May 23, 2019

Supreme Court Holds Trademark License Not Terminated Upon Rejection in Bankruptcy

In an 8-1decision issued on May 20, the Supreme Court held that rejection of an executory trademark license agreement in a bankruptcy of the licensor is merely a breach, and not a termination or rescission, of the agreement. The licensee retains whatever rights it would have had upon a breach of the agreement prior to bankruptcy and can continue to use the trademarks pursuant to its contractual rights under applicable law. *Mission Product Holdings, Inc. v. Tempnology, LLC*, 587 U.S. ___, No. 17-1657 (May 20, 2019).

Background

Tempnology, a manufacturer of clothing and accessories designed to stay cool when used in exercise, marketed those products under the name "Coolcore" using trademarks to distinguish its products from other athletic apparel. In 2012, Tempnology granted Mission a non-exclusive license to use the Coolcore trademarks. Approximately nine months before the agreement's July 2016 expiration, Tempnology filed a petition for relief under Chapter 11 of the Bankruptcy Code and, with the bankruptcy court's approval, rejected the license agreement under Section 365(a) of the Bankruptcy Code. Section 365(g)(1) of the Bankruptcy Code provides that "rejection of an executory contract . . . of the debtor constitutes a breach of such contract . . . immediately before the date of the filing of the petition." The rejection of an executory contract excuses further performance by the debtor and any claim arising from the breach of contract is a pre-petition claim that typically is paid only cents on the dollar.

The parties agreed that rejection of the trademark license relieved Tempnology of further performance of its obligations under the agreement and that Mission could assert a pre-petition claim for damages resulting from Tempnology's non-performance. But Tempnology subsequently sought declaratory relief that rejection of the license agreement terminated the rights of Mission to use the Coolcore trademarks. The bankruptcy court, relying on a negative inference drawn from special provisions in the Bankruptcy Code giving the counterparty to certain rejected contracts the right to keep exercising its contractual rights after rejection, held that because no such provision applies to trademark licenses, the rejection of the trademark license agreement revoked Mission's right to use the trademarks. In particular, Section 365(n) of the Bankruptcy Code gives certain rights to the counterparties to rejected patent and copyright licenses to continue to use the intellectual property, but that section does not apply to trademark licenses.

The Split in the Circuit Courts

The Bankruptcy Appellate Panel for the First Circuit, relying heavily on the Seventh Circuit's decision in *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC*, reversed, holding that the rejection of the license agreement was merely a breach of the contract and did not

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"terminate the contract" or "vaporize[]" the counterparty's rights. 559 B. R. 809, 820-22 (B.A.P. 1st Cir. 2016) (quoting *Sunbeam*, 686 F.3d 372, 377 (7th Cir. 2012)). The Court of Appeals for the First Circuit, in a 2-1 decision, rejected the BAP's and Seventh Circuit's view and reinstated the bankruptcy court decision, endorsing the bankruptcy court's negative inference drawn from Section 365(n). *In re Tempnology, LLC*, 879 F.3d 389 (1st Cir. 2018). The Supreme Court granted Mission's petition for certiorari to resolve the split between the circuit courts.

Supreme Court Ruling

Reversing the First Circuit, the Supreme Court reasoned that "both Section 365's text and fundamental principles of bankruptcy law" require a holding that the rejection of the trademark license is merely a breach of contract and that the counterparty retains whatever rights it would have had upon a breach of contract prior to bankruptcy (except that, in bankruptcy, its claim for breach damages is deemed to be a pre-petition claim).

The Court rejected Tempnology's two principal arguments—that executory contracts are terminated upon rejection unless there is a special exception in the Bankruptcy Code, and that forcing Tempnology, post-rejection, to monitor and exercise quality control over the goods sold with its trademarks was burdensome. The Court observed that the special bankruptcy exceptions that give tenants the option under rejected real property leases to remain in the premises and licensees of patents and copyrights the option to retain their intellectual property rights, were not a carefully constructed scheme of narrowly tailored exceptions, but "emerged at [] different time[s] over a span of a half a century" to address specific problems. Although the legislative history regarding the enactment of section 365(n)'s protection for patent and copyright licensees makes clear that Congress intended to repudiate the holding of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* 756 F.2d 1043, 1045-48 (4th Cir. 1985) that rejection of a patent license terminated the licensee's rights, the Court rejected any negative inference that Congress intended that trademark licenses (and every other kind of executory contract) were otherwise subject to the *Lubrizol* holding. Moreover, the Court noted, Tempnology's argument failed to give any meaning to Section 365(g)'s general provision that rejection of an executory contract constitutes a breach.

The Court also rejected Tempnology's argument that because a trademark owner may need to expend resources to monitor and exercise quality control over the goods and services sold under a trademark license or risk losing the trademark or its value, anything short of termination of the license would leave Tempnology with an ongoing, post-rejection burden hampering its ability to reorganize. Observing that under Tempnology's reading of Section 365, unless a contract falls within an express statutory exception, rejection of the contract constitutes termination, the Court rejected Tempnology's attempt to use the distinctive features of trademarks to have the Court adopt a construction of Section 365 that would govern not only trademark agreements, but nearly every executory contract. "However serious Tempnology's trademark-related concerns, that would allow the tail to wag the Doberman."

Agreeing that the Bankruptcy Code aims to make reorganizations possible, the Court cautioned that "it does not permit anything and everything that might advance that goal." In allowing the debtor to escape its future contractual obligations through rejection, "Section 365 does not grant the debtor an exemption from all the burdens that generally applicable law—whether involving contracts or trademarks—imposes on property owners." In enacting the provisions of Section 365, "Congress also weighed (among other things) the legitimate interests and expectations of the debtor's counterparties." Section 365(g)'s edict that rejection of an executory contract constitutes a breach "expresses a more complex set of aims than Tempnology acknowledges."

Justice Gorsuch, the sole dissenter, believed that the case was moot and should not have been decided because the license had expired and he did not believe that Mission suffered any damages caused by Tempnology.

Conclusion

The Supreme Court's decision should give comfort to licensees of trademarks who have the contractual rights to continue to use the trademarks after a breach by their licensor that a rejection of the license in a licensor's bankruptcy will not strip the licensee of those rights. The decision also may afford trademark licensees a better set of rights in some respects than copyright and patent licensees under Section 365(n), particularly if the copyright or patent licensee does not require any further performance or turnover of intellectual property from the licensor. Section 365(n) requires licensees to elect whether to treat a rejected license as terminated or to keep its rights to the intellectual property (including exclusivity rights but excluding any other specific performance of the license). If the copyright or patent licensee elects to keep the intellectual property, it must make all royalty payments and waive any right of setoff it may have with respect to the license and any administrative priority claim arising from performance of the license. No such waiver obligations are imposed on counterparties to trademark licenses or other executory contracts.

Section 365(n) was intended primarily as a shield to protect copyright and patent licensees from a forced termination of their rights to the intellectual property as the *Lubrizol* court held, but also required licensees to continue to pay royalties and waive certain rights. It is unclear after *Mission Product* whether copyright and patent licensees will have an option upon rejection to try to keep their rights as a counterparty to a breached contract without complying with Section 365(n) or whether Section 365(n) will become a sword for the bankruptcy estate forcing compliance with its provisions as the only method by which copyright and patent licensees may retain their intellectual property after rejection of their license.