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Triumph for Trademark Licensees: Supreme Court Says Right to Use Trademarks Following Debtor's Rejection of Licensing Agreement Is Determined By Non-Bankruptcy Law

By The Restructuring Group

Holders of trademark licenses can breathe a sigh of relief after the Supreme Court issued its decision on May 20, 2019, in *Mission Product Holdings, Inc. v. Tempnology, LLC*[1] holding that a debtor-licensor's rejection of a trademark licensing agreement under section 365 of the bankruptcy code does not automatically terminate the licensee's right to continue using the trademark. Instead, the Court determined that rejection operates as a breach of the licensing agreement and the consequences of the breach are determined by non-bankruptcy law. According to the Court, non-bankruptcy law generally provides that the licensee may continue to pay for and use the trademark (barring any contrary contract term or state law), notwithstanding the licensor's breach. Consequently, the *Tempnology* decision should give trademark licensees greater leverage in negotiating with distressed companies who are in the process of, or are contemplating, a restructuring.

I. Bankruptcy Code Framework

Before the Supreme Court took up the issue in *Tempnology*, courts were split over how certain subsections in section 365 of the Bankruptcy Code should be read, specifically subsections 365(a), (g), and (n). To best understand the *Tempnology* decision, a review of those provisions is helpful. Section 365(a) of the Bankruptcy Code provides a debtor the right to assume or reject an "executory" contract (meaning a contract where "performance remains due to some extent on both sides"[2]), subject to court approval.[3] Section 365(g) of the Bankruptcy Code provides that rejection of an executory contract "constitutes a breach of such contract" and such rejection is deemed to occur "immediately before" the bankruptcy case, giving rise to a prepetition unsecured claim against the bankruptcy estate.[4] Such unsecured claims are likely to receive only cents on the dollar in a typical bankruptcy case.[5]

In 1988, however, Congress added section 365(n) to the Bankruptcy Code, which provides that when the debtor rejects a contract under which it is a licensor of "intellectual property," the licensee can choose to either (a) treat the contract as terminated or (b) retain its rights under the contract.[6] "Intellectual property" is a defined term under the Bankruptcy Code that is not intuitive: the definition includes certain concepts like trade secrets, patents, and copyrights, but it omits trademarks, trade names, and service marks[7]—this omission was not unintentional as Congress intended to allow more

time for studying trademarks and the like and left the courts to determine how they should be treated.[8] Thus, by its terms, section 365(n) of the Bankruptcy Code is inapplicable to trademark licensees.

II. The Case Law Split

Section 365(n) was widely seen as Congress's repudiation of an earlier decision—*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[9]—which held that a debtor's rejection of a patent licensing agreement also revokes the debtor's grant of the patent license.[10] But, by not including "trademarks" in section 365(n) of the Bankruptcy Code, courts reasoned by negative inference that Congress intended for *Lubrizol* to control in the trademark context and for rejection to cut off a licensee's right to use a debtor's trademark post-rejection.[11]

In 2012, the Seventh Circuit disagreed with the premise of *Lubrizol* when it held in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*[12] that rejection does not preclude the continued use of a trademark. The court reasoned that section 365(g) of the Bankruptcy Code states that rejection of a contract constitutes a breach of the contract and that outside of bankruptcy a contractual breach does not eliminate rights the contract had already conferred on the non-breaching party.[13] Although rejection "convert[s]" a "debtor's unfulfilled obligations" to a prepetition unsecured damages claim, "nothing about this process implies that any rights of the other contracting party have been vaporized."[14] According to the *Sunbeam* court, that section 365(n) of the Bankruptcy Code does not include trademarks was simply an omission that did not codify nor disapprove of *Lubrizol* as applied to trademarks.[15]

III. Background in *Tempnology*

In *Tempnology*, the debtor, which had filed chapter 11, was a party to a licensing agreement under which it granted a nonexclusive trademark license. In accordance with section 365 of the Bankruptcy Code, the debtor rejected the agreement and later asked the bankruptcy court for a declaratory judgment confirming that the rejection also terminated the licensee's right to continue using the licensed trademarks. The bankruptcy court complied, and relying on *Lubrizol* and the negative inference view, held that the rejection also rescinded the trademark license.[16] The Bankruptcy Appellate Panel for the First Circuit (the "BAP") reversed, following the *Sunbeam* decision.[17]

