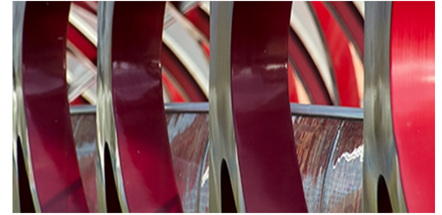

News & Types: Commercial, Competition & Trade Update

Trademark Licensees in Limbo Again?

5/2/2018

Practices: Commercial, Competition & Trade

After a January 2018 decision by the First Circuit Court of Appeals, trademark licensees are faced with uncertainty again. (*In re Tempnology, LLC*, 879 F.3d 389 (1st Cir. 2018)). In our previous update, we discussed a 7th Circuit case dealing with the same issue. At the time we predicted that the holding in the case may have resolved the issue. (*Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012)). But that was wrong.

First, a little history. In 1985, the 4th Circuit Court of Appeals held that, when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. (*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc*., 756 F.2d 2043 (4th Cir. 1985)). The *Lubrizol* decision was heavily criticized, since it permitted an intellectual property licensor to get out of a license agreement through bankruptcy. Even the 4th Circuit acknowledged, in the opinion, that permitting rejection of an intellectual property license could have a “chilling effect” on the willingness of potential licensees to contract with licensors in financial difficulty.

Three years later, Congress amended the Bankruptcy Code to overturn *Lubrizol*. Congress added Section 365(n) of the Bankruptcy Code to permit an intellectual property licensee, faced with a bankrupt licensor’s attempt to reject the contract, to either treat the contract as terminated or to retain rights under the contract. But, in a notable omission, the definition of “intellectual property” in Section 365(n) did <u>not</u> include trademark rights. The Senate Report that accompanied the Bankruptcy Code amendment stated that omission of trademarks was not because Congress felt trademark licensees should not be protected. Rather, it was because trademark licenses depend on quality control of the products sold by the licensee and this was an area beyond the scope of the amendment. The Senate Report went on to say that Congress “postpone[d] action on trademark licenses to allow the development of equitable treatment of this situation by bankruptcy courts” (S. Rep. No. 100-505).

In a Risk Management Update of June 21, 2010 we discussed a 3rd Circuit Court of Appeals decision on this issue. (*In re: Exide Technologies*, 607 F.3d 957 (3rd Cir. 2010)) These cases usually include an interesting fact pattern and *Exide Technologies* was no exception. In 1991, Exide sold its industrial battery business to a company that eventually became EnerSys Delaware, Inc., at the time granting EnerSys a perpetual, royalty-free license to use the “Exide” trademark in the industrial battery business. In 2000, Exide wanted back in the industrial battery business but could not regain the trademark from EnerSys. So Exide ended up selling industrial batteries competing with industrial batteries under its former “Exide” trademark. But Exide’s opportunity came when it filed for bankruptcy in 2002. Under the Bankruptcy Code, it could reject the trademark license and regain the “Exide” trademark from EnerSys. (Recall that the amended Bankruptcy Code protected intellectual property licenses from rejection, but not trademarks.)

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The 3rd Circuit opinion held that the trademark license was not an “executory” contract under the Bankruptcy Code and, therefore, Exide could not reject it. It found that EnerSys had “substantially performed” its obligations under its agreement with Exide. It acknowledged Exide’s obligation to observe quality standards, but found this obligation was “minor.”

In a concurring opinion, Judge Ambro found another basis to conclude that EnerSys retained the trademark license rights. Judge Ambro cited the Senate Report described above and agreed that the omission of trademarks was not because Congress felt trademark licenses should not be protected. Judge Ambro concluded that the court could have used its equitable power to deny Exide’s efforts to reject the trademark license.

Then, in a thundering opinion in 2012, Judge Easterbrook of the 7th Circuit seemed to put this issue to rest. (*Sunbeam Products*, cited above and discussed in a Risk Management Update.) Judge Easterbrook agreed that trademark licensees should be protected from rejection by bankrupt trademark licensors, but not for the reasons cited in the opinion and concurrence in *Exide*. Judge Easterbrook explicitly rejected the holding in *Lubrizol*. *Sunbeam* was another interesting situation. Lakewood Engineering & Manufacturing (later acquired by Sunbeam in bankruptcy) licensed Chicago American Manufacturing, LLC (CAM) to manufacture and sell box fans using the Lakewood trademarks. CAM, concerned about Lakewood’s financial condition, negotiated the ability to sell the fans itself if Lakewood did not purchase them.

