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Are Trademarks IP Under the Code?

The Uncertain Treatment of Trademark License Agreements

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Section 365 of the Bankruptcy Code provides debtors[1] the right to assume beneficial executory contracts and leases and reject those that are burdensome, subject to bankruptcy court approval.[2] Rejection rights under § 365 free the debtor from burdensome obligations that might hinder its reorganization rights and, as such, are cardinal rights under the Code. When the debtor/licensor rejects an executory contract, the nondebtor party no longer has an obligation to perform under the rejected agreement and has a claim for damages against the bankruptcy estate. However, when a debtor seeks to reject a license of *intellectual property* (IP), the nondebtor *licensee's* right to use the licensed IP is less certain.

Under the current law, the result depends on which *category* of IP is involved. While a licensee of a patent or a copyright retains its prebankruptcy right to continue to use the licensed IP, a licensee of a trademark may or may not retain the right to use the licensed trademark after the rejection of the license agreement in the licensor's bankruptcy.[3] Due to the increasing importance of trademark licenses in commercial practice, issues resulting from the disparate treatment of IP will multiply, and the result should not depend on where the licensor's bankruptcy case was filed. Congress should amend § 365 to address this issue, or the U.S. Supreme Court should resolve the circuit split to provide some certainty to licensees.

Background of § 365(n)

In 1985, the Fourth Circuit Court of Appeals ruled that (1) a license agreement was an executory contract subject to rejection under § 365, and (2) the nondebtor licensor was entitled to monetary damages only, not specific performance.[4] As a result, the licensor lost the right to use the licensed IP, including patents, trademarks and copyrights.[5]

Three years later, Congress enacted the Intellectual Property Bankruptcy Protection Act (IPBPA) in response to the *Lubrizol* decision.[6] The Senate Report identified the IPBPA's purpose as follows:

> The purpose of the bill is to amend Section 365 ... to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy. Certain recent court decisions interpreting Section 365 have imposed a burden on American technological development that was never intended by Congress in enacting Section 365. The adoption of this bill will immediately remove that burden and its attendant threat to the development of American Technology and will further clarify that Congress never intended for Section 365 to be so applied.[7]

Congress expressed concern about *Lubrizol*'s perceived impact, noting that similar judicial decisions "threaten an end to the system of licensing of intellectual property."[8] Congress feared that the instability resulting from the *Lubrizol* decision might compel would-be licensees to demand assignments of IP, forcing the creator of the IP to lose his/her personal stake in the property.[9] Congress also determined that license agreements merited additional protection, as a licensee cannot "obtain precise cover from another source."[10]

To address those concerns, the IPBPA added a new subsection (n) to § 365 of the Bankruptcy Code, which established the rights of licensees when a debtor rejects an executory contract under which the debtor is a licensor of a right to IP. The nondebtor licensee has the option to treat the contract as terminated by such rejection, or retain its rights to the license under the contract.[11] Section 365(n) is limited to licenses of "intellectual property," which is defined in § 101(35A) of the Bankruptcy Code as a "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent applications; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17; to the extent protected under applicable nonbankruptcy law."[12]

1 Trustees and debtors in possession are granted the same rights for purposes of § 365. For purposes of this article, a reference is made to debtors for ease of reference.
2 11 U.S.C. § 365(a).
3 11 U.S.C. § 365(n).
4 *Lubrizol Enter. Inc. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.)*, 756 F.2d 1043, 1048 (4th Cir. 1985).
5 *Id.*
6 S. Rep. No. 100-505, at 2 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3201.
7 *Id.* at 1.
8 *Id.* at 3.
9 *Id.*
10 *Id.* at 4.
11 11 U.S.C. § 365(n).
12 11 U.S.C. § 101(35A).

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Notably missing from this definition are trademarks, trade names and service marks.[13] While Congress expressed concern over the rejection of such license agreements due to the *Lubrizol* decision, it intentionally omitted trademarks from the scope of the IPBPA:

> In particular, trademark, trade name, and service mark licensing relationships depend to a large extent on control of the quality of the product 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 to allow the development of equitable treatment of this situation by bankruptcy courts.[14]

The omission of trademarks from the scope of § 365(n) has resulted in uncertainty and inconsistent treatment of trademark-license agreements among the circuits. Post-IPBPA, courts were effectively left with two alternatives: (1) adopt the categorical approach of *Lubrizol*; or (2) consider the equities per legislative intent. Since *Lubrizol* and the IPBPA, the Seventh and First Circuits have issued opinions on the effect of rejection of trademark licenses, with a noteworthy concurring opinion from the Third Circuit.