In reversing the BAP, the First Circuit largely adopted the bankruptcy court's reasoning and relied on the unique features of trademark law, namely that trademark owners are required to monitor and exercise quality control over the trademark or risk losing their ownership rights in the trademark.[18] A licensor's failure to monitor a licensee's use of a trademark can lead to disastrous results, including the cancellation of the trademark.[19] The First Circuit reasoned that if rejection did not terminate the licensee's use of the trademark, the debtor would be forced to continue its monitoring activities post-rejection and this required monitoring would frustrate the Congressional purpose behind rejection: to "release the debtor's estate from burdensome obligations."[20]

IV. *Tempnology* Decision

Writing for the 8-1 Court majority,[21] Justice Kagan held that rejection does not "rescind" a contract, but rather simply constitutes a breach of the contract under section 365(g) of the Bankruptcy Code.[22]

According to the Court, a contractual breach "means in the [Bankruptcy] Code what it means in contract law outside bankruptcy," and the Court used a hypothetical to illustrate that a party in breach generally does not have the ability to rescind contractually granted interests.[23] In the Court's example,

a debtor leased a copier to a law firm and the debtor agreed to service it every month. If the debtor materially breached the lease by ceasing to service the copier, the law firm could either (a) continue to pay for using the machine and sue for damages or (b) cancel the contract, return the machine, and sue for damages.[24] According to the Court, the same options would follow from rejection in bankruptcy; and whether inside or outside of bankruptcy, the debtor could not take back the copier if the law firm went with option (a).[25] Similarly, the Court held that absent a special contract term or state law to the contrary, a breach of a licensing agreement "does not revoke the license or stop the licensee from doing what it allows."[26]

The Court believed that adopting the "rejection-as-rescission approach" would undermine the bankruptcy process.[27] Specifically, "[i]f trustees (or debtors) could use rejection to rescind previously granted interests, then rejection would become functionally equivalent to avoidance."[28] In that event, the Bankruptcy Code's narrowly tailored avoidance actions would be greatly expanded.

The Court also held that in disavowing *Lubrizol*, "Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g)" and rejected the negative inference view.[29] Instead, section 365(n) and other subsections in section 365 addressing a counterparty's rights following rejection "set[] out a remedial scheme embellishing on or tweaking the general rejection-as-breach rule."[30] For example, a licensee covered by section 365(n) that chooses to retain its rights post-rejection "must make all of its royalty payments; the licensee has no right to deduct damages from its payments even if it otherwise could have done so under non-bankruptcy law."[31]

Finally, the Court conceded that its decision "may indeed impede some reorganizations" because debtors may need to continue to "invest the resources needed to maintain a trademark," but the purpose of the Bankruptcy Code is not to "permit anything and everything that might advance [a restructuring]."[32] In her concurring opinion, Justice Sotomayor stressed the limits of the Court's holding, remarking that it did not give trademark licensees the "unfettered right to continue using licensed marks postrejection."[33] Rather, applicable non-bankruptcy law and the licensing agreement at issue could provide otherwise.[34]

V. Implications

After *Tempnology*, a trademark licensee should have greater confidence that it can continue using a trademark even when a licensor has moved to reject the licensing agreement in bankruptcy. While it is unclear which non-bankruptcy law that the Court alluded to would require a different result, licensors and licensees may wish to specify in their licensing agreements whether rejection in bankruptcy results in revocation of the licensee's continued use of intellectual property to avoid litigation over ambiguous agreements. In addition, to prevent a licensed trademark from being deemed abandoned and cancelled, it may be advisable for licensing agreements to address how the licensor's costs for monitoring the use of the trademarks will be funded following rejection. But trademark licensees ultimately need to be wary of placing too much reliance on the debtor's obligations under the terms of a licensing agreement. A debtor's breach of a pre-petition licensing agreement still only gives rise to prepetition claims as to which the debtor may be agnostic (particularly in cases where the debtor anticipates liquidating rather than reorganizing its business).[35]

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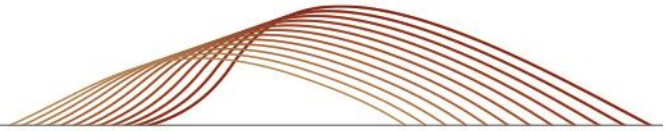

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1 No. 17-1657, 2019 WL 2166392 (U.S. May 20, 2019).