Sure enough, Lakewood entered bankruptcy and the trustee sold the assets to Sunbeam. Sunbeam did not want the fans CAM had manufactured and did not want the fans in the market to compete with Sunbeam. So Sunbeam caused the trustee to reject Lakewood’s contract with CAM. So CAM risked holding inventory it could not sell and losing money on unrecovered production costs. The bankruptcy judge, following Judge Ambro’s approach, cited “equitable grounds” to protect CAM from rejection of the trademark license.

On appeal, Judge Easterbrook directly attacked the holding in *Lubrizol*. He noted that no other court of appeals had agreed with *Lubrizol*. He also noted that, outside bankruptcy, had Lakewood breached its agreement, “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 just by declaring that the debt will not be paid.” The rights of the other party are not “vaporized.” Judge Easterbrook explicitly rejected notions of equity.

> “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. . . . Rights depend, however, on what the Code provides rather on notions of equity.”

Judge Easterbrook ended the *Sunbeam* opinion on what seemed a note of finality, probably intending to end this issue forever.

> “This opinion, which creates a conflict among the circuits, was circulated to all active judges . . . . No judge favored a hearing en banc.” [En banc refers to a hearing that includes all the judges of the circuit, not just the three judges deciding the case.]

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At the time, we predicted that *Lubrizol* (the 1985 case that created the issue) would be abandoned as an outlier and not followed by any other court of appeals. But that turned out not to be the case.

On January 12, 2018, the 1st Circuit issued *In re Tempnology, LLC* (cited above), that contradicted *Exide* and *Sunbeam*. So the stage is set for a conflict requiring some form of resolution.

Tempnology LLC made specialized products, such as towels, socks, headbands and other accessories, designed to remain at low temperatures even when used during exercise. On November 21, 2012, Tempnology entered into a Co-Marketing and Distribution Agreement with Mission Product Holdings, Inc. The Agreement granted Mission distribution rights to certain manufactured products within the United States. The Agreement also granted Mission a nonexclusive license to Tempnology's intellectual property, not including trademarks. Trademarks were the subject of a separate grant of rights from Tempnology to Mission for the term of the Agreement "for the limited purpose of performing [Mission's] obligations [under the Agreement]."

As permitted in the Agreement, on June 30, 2014, Mission terminated the Agreement without cause, triggering a "wind-down period" of about two years.

Tempnology filed for Chapter 11 bankruptcy on September 1, 2015 and immediately moved to reject the Agreement with Mission. The 1st Circuit Court of Appeals, in a decision written by Judge Kayatta, disagreed with *Sunbeam* and held that Mission's right to use Tempnology's trademarks did not survive Tempnology's rejection of the Agreement in bankruptcy.

The court noted the ambiguity in the law that purported to override *Lubrizol*, omitting trademarks as a type of intellectual property license protected from rejection by the debtor. Does this mean that debtor licensors can reject trademark licenses and strip licensees of any rights under the license?

Not exactly, said Judge Kayatta. Licensees still have a claim for damages, as provided in the Bankruptcy Code. Judge Kayatta agreed with Judge Easterbrook in *Sunbeam* in the reluctance to take an "equitable" approach, as suggested in the Senate Report.

But Judge Kayatta took issue with Judge Easterbrook's rejection of *Lubrizol*. Another major goal of the Bankruptcy Code is to foster a successful reorganization. But a trademark licensor is obligated to "monitor and exercise control over the quality of the goods sold to the public under cover of the mark." So requiring a debtor licensor to continue the trademark license agreement imposes obligations which hinder a successful recovery. Probably with intended irony, Judge Kayatta cited 7th Circuit opinions that "[A] naked license abandons a mark." Said Judge Kayatta,

> "The Seventh Circuit's approach, therefore, would allow Mission to retain the use of Debtor's [Tempnology's] trademarks in a manner that would force Debtor to choose between performing executory obligations arising from the continuance of the license or risking the permanent loss of its trademarks, thereby diminishing their value to Debtor . . .
>
> In sum, the approach taken by *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens."

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Judge Kayatta minimized the burden on the trademark licensee faced with a rejected trademark license: “The counterparty may still make and sell its products—or any products—just so long as it avoids use of the trademark precisely when the message conveyed by the trademark may no longer be accurate.”

There was a dissent by Circuit Judge Torruella who would have followed *Sunbeam* and permitted Mission to continue using the licensed trademarks, in spite of rejection by the debtor, Tempnology.

