CHAPTER 11

# IP LICENSES IN BANKRUPTCY A CIRCUIT SPLIT BRINGS US BACK FULL CIRCLE PAST § 365(N) OF THE BANKRUPTCY CODE

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## § 11.01 INTRODUCTION

In 1988, Congress added Section 365(n) to the Bankruptcy Code. The stated purpose of Section 365(n) was to protect licensees of intellectual property when a licensor enters bankruptcy and then rejects the license. Under the 1985 Fourth Circuit case *Lubrizol v. Richmond Metal Finishers*, when a debtor-licensor rejects a license, the licensee loses its license rights, which then revert to the licensor. Section 365(n) was enacted to ameliorate the effect of *Lubrizol* on the licensee.

But the ensuing years have revealed some anomalies in the operation of Section 365(n) and, most recently, the Seventh Circuit has rejected *Lubrizol* and held that it was wrongly decided. So what does this mean going forward for licensees whose licensor is in bankruptcy? This chapter looks at the background and history of Section 365(n), analyzes the recent Seventh Circuit case, *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, and discusses some possible ramifications of the circuit split.

## § 11.02 BACKGROUND—SECTION 365 OF THE BANKRUPTCY CODE

Section 365 of the Bankruptcy Code permits the debtor, subject to court approval, to assume, assume and assign, or reject an executory contract. Although "executory contracts" are not defined in the Bankruptcy Code, they are commonly understood as contracts "'on which performance remains due to some extent on both sides.'"[1] Whether a contract is executory is measured as of the petition date.[2]

Assuming a contract means simply that its existence is reinstated, subject to certain conditions the Bankruptcy Code prescribes. The debtor chooses to be bound by its terms, and from the date of assumption forward, both parties must comply with its terms exactly as they would absent bankruptcy. A debtor may also assume and assign the contract—again, subject to conditions imposed by Section 365.[3]

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[1] NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984), quoting H.R. Rep. No. 95-595 at 347 (1977). The most commonly used working definition of an executory contract is the so-called "Countryman definition," which defines an executory contract as

> a contract under which the obligations of both the bankrupt and the other party are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, *Executory Contracts in Bankruptcy Law: Part I*, 57 Minn. L. Rev. 439 (1973). Whether a contract is executory is measured as of the petition date.

[2] *See, e.g., In re* Exide Techs., 607 F.3d 957 (3d Cir. 2010); *In re* Spansion, Inc., 2011 WL 3268084, slip op. at 9 (D. Del. July 28, 2011).

[3] For example, it must provide adequate assurance that the assignee can perform. "Adequate assurance" is a pragmatic test, focused on the ability of the proposed assignee to perform in the

Rejection is an approximate opposite of assumption: the debtor refuses to be bound further by the contract. Under Sections 365(g) and 502(g) of the Code, rejection is deemed to be a breach by the debtor, that gives rise to a pre-petition claim for damages for breach of contract. That damages claim, if allowed by the bankruptcy court, will be a general unsecured claim, which means the other party to the contract is simply a member of the general creditor body.[4] Specific performance is not an available remedy, even if it would be available absent bankruptcy.[5] Rejection of a trademark license has been held to be a material breach that, under normal contract principles, justifies the non-breaching party in suspending its performance.[6]

## § 11.03 *LUBRIZOL*'S THREAT TO IP LICENSEES

For intellectual property licensees, rejection can be harsh medicine, because the licensed property is often critical to their businesses. This difficulty came to the attention of Congress after the Fourth Circuit's 1985 decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[7] The *Lubrizol* court applied the normal analysis that is used in any rejection case. The court first determined that the technology license at issue was executory. It then approved rejection under the "business judgment" standard, noting that so long as the debtor's decision to reject was neither taken in bad faith nor a gross abuse of business discretion, the court would approve rejection even if it disagreed with the decision on the merits.

The *Lubrizol* court recognized explicitly the difficulties that rejection imposes on licensees, and even noted that the prospect of possible rejection could have a "chilling effect" on intellectual property licensing by any companies other than the financially strongest. Nevertheless, the Fourth Circuit felt bound to apply the law as it then stood.

