RECONCILING TRADEMARK LAW WITH BANKRUPTCY LAW IN LICENSE REJECTION

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Trademark law serves two primary purposes: protect the trademark holder's property interest in the mark and protect the public's interest in knowing the common source and consistent quality of anything bearing a trademark. To achieve both objectives, trademark law allows trademark holders to license their marks but requires them to actively control the quality of the marks when doing so. Trademark holders who do not actively control their licensed marks' quality risk losing their rights to the trademark. The quality control requirement becomes problematic in bankruptcy. In bankruptcy, the estate of a bankrupt trademark licensor must decide whether to assume the license, thus taking on the obligations of the contract, or to reject the license, thus effecting a breach by the licensor immediately before bankruptcy and creating a pre-petition claim for damages but not unwinding the contract. One key objective of rejection is to allow a bankruptcy estate to relieve itself of the burdens of ongoing obligations of contracts entered into by the bankrupt before bankruptcy.

The question for trademark licenses is what happens to the licensee's rights to the trademark after the licensor rejects. On the one hand, the trademark licensee has a property

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interest in the trademark that the bankruptcy estate does not––and should not be able to—acquire through rejection. On the other hand, the bankruptcy estate should not be forced to protect its interest in the trademark by continuing to control the quality of the trademark after rejection.

The appellate courts are divided on this issue. Most recently, the Seventh Circuit held in Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC *that the licensee may retain its rights to the trademark after the licensor's bankruptcy estate rejected the license. The Seventh Circuit's holding does not adequately account for the tension between trademark law's quality control requirement and bankruptcy law's relief from ongoing obligations through rejection.*

This Note examines why the bankruptcy estate should not be able to replace the licensee's rights to the trademark with a pre-bankruptcy breach claim for damages and why the estate should not be required to allow the licensee to retain its rights to the trademark after rejection. Instead, the bankruptcy estate should be able to terminate the licensee's rights to the trademark by paying for those rights as administrative expenses, compensating the licensee in full dollars rather than in miniscule bankruptcy dollars. In doing so, the estate can maximize its value and relieve itself of burdensome ongoing obligations, but only if it pays full value for the property interest owned by the licensee—a property interest the estate does not otherwise have.

I. INTRODUCTION

In bankruptcy, the trustee of an estate has the power to assume or reject any executory contract of the debtor, subject to the court's approval.[1] Over the past few decades, courts and scholars have grappled with rejection, uncertain about its meaning and effects.[2] Courts have been particularly divided with regard to rejection of intellectual property licenses. On one hand, intellectual property licenses can be seen as ongoing covenants by the licensors not to sue the licensees for infringement. On the other hand, intellectual property licenses can be seen as conveying to the licensee a possessory interest in the intellectual property—an interest that would not necessarily end just because the licensor breaches the license.

In the bankruptcy setting, courts have explored whether to allow licensees to retain their rights to the licensed intellectual property on rejection or to treat rejection as eliminating those rights. This problem has been particularly

1 *See* 11 U.S.C. § 365(a) (2012).

2 *See, e.g.*, Top Rank, Inc. v. Ortiz (*In re* Ortiz), 400 B.R. 755, 762 (C.D. Cal. 2009) (describing widespread confusion in the case law regarding rejection of executory contracts in bankruptcy).

troublesome for trademark licenses. Trademarks are not only property rights; they also protect the public from fraud by manufacturers and sellers of products. Trademarks give consumers confidence that the products bearing the marks will be consistent in quality and will come from the same source. In order to protect these expectations, trademark law requires a trademark holder to exercise control over the quality of the trademark when licensing it. Should the licensor file for bankruptcy, however, the trustee may wish to reject the license to relieve the estate of the burdens of controlling the trademark's quality, either because controlling the quality would be impracticable for the estate or because the trademark would be more valuable if the estate no longer had to monitor and control the quality of the licensed use. Though Congress identified this tension in 1988,[3] courts have yet to settle on a feasible way to allow the estate to relieve itself of the quality control burden without risking its interest in the trademark.