The central issue in *In re Exide Technologies* was whether the contract was executory.[15] However, Hon. Thomas Ambro's concurring opinion was the first unambiguous application of equitable treatment as described in the legislative history.[16] He concluded that the negative inference that Congress intended to exclude protection to trademarks was inappropriate. Judge Ambro argued that bankruptcy courts should not conflate rejection with rescission or termination, and bankruptcy courts should not use § 365 to "take back trademark rights [that the debtor] bargained away."[17] Rather, bankruptcy courts should use their equitable powers to eliminate the burdensome obligations under the rejected trademark license, while preserving the licensee's right to continue use of the trademark.[18]

In 2012, a new approach was adopted. In *Sunbeam Prod. Inc. v. Chicago Am. Mfg. LLC*, the Seventh Circuit rejected the bankruptcy court's reliance on equity to permit the licensee's continued use of trademarks.[19] The court agreed with Judge Ambro's concurring opinion in *Exide* and strongly criticized *Lubrizol*.[20] The Seventh Circuit found that § 365(n) did not apply to trademarks at all and that bankruptcy courts should therefore look to the other provisions of § 365 for guidance.[21]

Under § 365(a), an executory contract may be assumed or rejected.[22] Pursuant to § 365(g) of the Bankruptcy Code, rejection constitutes a breach of the contract.[23] As a result, the debtor's unperformed obligations under the rejected agreement are converted to damages,[24] but "nothing about the process implies that any rights of the contract counterparty have been vaporized."[25] Hon. Frank Easterbrook further noted that "[o]utside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property."[26] In other words, the bankruptcy court should look to the license agreement and applicable nonbankruptcy law in order to determine the nondebtor licensee's rights after rejection. To the Seventh Circuit, it was clear that the nondebtor retains its rights to the license to the extent that it would outside of bankruptcy after a breach by the licensor.

The First Circuit Court of Appeals also recently weighed in on the § 365(n) issue. In *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, the First Circuit disagreed with *Sunbeam* and held that the nondebtor licensee retained only a claim for damages, and the debtor/licensor was relieved of any further obligation to perform under the trademark license.[27] The First Circuit noted that trademarks signal uniform quality to consumers, unlike patents.[28] The *Tempnology* court minimized the business impact on the licensee, as the licensee might still sell products, as long as it does not use the licensed trademark "precisely when the message conveyed by the mark may no longer be accurate."[29] To the *Tempnology* court, the *Sunbeam* decision would impose an unwarranted burden on a debtor, and the equitable approach argued by the dissent would cause uncertainty and increased litigation in bankruptcy.

Are Trademarks "Intellectual Property"?

The foregoing begs the question of why Congress excluded trademarks — albeit temporarily, per the legislative history — from the scope of § 365(n). Clearly, § 365(n) was enacted to address the harsh results of *Lubrizol* and protect the nondebtor licensee's bargained-for interests in the licensed IP. The omission of trademarks from the definition of "intellectual property" in § 101(35A) has created the precise inequitable treatment and uncertainty that § 365(n) was intended to address. Likewise, parties may "bundle" IP rights into one agreement. For example, a licensor might grant a license to use its trademark in connection with a contemporaneously licensed patent or copyright. If the licensee requires use of the trademark to benefit from the licensed patent or copyright, the result for the licensee upon rejection of the license agreement could be crippling to the licensee.

Trademarks are distinct from patents and copyrights in several respects. A trademark is a word, name, symbol, device or any combination thereof (or registered with intent to use) to identify and distinguish goods.[30] Trademarks commonly protect brand names and logos, while patents protect inventions and copyrights protect original artistic or literary

13 For ease of reference, trademarks, trade names and service marks will be collectively referred to as "trademarks."
14 S. Rep. No. 100-505, at 6 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.
15 *In re Exide Techs.*, 607 F.3d 957, 960 (3d Cir. 2010).
16 *Id.* at 967 (Ambro, J. concurring).
17 *Id.* at 967-68 (Ambro, J. concurring).
18 *Id.*
19 *Sunbeam Prod. Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372, 376 (7th Cir. 2012).
20 *Id.*
21 *Id.*
22 *Id.*; 11 U.S.C. § 365(a).
23 *Sunbeam*, 686 F.3d at 376; 11 U.S.C. § 362(g).
24 *Id.* at 377.
25 *Id.*
26 *Id.* at 376.
27 *Mission Prod. Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389, 392 (1st Cir. 2018).
28 *Id.* at 402.
29 *Id.* at 404.
30 15 U.S.C. § 1127 (2006).