In response to *Lubrizol*, Congress enacted the Intellectual Property Bankruptcy Protection Act in 1988, which amended Section 365 in order to ameliorate some of the difficulties highlighted by *Lubrizol*. Instead of leaving the decision as to the future of the license solely in the hands of the debtor-licensor (subject to

future. *See In re* Glycogenesys, Inc., 352 B.R. 568, 578 (D. Mass. 2006); *In re* Jennifer Convertibles, Inc., 447 B.R. 713, 719-20 (Bankr. S.D.N.Y. 2011). As a general rule, the debtor may assign an executory contract even in the face of a contractual provision that prohibits or limits assignment. 11 U.S.C. § 365(e).

[4] Although the claim for breach is a prepetition claim, that does not necessarily mean the breach is deemed to have occurred petition. *See, e.g.*, A&L Labs. v. Bou-Matic LLP, 429 F.3d 775 (8th Cir. 2005).

[5] Lubrizol Enters., Inc. v. Richmond Metal Finishers Inc., 756 F.2d 1043, 1048 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986); *In re* EI Int'l, 123 B.R. 64 (Bankr. D. Idaho 1991).

[6] *See* Beckerman v. M. Hidary & Co., Inc., 324 B.R. 434, 443-44 (D. Conn. 2005).

[7] 756 F.2d 1043 (4th Cir. 1985), *cert. denied,* 475 U.S. 1057 (1986).

court approval), the new Section 365(n) gave licensees of "intellectual property" (as defined in the Code) the option to retain certain rights under the license even in the face of the debtor-licensor's rejection. Under Section 365(n), if the court approves rejection of the license, the licensee can either (i) treat the rejection as a breach giving rise to a potential claim for money damages under Section 365(g), as with other rejected contracts, or (ii) retain the rights to the intellectual property covered by the license, including any exclusivity rights.[8] If the licensee elects to retain its rights under the agreement, the debtor must permit the licensee to exercise its rights and the licensee must continue to make all royalty payments due under the contract.[9] The licensee retains this right to the licensed property for the remaining life of the license plus any as-of-right renewal or extension period. However, rejection relieves the debtor from performing any of its ongoing or future affirmative obligations under the contract.[10] The debtor is still bound by passive obligations, like maintaining confidentiality, that are necessary for the licensee to enjoy the benefits of the license.[11] The licensee is not entitled, however, to the benefits of a debtor's post-petition labors even if it elects under Section 365(n) to retain its license rights; thus, a Section 365(n) election will not entitle a patent licensee to any improvements the debtor developed post-petition. Those belong to the debtor.[12]

Notably for current purposes, Section 365(n) applies only to licenses of "intellectual property" as defined in the Code. And the Code definition of "intellectual property" in Section 101(35A) includes patents, copyrights, trade secrets, and semi-conductor chip mask works—but not trademarks. That is because Congress's concern over *Lubrizol* centered around new and unproven start-up companies in the computer software and biotechnology industries, which were heavily

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[8] The right to enforce an exclusivity provision is an exception to the general rule proscribing specific performance as a remedy for the debtor's breach of the license.

[9] Section 365(n)(1)(B).

One issue that has come up under § 365(n) is which payments are to be treated as "royalties" that the licensee must continue to pay after rejection by the debtor licensee. In *In re Prize Frize,* 32 F.3d 426 (9th Cir. 1994), the Ninth Circuit held, in essence, that all monies a licensee must pay for the right to use the licensed property (in that case, patents and technology for a french fry vending machine) were § 365(n) "royalties" that had to be paid even after rejection. The court rejected the licensee's argument that "license fees" and "royalties" were distinct; the licensee had wanted to pay only royalties (percentage of sales) but not license fees (in that case fixed sums payable over a prescribed time).

[10] Section 365(n)(2)(C) provides that a licensee who elects to retain rights under § 365(n) is deemed to waive the right of setoff against royalty payments and the right to collect administrative expenses; the licensee may still seek damages from the debtor, but only as a general unsecured creditor.

[11] *In re* Szombathy, 1996 Bankr. LEXIS 888, slip op. at 31-32 (Bankr. N.D. Ill. 1996) (citing S. Rep. 100-505) *rev'd on other grounds*, 1997 U.S. Dist. LEXIS 5168 (N.D. Ill. 1997).

[12] *In re* Szombathy, 1997 Bankr. LEXIS 888, slip op. at 9-10 (N.D. Ill. 1997).

dependent on licensing.[13] The *Lubrizol* decision was perceived as a direct threat to the growth of these industries; Congress was concerned that potential licensees would shy away from dealing with financially unsteady startups for fear of having to invest substantial sums to commercialize a product only to lose the licenses upon the licensor's bankruptcy.

