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INTELLECTUAL PROPERTY & CREDITORS' RIGHTS AND BUSINESS RESTRUCTURING
ALERT
JUNE 2019

Supreme Court: Licensees Retain Trademark Rights After Rejection Under Section 365 of the Bankruptcy Code

By Daniel M. Pereira

On May 20, 2019, the U.S. Supreme Court issued its decision in *Mission Product Holdings, Inc. v. Tempnology, LLC*, resolving what was substantively one of the more significant circuit court splits existing under the Bankruptcy Code. The Court's decision hands a clear victory to trademark licensees, and provides some certainty regarding the continued viability of a licensee's trademark rights following the bankruptcy filing of a counterparty licensor.

Background

The issue before the Court in its simplest terms was whether a bankruptcy debtor/licensor's rejection of a trademark licensing agreement under Section 365 of the Bankruptcy Code terminates the licensee's trademark rights. Mission Product Holdings, the trademark licensee, contended that a debtor trademark owner's rejection of a licensing agreement under Section 365 should leave in place the rights a licensee would otherwise have upon a breach outside of bankruptcy. The debtor, Tempnology, argued that its rejection should terminate the licensee's right to continue using the trademarks in question.

In the licensing agreement at issue, Tempnology gave Mission Product Holdings, among other things, a non-exclusive license to use Tempnology's "Coolcore" trademarks and logo on athletic apparel sold in Mexico. After filing for Chapter 11 bankruptcy protection, Tempnology rejected the licensing agreement and asserted that its rejection terminated Mission Product's right to use its trademark. Both the bankruptcy court and the U.S. Court of Appeals for the First Circuit agreed with the debtor and held that Mission Product Holdings' rights to continue using the debtor's trademark terminated as a result of the rejection.

One of a debtor's most powerful tools in bankruptcy is the ability to decide whether to assume or reject its executory contracts – contracts in which some form of performance remains due from both sides. The courts give great deference to a debtor's decision to reject a contract under the "business judgment" rule and debtors wield the rejection power to shed onerous or unfavorable contracts. Section 365(g) of the Bankruptcy Code provides that "the rejection of an executory contract [ ] constitutes a breach of such contract" occurring immediately before the filing of the bankruptcy. One result of rejection, therefore, is that the non-debtor counterparty receives an unsecured claim against the bankruptcy estate for rejection damages. Pursuant to the Bankruptcy Code's rules for distributions, this means that a counterparty whose contract is rejected rarely will be fully compensated for the losses it suffers as a result.

Lower Court Split

Leading up to the Court's decision in *Mission Product Holdings*, the lower courts had reached conflicting determinations as to whether a debtor's rejection under Section 365 terminates a licensee's right to continue using a trademark. This divergence among the courts had its genesis in a 1985 decision by the Fourth Circuit holding that a debtor's rejection of a licensing agreement terminated the counterparty's patent rights. *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985). In response, Congress added Section 365(n) to the Bankruptcy Code which expressly gives a licensee of "intellectual property" the option either to treat rejection as a termination of the licensing agreement or to retain its rights as they existed prior to the bankruptcy.

Unfortunately, although the Bankruptcy Code's definition of "intellectual property" includes such things as trade secrets, patents, and copyrights, the definition does not explicitly list trademarks. 11 U.S.C. § 101(35)(A). Partially as a result of this omission, some courts concluded that for trademarks a rejection terminates the licensee's rights, unlike the forms of intellectual property explicitly listed in the definition. *See, e.g., In re Global Holdings, Inc*., 290 B.R. 507, 513 (Bankr. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property . . . the Franchisees' right to use the trademark stops on rejection."). Other courts, most notably the Seventh Circuit, came to the opposite conclusion. In a well-reasoned decision by Judge Easterbrook in *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC,* 686 F.3d 372, 376-77 (7th Cir. 2012), the Seventh Circuit held that rejection does not terminate a licensee's trademark rights because under Section 365(g), rejection constitutes a breach and under non-bankruptcy law a breach does not ordinarily terminate the licensee's trademark rights. The U.S. Supreme Court granted cert in *Mission Product Holdings* in order "to resolve the division between the First and Seventh Circuits."

Justice Kagan's Majority Opinion

Justice Kagan – writing for an 8-1 majority of the court – concluded that because "breach" is not a defined or specialized bankruptcy term, the term "means in the Code what it means in contract law outside bankruptcy." As explained by Justice Kagan, under non-bankruptcy contract law, a party's breach of an executory contract ordinarily gives the counterparty the right either to treat the contract as terminated or to continue performing its obligations and enforcing its rights under the contract. Therefore, a trademark licensee whose licensing agreement has been rejected, likewise has the same choice, including the right to continue using the marks in question.