The *Tempnology* decision has placed the issue of trademark licenses in bankruptcy back into play. For example,

1. Can A Trademark License Ever Be Non-Executory?

Judge Kayatta spent most of the decision disputing the *Sunbeam* holding by Judge Easterbrook. But Judge Kayatta also questioned the majority opinion in *Exide Technologies*. Recall that the *Exide Technologies* decision found in favor of the trademark licensee, preventing rejection of the license, by finding that the trademark license agreement had been largely performed and the remaining obligations of the licensor were “minor.” But Judge Kayatta emphasized the ongoing obligation of the trademark licensor to monitor and exercise quality control over the goods sold to the public under the trademark.

So the *Tempnology* court would dispute all of the bases under which a trademark license might be preserved in bankruptcy.

A. Equitable—Both Judge Kayatta (*Tempnology*) and Judge Easterbrook (*Sunbeam*) would not agree with Judge Ambro’s concurring opinion in *Exide Technologies* that would allow bankruptcy courts to apply equitable principals to prevent a trademark licensor from rejecting the license in bankruptcy.

B. Overturning *Lubrizol*—Judge Kayatta also disputed Judge Easterbrook in *Sunbeam* in rejecting the *Lubrizol* holding that permitted licensors to reject the license in bankruptcy.

C. License as Non-Executory Contract—As noted, the *Tempnology* holding leaves little room to claim that a trademark license is non-executory and therefore not subject to rejection. The licensor’s ongoing obligation to monitor quality of the goods will almost always make the license executory.

2. What about potential trademark licensors and licensees?

Both the *Lubrizol* and the *Tempnology* opinions purported to favor trademark licensors in bankruptcy by permitting them to reject a trademark license, enhancing the value of the debtor’s estate. But one of the ironies of the *Tempnology* decision, acknowledged by the court in *Lubrizol*, is that potential trademark licensors, especially those in financial distress, will find their trademark license devalued, if they can find a licensee at all. The fact situation in *Sunbeam* illustrated this point well. The trademark licensee, faced with a distressed licensor, took extra steps to protect itself in the agreement. If the licensee had lost, it would have been faced with inventory it could not sell and production costs it could not recover.

Interestingly, the *Tempnology* opinion seemed to minimize these risks. Said Judge Kayatta in *Tempnology*, “The counterparty [trademark licensee] may still make and sell its products—or any products—just so long as it

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avoids use of the trademark precisely when the message conveyed by the trademark may no longer be accurate." But many trademark licensees would not see the solution as so simple. A trademark gives value to products and removing the trademark destroys the value. Also, trademarks are often not just stickers on the product but are part of the design or the tooling used to manufacture the product, again not a simple matter to change or re-construct.

3. How should the amendment to the Bankruptcy Code overturning *Lubrizol* be interpreted with respect to trademark licenses?

Congress omitted trademarks when it overturned *Lubrizol* and permitted licensees of other forms of intellectual property to retain their rights even in the case of the licensor's bankruptcy. How should this omission be interpreted? This may end up with the U.S. Supreme Court.

It would be hard to interpret the Senate Report (discussed above) as showing Congress' intent that trademark licensees should not be protected at all. The Senate Report suggested that trademark licensees deserved protection but, for other reasons, action would be "postponed."

But some members of the U.S. Supreme Court prefer to look at the statutory language only, without reference to legislative history. If so, the choice is stark. The U.S. Supreme Court must either overturn *Lubrizol* in its entirety (as Judge Easterbrook attempted to do) or to interpret the statute as written and permit trademark licensors to reject the license agreement, stripping the licensees of rights to the trademark.

As the three Courts of Appeals decisions illustrate, the fact situations behind these cases are often interesting and complex. So certainly it is difficult to forecast a result in the abstract, without reference to the fact situation in a case that reaches the U.S. Supreme Court.

4. Could there be a contractual solution?

In most cases, the law prohibits pre-bankruptcy petition waivers of rights that could protect a debtor in bankruptcy. The reason is obvious – the other party to the contract would require pre-bankruptcy petition waivers of all the rights leaving the bankruptcy protections largely meaningless. As an exception, in recent years, a large body of law has developed over the enforceability of pre-petition waivers of the automatic stay in bankruptcy. Depending on the situation, courts are enforcing some of these pre-petition waivers.

Could a similar alternative be used for trademark licenses? Certainly a potential trademark licensor, especially one in financial distress, would want to provide assurances to its licensee that the license would be protected in bankruptcy. Perhaps the courts would enforce a pre-petition agreement by a trademark licensor that waives the ability to reject the license in bankruptcy. Certainly the contractual language, and the circumstances under which it would be enforced by the courts, would require many years to develop.

So trademark license agreements are once again in limbo – protected from rejection in some circuits, able to be rejected in other circuits, or faced with uncertainty in other circuits based on "equitable principles." It seems likely that this situation will be resolved either through a U.S. Supreme Court decision or action by Congress.

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