The legislative history indicates that Congress specifically did not intend, by amending Section 365, to "bring every retail franchise involving a trademark within the purview of the legislation, thus extending the reach of the bill far beyond what appears necessary."[14] At least part of the reason is the unique legal issues that distinguish trademarks from the other forms of intellectual property addressed in Section 365(n). Unlike copyrights and patents, trademark owners must take affirmative steps to control use of the mark in order to retain their continued rights. And by exercising control of the mark, the owner's rights potentially may last forever—in contrast to patents and copyrights, which have statutory expiration dates. This quality control requirement is at odds with Section 365(n); the continuing obligation on the licensor is contrary to the purpose behind rejection, which is to free the debtor from its obligations on the rejected contract.[15]

Congress's exclusion of trademarks from the definition of "intellectual property" did not mean that Congress ignored the difficulties of trademark licensees.[16] All it means is Congress focused on what it viewed as the more pressing threat at the time: potential damage to technology licensing. Nevertheless, Congress

[13] *See Intellectual Property Contracts in Bankruptcy: Hearings on H.R. 4657 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary,* 100th Cong. 2d Sess. (June 3, 1988) (hereinafter "House Hearings") (statement of James Burger, Chief-Counsel - Government, Apple Computer Inc.); *A Bill to Keep Secure the Rights of Intellectual Property Licensors and Licensees Which Come Under the Protection of Title 11 of the United States Code, the Bankruptcy Code: Hearings on S.1626 Before the Subcomm. on Courts and Administrative Practice of the Senate Comm. on the Judiciary*, 100th Cong. 1st Sess. (June 10, 1988) (hereinafter "Senate Hearings") (statement of John L. Pickitt, President, Computer and Business Equipment Manufacturers Association).

[14] Senate Hearings, statement of George A. Hahn on behalf of the National Bankruptcy Conference at 4. *See also* Letter by George A. Hahn on behalf of the National Bankruptcy Conference (July 14, 1988), in *The American Bankruptcy Institute Survey* at 344. ("[t]he Conference supports this legislation on a semi-emergency basis in order to further the activities of American research and development companies in the world race for technological leadership. The Conference sees no such emergency for and has no particular interest in, extending such protection to trademarks connected with traditional distributorships and retail businesses at this time.").

[15] S. Rep. No. 505, 100th Cong., 2d Sess. (1988). *See also* Senate Hearings at 4.

[16] To the contrary, the legislative history reflects clear awareness of the problem. *See* S. Rep., *supra*, ("While such rejection [of a trademark license] is of concern because of the interpretation of § 365 by the *Lubrizol* court and others [citations omitted], such contracts raise issues beyond the scope of this legislation").

explicitly encouraged the courts to develop and pursue equitable treatment of trademark licenses in the rejection context.[17] As the Senate report put it:

> 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. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts . . . .[18]

## § 11.04 WHAT SHOULD HAPPEN IF *LUBRIZOL* WAS WRONGLY DECIDED?

In 2012, the Seventh Circuit decided *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[19] which calls into question the very underpinning of Section 365(n). In *Sunbeam*, the debtor, Lakewood, had owned patents and trademarks to manufacture box fans. But it was not financially able to manufacture the fans itself, so it entered into a contract with CAM under which CAM would manufacture the fans according to Lakewood's patented processes, place Lakewood's trademark on the fans, and then sell them to Lakewood for shipment to Lakewood's customers. Lakewood was anticipating selling 1.2 million fans—a huge order.

To manufacture that many fans, CAM would have to make substantial investments in plant and equipment. But it was concerned that Lakewood might not be able to sell the 1.2 million fans, and was unwilling to make the investment without some kind of protection. After all, if Lakewood could not sell the fans, CAM might not get paid. So Lakewood and CAM agreed that CAM could sell the fans itself if Lakewood was unable to sell the entire run.

Three months into the contract Lakewood filed for bankruptcy under Chapter 7. The Chapter 7 Trustee sold the fan business to a company called Jarden. Jarden wanted to make and sell the box fans itself, without competition from CAM, so its agreement with the Trustee provided for the estate to reject the contract with CAM. The premise was to invoke *Lubrizol*, and leave CAM with no ability to use the licensed property. That would leave CAM with inventory it could not sell (which Jarden would presumably buy up at a deep discount), and leave CAM with no recourse to recoup its capital investment in the manufacturing facility. CAM in principle could invoke Section 365(n) to retain the right to practice the patent, but because Section 365(n) does not cover trademarks, Jarden was sure CAM could not sell the inventory under the Lakewood brand.