The Court also observed the general bankruptcy axiom that "[t]he [bankruptcy] estate cannot possess anything more than the debtor itself did outside bankruptcy." Accordingly, because rejection under Section 365 is the equivalent of a non-bankruptcy breach and outside of bankruptcy a licensor does not have the power to unilaterally rescind a licensee's trademark rights, Section 365 preserves the licensee's rights and ensures that a debtor does not receive a greater interest in the trademarks than it would otherwise have outside of bankruptcy.

In addition, the Court noted the Bankruptcy Code's "stringent limits" on a debtor's power to pursue avoidance actions. Unlike Section 365's rejection power "which may be exercised for any plausible economic reason," a debtor's avoidance powers are narrowly circumscribed by the Bankruptcy Code. Therefore, a reading of Section 365 that permits a debtor to use the broad power of rejection to effect an avoidance of a licensee's trademark rights would improperly undermine the otherwise limited scope of a debtor's avoidance powers.

The Court rejected Tempnology's primary argument that certain subsections of Section 365 expressly preserve a counterparty's contractual rights upon rejection, but not for the termination of a licensee's trademark rights. The Court rejected this "negative inference" argument, observing that the legislative history of these subsections shows they were added to Section 365 in piecemeal fashion over a span of 50 years, "as often as not, correcting a judicial ruling of just the kind Tempnology urges." The Court concluded, therefore, that Congress, by its enactment of each of these provisions, has demonstrated its disapproval of the view that rejection terminates contractual rights.

Finally, Tempnology had argued that permitting a licensee to continue using trademarks after rejection would require licensors in bankruptcy to expend scarce resources to monitor trademarks to protect their integrity or forgo the value that such marks could otherwise realize for the bankruptcy estate. The Court, however, noted that this argument directly conflicted with Tempnology's primary argument – that rejection results in a counterparty's loss of contractual rights unless Congress has enacted some provision specifically protecting the rights in question. Accordingly, the Court refused to rest its interpretation of Section 365 on special considerations of trademark law where its decision would have an impact on a variety of other kinds of executory contracts. Further, as the Court observed, debtors frequently must make difficult economic choices on how to expend limited resources in order to preserve something of value for the bankruptcy estate, and Section 365 is not intended to relieve them of that burden.

Impact of the Decision

The Court's decision is a major victory for trademark licensees. Due to the conflicting decisions by the lower courts on this issue, trademark licensees previously faced significant uncertainty whenever a trademark owner filed for bankruptcy protection. It is not difficult to imagine the significant financial havoc that might result from a licensor's ability to unilaterally terminate a licensee's trademark rights. Under the interpretation of Section 365 reached by the First Circuit and urged by Tempnology, entire business plans, marketing strategies and product lines could be unilaterally unraveled by a debtor's decision to reject unfavorable trademark agreements. Further, because the bankruptcy courts, applying the business judgment rule, afford great deference to a debtor's decision to reject executory contracts, trademark licensees would have little leeway in protecting their rights even where the result might be highly inequitable or even prove ruinous to their business.

At the same time that the Court's decision provides a level of predictability for trademark licensees, it also gives licensees a choice. The Court's decision makes clear that licensees whose agreements are rejected may choose to treat the contract as terminated, provided they could otherwise do so upon a breach. In this way, a licensee unhappy with the terms of its agreement or afraid of the consequences of the licensor's bankruptcy can take advantage of a debtor's rejection by electing to simply treat the agreement as terminated.

Despite the importance and clarity of the Court's decision, certain ramifications remain unclear. As highlighted by the concurring opinion of Justice Sotomayor, "the baseline inquiry remains whether the licensee's rights would survive a breach under applicable nonbankruptcy law" including applicable state law and the contractual terms in a given case. To some extent, bankruptcy courts will now necessarily have to wade in and grapple with interpreting trademark licenses where questions arise regarding the scope of a licensee's rights and obligations under non-bankruptcy law. And licensors will not be left without some element of control in certain situations. For example, where a trademark license agreement's quality control provisions require a licensee to incorporate a part or ingredient supplied by the licensor into its final product, the licensee may still be unable to continue using the marks in question where rejection relieves the debtor of its obligation to supply the component part or ingredient. After all, whatever rights the licensee retains after rejection, it's also clear that rejection relieves the licensor of its obligations. Further, although so-called *ipso facto* clauses – provisions which alter contractual rights upon the filing of a bankruptcy – are generally unenforceable in bankruptcy, in the future creatively drafted quality control provisions might be incorporated into licensing agreements to create some form of escape hatch and shift an element of control back to debtor licensors.

The Court's decision will also certainly have ramifications for other forms of contracts as well. Although the exact implications will emerge on a case-by-case basis, it is not difficult to imagine counterparties, such as individuals whose employment contracts are rejected, utilizing the Court's decision to more forcefully seek enforcement of contractual rights that they previously may have perceived as fatally undermined by rejection.

In short, this important Supreme Court decision serves to both settle some crucial questions at the intersection of intellectual property law and bankruptcy law, as well as provide some leverage to trademark licensees and other contract parties who find themselves facing potential rejection of their contracts by counterparty debtors under the Bankruptcy Code. ◆

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