In one of the first cases to address this issue, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, the Fourth Circuit held that when a trustee of the debtor-licensor's estate rejects intellectual property licenses, the licensee loses the rights to the intellectual property and is left only with an unsecured claim for damages.[4] Congress, courts, and scholars alike were concerned by *Lubrizol*'s harsh consequences for the non-debtor parties.[5] Congress's response, the Intellectual Property Licenses in Bankruptcy Act of 1988 ("IPLBA"), amended the Bankruptcy Code to affirm that non-debtor intellectual property licensees could retain their rights to the intellectual property after

3 *See* S. REP. NO. 100-505, at 6 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204 (stating that "[w]hile . . . [section 365] rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others . . . , such contracts raise issues beyond the scope of this legislation" (internal citations omitted)).

4 756 F.2d 1043, 1048 (4th Cir. 1985).

5 *See In re Ortiz*, 400 B.R. at 762 (describing the case law and literature grappling with the rights of licensees in § 365(a) rejection).

rejection.[6] However, unsure how to handle the unique requirements of trademark law, Congress specifically did not include trademarks in the IPLBA's definition of "intellectual property."[7] More broadly, the reaction to *Lubrizol* led to the emergence and dominance of a new view of rejection in general: treating rejection as a declaration that the estate will no longer perform its outstanding obligations, leaving the other party in the same position in which it would have been had the debtor breached immediately before bankruptcy.[8]

After *Lubrizol*, it was not until 2010 that a circuit court addressed the issue of whether a non-debtor trademark licensee could retain its rights after rejection,[9] and not until 2012 that a circuit court actually held on the issue.[10] In *Sunbeam Products v. Chicago American Manufacturing*, the Seventh Circuit held that a non-debtor trademark licensee could indeed retain its rights to the trademark after rejection, creating a circuit split.[11] While the Seventh Circuit applied the modernized analysis of rejection in finding that the licensee could retain its trademark rights after rejection, the court failed to address the quality control

6 Intellectual Property Licenses in Bankruptcy Act of 1988, Pub. L. No. 100-506, 102 Stat. 2538 (1988) (codified at 11 U.S.C. § 365(n)).

7 S. REP. NO. 100-505, at 6; *see also* Raima UK Ltd. v. Centura Software Corp. (*In re* Centura Software Corp.), 281 B.R. 660, 669–70 (Bankr. N.D. Cal. 2002) (observing that the legislative history of § 365(n) indicates that Congress was concerned about the exclusion of trademark licenses but that nevertheless such licenses were considered beyond the scope of the legislation).

8 *See In re Ortiz*, 400 B.R. at 762–63 (discussing developments in the case law and literature about the rejection of executory contracts).

9 *In re* Exide Techs., 607 F.3d 957, 964–68 (3d Cir. 2010) (Ambro, J., concurring) (agreeing with the majority that the instant trademark license was non-executory, but stating that where a court finds a trademark license to be executory, the trademark licensee should retain its rights to the trademark following rejection).

10 *See* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012) (holding that a non-debtor trademark licensee could indeed retain its rights to the trademark after rejection).

11 *Id.* at 377–78.

requirements of trademark law—the unique feature of trademark law that led Congress to leave trademarks out of the IPLBA.[12]

This Note argues that courts should allow the trustee rejecting a trademark license to terminate the licensee's rights to the trademark in exchange for an administrative claim for the licensee's interest in the trademark. Part II describes how the law of rejection of executory contracts in bankruptcy has evolved, and explains why the modern approach is superior to the approach adopted in *Lubrizol*. Part III describes the requirements of trademark law that necessitate a unique approach to rejection of trademark licenses in bankruptcy. Part IV examines the solutions to the quality control problem that have been proposed. Finally, Part V explains why the trustee should be allowed to terminate the licensee's rights to the trademark and why that termination should be treated as an administrative expense.

II. REJECTION OF EXECUTORY CONTRACTS

Before examining how courts have dealt with or should deal with trademark license rejections where the debtor is the licensor, it is important to understand how courts have treated rejection generally. Courts and scholars first grappled with how to define "executory" contracts for the purposes of section 365 of the Bankruptcy Code (governing executory contracts). By any of the settled definitions of executory contracts, though, trademark licenses typically have been found to be executory. Upon finding that a trademark license is executory, a court would then need to determine whether it should allow the trustee to reject the license. When making such a decision, a court considers whether the rejection at issue would align with the purposes of rejection in general and with the overarching goals of bankruptcy. Finally, once a court has approved rejection, it must determine how that rejection will affect the rights of the non-debtor party. Such a determination has been

12 *See* S. REP. NO. 100-505, at 5.