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[17] S. Rep. No. 100-505 at 5.
[18] S. Rep. No. 100-505.
[19] 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012).

CAM nevertheless continued to manufacture and sell fans using Lakewood's trademark and patents. Jarden sued.

The main issue before the Third Circuit was the effect of rejection on CAM's ability to continue using Lakewood's trademarks. (The patents were not an issue because of Section 365(n).) The Seventh Circuit held that the sole effect of rejection was that the debtor breached the contract: rejection did not terminate the contract nor did it affect the non-breaching party's right to the benefit of the contract. A licensor who breaches a license outside bankruptcy cannot use its own breach as a basis for preventing the licensee from using the licensed intellectual property. So a breach by a bankrupt licensor should have no different effect.

In other words, according to the Seventh Circuit, *Lubrizol* was wrong—and, implicitly, Section 365(n) was unnecessary. The licensee does not lose its rights when the debtor-licensor rejects the license. Breach of a contract is not necessarily a termination of the contract, so rejection is not a termination either. Under the Seventh Circuit's decision in *Sunbeam*, there is no reason to treat trademarks differently from patents and copyrights—in either case the non-breaching party can elect to keep its rights. This may, in effect, give patent or copyright licensees an option whether to be governed by Section 365(n) or not, because *Sunbeam* gives them the ability to retain their license rights even without invoking Section 365(n).

*Sunbeam* does leave open some important issues, though. If the debtor is no longer obligated to perform under the license after rejection, must it continue to honor an exclusivity provision if the non-debtor did not proceed under Section 365(n)? How about quality control: is the debtor left with no ability to discipline the licensee if the licensee uses the mark in unauthorized or defective ways? *Sunbeam* does not provide answers. So we must wait to see how subsequent case law develops.

The first indications are pro-licensee. *In re Crumbs Bake Shop*,[20] decided in October 2014, concerned mainly the status of trademark licensees after the debtor rejected their licenses. The debtor had sold all its assets to a purchaser. After the bankruptcy court approved the sale, the debtor moved to reject the trademark licenses. The licensees claimed to have the right under Section 365(n) to retain their license rights, even though Section 365(n) by its terms does not cover trademark licenses.

The bankruptcy court held that the licensees retained their rights under Section 365(n). The bankruptcy court noted that Congress in enacting Section 365(n) had left it to the courts to fashion equitable rules for trademark licenses (*see* Section 11.03, *supra*). In this case, the bankruptcy court ruled that equity required permitting the licensees to retain their rights.

The bankruptcy court did not stop there, though. It noted that even apart from equitable considerations, rejection of the trademark licenses simply did not

[20] 522 B.R. 766 (Bankr. D.N.J. 2014).

strip the licensees of their rights. Citing to *Sunbeam*, the bankruptcy court relied heavily on the Seventh Circuit's view that a rejection is merely a breach that (with certain bankruptcy-specific exceptions) leaves the non-breaching party's rights intact.[21] It even specifically declined to follow *Lubrizol* and characterized it as "discredited."[22]

Interestingly, the bankruptcy court was singularly unsympathetic to the purchaser's (the new licensor's) pleas that it would be left without the ability to exercise quality control. In the bankruptcy court's view, licensees had sufficient economic incentives to maintain quality even without enforcement by the licensor; moreover, the licensees in effect warrant the quality of their goods. The result, according the bankruptcy court, is that market forces and anti-fraud laws would together prevent quality control issues.[23]

While this is a questionable result as a matter of trademark law—quality control is central to trademarks, and failure to enforce can raise issues of abandonment—this new case law does underscore the ongoing ferment concerning what the fallout is from rejection of intellectual property licenses. Undoubtedly there will be more case development in the fullness of time.

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[21] *Id.* at 772-73.

[22] *Id.* at 770.

[23] *Id.* at 773 (*quoting* David M. Jenkins, *Licenses, Trademarks, and Bankruptcy, Oh My: Trademark Licensing and the Perils of Licensor Bankruptcy*, 25 J. Marshall L. Rev. 143, 162-64 (1991).