work.[31] Trademarks provide quality assurance and protect owners from misappropriation of their property and misuse of their brand and associated goodwill.[32] Trademarks are protected indefinitely unless the trademark is abandoned, while patents and copyrights have defined terms.[33]

When a trademark owner licenses the trademark, it has a duty to monitor and control the quality of goods sold under its trademark.[34] The First Circuit concluded that the debtor's continuing duty to monitor quality was unjustifiably burdensome and could hamper its fresh start.[35] Tellingly, the court was unable to identify the precise burden. If the license agreement was an executory contract subject to rejection, it follows that the debtor was continuing to receive royalty payments or other compensation for the use of its trademark and its related monitoring duty. It is improbable that the debtor's reorganization efforts would be impaired from its duty to monitor the quality of goods sold under its trademark. A debtor's desire to re-trade the price for its trademark is not a legitimate basis to deny a licensee the benefit of its bargain.[36]

While differences exist between categories of IP, the result from the loss of the use of the licensed property and the predicament faced by the nondebtor licensee are often the same. If the licensee of a trademark is limited to asserting a monetary claim for damages, the licensee is presented with the daunting task of quantifying those damages. Damages will often be the speculative loss of future business. As the purpose of licensing is typically to expand products into different markets or product lines, the damage sustained by the licensee due to the loss of the use of the trademark will be unliquidated and likely difficult to prove. Thus, the licensee would sustain a loss for which it could not be adequately compensated, much as a licensee would in the event of the loss of a licensed patent or copyright.

Proposed Solutions

One clear solution to address the uncertain treatment of trademark licenses upon rejection is for Congress to amend the Bankruptcy Code. In the absence of congressional action, the Supreme Court should grant *certiorari* in order to resolve the circuit split and adopt an approach that balances the competing interests of the debtor/licensor and the nondebtor licensee. The debtor must have the ability to reject burdensome obligations that could impede its reorganization efforts, while the nondebtor licensee should retain its bargained-for interests in the trademark. As the circuit split reveals, striking an equitable balance is not simple.

In the interim, bankruptcy courts must weigh the equities of each case, including the language in the relevant license agreement, in determining the effect of rejection. As in *Sunbeam*, bankruptcy courts should evaluate the result of a breach by the licensor under applicable nonbankruptcy law. This approach allows the parties some degree of certainty in the outcome upon the licensor's bankruptcy, which the parties can take into consideration when selecting governing law and the provisions in the license agreement.

The categorical approach adopted in *Lubrizol* and *Tempnology* may often yield harsh results for licensees. If licensees fear that use of a trademark might be terminated by the licensor's bankruptcy, licensees may increasingly demand assignments of trademarks rather than mere licenses, forcing the would-be licensor to lose control of its trademark and its stake in the quality of the trademark. Such an approach might discourage innovation and entrepreneurship if parties cannot facilitate a license arrangement in order to expand into new markets or product lines, particularly where the licensor does not have the financial means to do so itself.

Licensees should require "§ 365(n) provisions" in license agreements, which stipulate to the parties' intent that all licenses granted under the agreement are, for purposes of § 365(n), licenses of rights to "intellectual property" as that phrase is defined in § 101. While such provisions will not be binding, a clear expression of the parties' intent might assist the bankruptcy court in weighing the equities.

A licensee might also consider including early termination fees or liquidated-damages provisions in order to facilitate liquidation of its claim upon rejection. While liquidated damages might be impossible to define with accuracy, such a provision might facilitate a quicker claims-reconciliation process and provide the licensee with more leverage in negotiating its claim. While parties have certain available mechanisms to lessen the severity of rejection, Congress should definitively respond to amend the Bankruptcy Code to address the rejection of trademark licenses, as the legislative history suggests that it intended to do after "more extensive study." abi

31 "Protecting Your Trademark," U.S. Patent and Trademark Office (May 2016), *available at* uspto.gov/sites/default/files/documents/BasicFacts.pdf (last visited June 28, 2018).
32 *Tempnology*, 879 F.3d at 402.
33 15 U.S.C. § 1127.
34 *Tempnology*, 879 F.3d at 402.
35 *Id.* at 403.
36 Congress appeared to recognize this principle in § 365(h)(1)(A) by prohibiting lessors of real property from evicting lessees through the rejection of a lease.