rule on the matter, the Court must “determine whether the Agreement…contained at least one obligation for both *Exide* and EnerSys that would constitute a material breach under New York law if not performed.” *Id.* at 962. The Court determined that the Bankruptcy Court “failed to properly measure whether either party had substantially performed.” *Id.* at 963. Ultimately, the Court determined that EnerSys had substantially performed by paying the purchase price and operating under the Agreement for ten years.

It is important to note that while the 3rd Circuit did reverse the prior Courts’ decision and effectively allowed the licensee to continue its use of the marks, it did so based on the applicable definition of executory contracts and the Court’s determination that based on the facts of the *Exide* case, one side had nothing left to perform under the agreement[1].

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[1]: Reference or citation to additional sources or information.
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Application of Section 365(n) to Executory License Agreements.

Assuming that the license agreement at issue is executory, Courts must determine whether rejection of the agreement terminates the right to use trademarks. Courts appear to be split on this issue, but a recent 7th Circuit opinion may provide some guidance.

1. Upholding the Lubrizol Approach

According to the Bankruptcy Court for Delaware, a franchise agreement that includes a trademark license can be executory, can be rejected and the licensee does not have any rights to use the marks upon such rejection pursuant to Section 365(n). In re HQ Global Holdings, Inc., 290 B.R. 507 (Bankr. D. Del. 2003). In the HQ Global case, the Court was asked to determine whether the Debtor could reject license agreements with franchisees granting them exclusive rights to use of certain trade names, trademarks, service marks, logos, emblems, insignia, and other indicia of origin. The Court notes that the agreements clearly state that the marks are to remain the property of the Debtor and that the license does not give rise to an ownership interest - in fact, the agreements forbid the franchisees from challenging the Debtors' ownership of the marks. Id. at 511 fn4.

The Court in HQ Global held that Section 365(n) does not apply to trademarks and the licensee does not retain the right to use the marks following rejection of the contract. Id. at 513. Specifically, the Court explained that “[t]he essence of the Agreements was the Debtors' affirmative grant to the Franchisees of the right to use their proprietary marks. As a result of the rejection, that affirmative obligation of the Debtors to allow the Franchisees to use the marks is excused.” Id. at 513. In short, “since 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.” Id. at 513.

2. Rejection of the Lubrizol Approach

Conversely, the Court of Appeals for the Seventh Circuit recently upheld the ruling of the U.S. Bankruptcy Court for the Northern District of Illinois that the right to use trademarks did not terminate upon rejection of the license.

In the underlying case, the plaintiff (in this case, the bankruptcy trustee) brought an adversary proceeding against a manufacturer of box fans alleging that the manufacturer infringed on the debtor's patents and trademarks by continuing to manufacture and sell box fans to third parties after the debtor's supply contract with the manufacturer was rejected by the trustee. Szilagyi v. Chicago American Manufacturing, LLC (In re Lakewood), 459 B.R. 306 (Bankr. N. D. IL 2011).

The intellectual property at issue included not just patents but also trademark rights. The Lakewood Court held that the manufacturer could retain trademark rights in addition to patent rights retained pursuant to Section 365(n). In reaching its conclusion, the Court first acknowledged that Section 365(n) does not apply to
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trademarks in light of the Bankruptcy Code’s definition of intellectual property. The Court further noted that subsequent decisions have reasoned by negative inference that since Congress excluded trademarks from the scope of Section 365(n), a subsection written in response to Lubrizol, Congress meant for the Lubrizol holding to apply to trademarks. In other words, that Congress must have intended that trademark licensees could not retain use of the marks post-rejection.

The Bankruptcy Court for the Northern District of Illinois rejected that reasoning in favor of exercising its equitable powers to extend the rights of Section 365(n) to licensees. In doing so, the Lakewood Court found the concurrence of Judge Ambro in Exide persuasive. Specifically, Judge Ambro notes in light of the legislative history surrounding the enactment of Section 365(n) that:

Rather than reasoning from negative inference to apply another Circuit’s holding to this dispute, the Courts here should have used, I believe, their equitable powers to give Exide a fresh start without stripping EnerSys of its fairly procured trademark rights. Cf. In re Matusalem, 158 B.R. 514, 521-22 (Bankr. S.D. Fla. 1993) (suggesting that rejection of a trademark license would not deprive a licensee of its rights in the licensed mark). 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.

Exide at 967-68.

Applying this logic, the Lakewood Court in declining to terminate the licensee’s rights determined that it would “begin the ‘development of equitable treatment’ Congress anticipated would occur.” Lakewood at 365. Thus, the holding is based not on an analysis of Section 365, but rather the exercise of the Court’s equitable powers.

The Lakewood decision was appealed to the Court of Appeals for the Seventh Circuit. Sunbeam Products, Inc. d/b/a Jarden Consumer Solutions v. Chicago American Manufacturing, LLC, 2012 U.S. App. LEXIS 13883 (3rd Cir. 2012). In its July 9, 2012 opinion, the 7th Circuit held that while the lower Court’s decision would be upheld, the 7th Circuit would do so on different grounds.

Specifically, the 7th Circuit rejected the equitable treatment argument and also stated that it rejects Lubrizol. In short, the 7th Circuit held that Lubrizol was not persuasive – meaning that even though trademarks are not specifically included in Section 365(n), rejection of the license did not terminate the right of the licensee to use the marks. The 7th Circuit explained that rejection does not “vaporize” the rights of parties to the rejected lease or contract. Id. at *9. Rather, rejection merely frees the debtor of the obligation to perform under the rejected contract. As such, rejection does not terminate the right of trademark licensees to continue to use the marks through the termination date of the agreement. Id. at *10-11.
Conclusion

Thus, the new 7th Circuit decision creates a conflict among the Circuits as to whether rejection of a license agreement terminates a licensee’s right to continue to use marks through the termination date of the agreement. With that being said, parties seeking to challenge termination of trademark licenses can now cite to authorities for the following theories 1) the agreement is not executory, 2) termination of the license is inequitable, and 3) rejection does not terminate the rights of trademark licensees to continue to use the marks. In light of the foregoing and in the absence of clarifying legislation, it would not be surprising to see this issue successfully litigated by licensees in other Circuits in the future.

[1] Note that the Countryman analysis used in Exide is not the standard in the 6th Circuit for determining whether or not a contract is executory.