A Call To Arms — 365(n) And Trademark Licensees

Law360, New York (May 09, 2012, 2:33 PM ET) -- On April 11, 2012, briefing before the Seventh Circuit concluded on the direct appeal of the Bankruptcy Court's decision in Szilagyi v. Chicago Am. Mfg. LLC (In re Lakewood Engineering & Manufacturing Co. Inc.), 459 B.R. 306 (Bankr. N.D. Ill. 2011). In Lakewood, the Bankruptcy Court found support in legislative history to confer on a trademark licensee protections expressly not made available to such licensee by statute.

The debtor in Lakewood was a major manufacturer of box fans. Faced with continuing losses, Lakewood decided to outsource the manufacture of certain of its products including box fans sold under the Lakewood trademark. Lakewood entered into a supply agreement with Chicago American Manufacturing LLC (CAM) for the manufacture of the fans.

The supply agreement included a license to CAM of the Lakewood trademark in the event that Lakewood failed to purchase the amount of fans required under the supply agreement. The purpose of such provisions was to allow CAM to sell the fans under the Lakewood trademark which CAM had built under the supply agreement in the event that Lakewood ailed to by fans.

Despite its efforts, Lakewood was unable to operate profitability and an involuntary bankruptcy petition was filed against Lakewood. An order for relief under Chapter 7 was entered shortly thereafter and a trustee appointed. The trustee rejected the supply agreement which contained the "springing" trademark license. Subsequently, a dispute arose between the trustee and CAM regarding whether the trademark license to CAM survived rejection of the supply agreement. The bankruptcy court concluded that the license was not terminated when the supply agreement was rejected and that using its equitable powers it would ensure that CAM not be stripped of its "fairly procured trademark rights."

One would have expected that the trademark licensee would have been deprived of the ability to use the trademark under Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc., 765 F.2d 1043 (4th Cir. 1985) and applicable nonbankruptcy law. Lubrizol is the well-known decision that held that rejection of a non-exclusive patent license deprived the licensee of further ability to use its patent and enabled the debtor licensee to enter into a new license post-petition.

The logic of Lubrizol (based on the Bankruptcy Code as it existed at that time) is compelling. Rejection constitutes a prepetition breach giving the nondebtor counter party a claim for damages but not any right for specific performance from the debtor. Further, the court in Lubrizol held that rejection relieves the rejecting debtor of the obligation to perform and, in the context of a patent license, performance means a waiver by the licensor of its right to sue the licensee for infringement.

Lubrizol was overruled in 1988 by Congress which, among other things added subparagraph (n) to Section 365. Section 365(n) conferred certain rights to licensees of "intellectual property" as the term is defined in also newly added Section 101(35A) of the Code. Among the rights granted to the licensee was the right to the intellectual property as it existed at the time of the petition in exchange for paying all royalties due.

Notably, however, trademarks were deliberately excluded by Congress from the definition of "intellectual property" in § 101(35A). Consequently, without the special preferred status conferred to a licensee of "intellectual property" (and to certain other classes of favored counterparties such as tenants, time share buyers, and others), one would have expected trademark licensees to be treated as any other non-favored contract counterparty. Lakewood, however, concluded otherwise.

In considering the Lakewood appeal, the Seventh Circuit will evaluate the Lakewood court's reliance on so-called equitable powers which were suggested in the concurrence in In re Exide Technologies, 607 F.3d 957 (3rd Cir. 2010). Judge Thomas Ambro, in his concurrence, wrote that "a trademark licensor's rejection of a trademark agreement under 11 U.S.C. § 365 does not necessarily deprive the licensee of its rights in the licensed mark." Judge Ambro went on to cite legislative history regarding § 365(n) which said:

In particular, 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. S.Rep. No. 100-105, at 5.

Judge Ambro appears to have elevated this statement in a Senate report to nearly the status of a congressional enactment. Indeed, the Lakewood bankruptcy court described the Senate report as a congressional “call to arms” to the bankruptcy courts to devise protections for trademark licensees.

In contrast to the so called “call to arms,” the Seventh Circuit must consider the fact that when Congress intended to grant broad equitable powers to the Bankruptcy Court it has done so expressly. In Section 1129 of the Bankruptcy Code, the court is required to determine whether a plan is “fair and equitable” and is proposed in “good faith.”

In authorizing the assumption and assignment of a contract, the Bankruptcy Court is given broad latitude to determine whether “adequate assurances” have been provided to the non-debtor party. See 11 U.S.C. § 365. Yet, the Bankruptcy Code is silent as to equitable relief for parties to most rejected contracts, and express as to those favored counterparties who are entitled to equitable relief. In short, Congress well knows how to vest the Bankruptcy Court with powers to exercise discretion in dealing with various issues and it chose not to in the case of trademark licensees.

Although the authors are of the opinion that trademarks should receive some form of equitable treatment to avoid the harsh result of Lubrizol, the Bankruptcy Code contains no such protections and allowing the courts to fashion relief on a case-by-case basis will lead to inconsistent results and forum shopping. Accordingly, the Seventh Circuit should take the opportunity to send a message to Congress and the Bankruptcy Courts: that trademark licensees should receive protection but only by way of statute.

The Lakewood decision from the Seventh Circuit is much anticipated and will be extremely important for trademark licensees. It will, however, be even more important as a guide for statutory construction and the appropriate use of legislative history.

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