2 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984).

3 11 U.S.C. § 365(a).

4 *See* 11 U.S.C. § 365(g)(1).

5 *Tempnology*, 2019 WL 2166392, at *3.

6 *See* 11 U.S.C. § 365(n). If the licensee chooses to retain its rights under the contract, it must make all royalty payments due under the contract. *Id.* § 365(n)(2)(B). In return, the licensee waives any right of setoff it may have under the contract and the right to assert an administrative expense claim (a type of claim paid before general unsecured claims in bankruptcy) arising from performance under the contract. *Id.* § 365(n)(2)(C).

7 *See id.* § 101(35A).

8 S. Rep. No. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.

9 756 F.2d 1043 (4th Cir. 1985).

10 *Tempnology*, 2019 WL 2166392, at *7 (discussing this view and the *Lubrizol* decision).

11 *See, e.g.*, *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] trademark . . . ."); *In re HQ Glob. Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademarks stops on rejection."); *In re Exide Techs.*, 607 F.3d 957, 966 (3d Cir. 2010) (Ambro, J., concurring), as amended (June 24, 2010) (discussing position and collecting cases).

12 686 F.3d 372 (7th Cir. 2012).

13 *Id.* at 376–77.

14 *Id.* at 377.

15 *Id.*

16 *In re Tempnology, LLC*, 541 B.R. 1, 7 (Bankr. D.N.H. 2015).

17 *See In re Tempnology, LLC*, 559 B.R. 809, 822 (B.A.P. 1st Cir. 2016).

18 *See In re Tempnology, LLC*, 879 F.3d 389, 402-04 (1st Cir. 2018).

19 *See, e.g.*, *Barcamerica Int'l USA Tr. v. Tyfield Importers, Inc.*, 289 F.3d 589, 598 (9th Cir. 2002) (affirming lower court's finding that licensor had abandoned registered trademark by engaging in "naked" or uncontrolled licensing and that cancellation of trademark was appropriate).

[20] *Tempnology*, 879 F.3d at 402.

[21] Justice Gorsuch dissented on the grounds that the case appeared to be moot because the licensing agreement had expired by its terms. *Tempnology*, 2019 WL 2166392, at *10 (Gorsuch, J., dissenting).

[22] *Id*. at *1.

[23] *Id*. at *5.

[24] *Id*.

[25] *Id*. at *5–6.

[26] *Id*.

[27] *Id*.

[28] *Id*.

[29] *Id*. at *7.

[30] *Id*. at *7 n.2.

[31] *Id*. at *9 (Sotomayor, J., concurring) (citing 11 U.S.C. § 365(n)(2)(C)(i)).

[32] *Id*. at *8.

[33] *Id*. at *9 (Sotomayor, J., concurring).

[34] *See id*.

[35] Moreover, provisions in agreements that attempt to dictate the consequences of the debtor's exercise of a bankruptcy right, such as the right to reject, could be construed as falling within the prohibition in section 541(c)(1) of the Bankruptcy Code. This provision invalidates, among other things, provisions in agreements that restrict or condition a transfer of an interest in property by the debtor as well as provisions that are conditioned on the financial position of the debtor or on the commencement of a bankruptcy case that have the effect of modifying the debtor's interest in property. *See* 11 U.S.C. § 541(c)(1). To address potential section 541(c)(1) issues, and as an alternative to the drafting suggestions outlined above, the parties could instead have their licensing agreement generally address whether rejection or the failure to fund trademark monitoring costs constitutes a general breach of the agreement notwithstanding any applicable non-bankruptcy law to the contrary.