ALERT MEMORANDUM

Supreme Court Holds Trademark Licensees Retain Rights Post-Rejection in Bankruptcy

May 22, 2019

On May 20, 2019, the U.S. Supreme Court held that a trademark licensee will retain its rights to use licensed trademarks following a debtor-licensor's rejection of a trademark license in its bankruptcy proceeding, subject to the terms of such agreement and applicable state law. *See Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 2019 WL 2166392 (U.S. May 20, 2019) ("*Tempnology*"). This decision, consistent (in result though not necessarily in reasoning) with court decisions in the Third[1] and Seventh[2] Circuits and in direct conflict with previously-established case law from the First[3] and Fourth[4] Circuits, settled an ongoing circuit split that had been at the forefront of the trademark licensing landscape for decades.

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[1] *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).
[2] *Sunbeam Prods., Inc. v. Chi. Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012).
[3] *Mission Prod. Holdings, Inc. v. Tempnology LLC* (*In re Tempnology*), 879 F.3d 389 (1st Cir. 2018).
[4] *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers*), 756 F.2d 1043 (4th Cir. 1985).

Background

Section 365 of the Bankruptcy Code enables a debtor to assume or reject any executory contract, including a trademark license. Once the contract is rejected, pursuant to Section 365(g) of the Bankruptcy Code, it is deemed to have been breached by the rejecting party immediately prior to the petition date, giving rise to a pre-petition claim for damages.

Section 365(n) of the Bankruptcy Code explicitly preserves the “intellectual property” (as defined in 11 U.S.C. § 101) rights of a non-debtor licensee following a debtor-licensor’s rejection of a license agreement, ensuring that licensee’s right to continue to use such “intellectual property” persists post-rejection. However, the definition of “intellectual property” in 11 U.S.C. § 101 includes patents, copyrights and trade secrets but omits trademarks. Legislative history indicates that Congress intentionally omitted trademarks from Section 365(n) of the Bankruptcy Code in order “to allow the development of equitable treatment of this situation by bankruptcy courts.”[5] Accordingly, the scope of protection that Section 365 of the Bankruptcy Code affords to non-debtor trademark licensees following a debtor-licensor’s rejection of a trademark license agreement has been the subject of ongoing debate, generating significant uncertainty and a longstanding split in authorities both in the circuit and lower courts.

Overview of The Split

In light of the ambiguity surrounding the treatment of non-debtor trademark licensees, many courts had held that a licensee’s rights under licensed trademarks continue unaffected following rejection of the underlying license. These courts reasoned that rejection does not constitute termination under a “plain reading” of Section 365(g) of the Bankruptcy Code[6], and/or have adopted an interpretation of Section 365(n) of the Bankruptcy Code that does not preclude its application to the licensee’s trademark rights.[7]

Other courts[8], including the First Circuit decision below in *Tempnology*, held that, to the contrary, a debtor-licensor’s rejection of an executory trademark license extinguishes a licensee’s right to use the licensed trademarks and that, under a plain textual reading, none of the protections available under Section 365, including Section 365(n), apply. In coming to this conclusion, the majority of such courts drew a negative inference from Congress’s omission of trademarks from the Bankruptcy Code’s definition of “intellectual property” [9].

Some courts have even avoided the issue of the consequences of rejection altogether by finding that the trademark license that was the subject of the litigation was not executory when considered part of a set of related transaction agreements, and thus could not be rejected.[10]

Open Question

To resolve the split, the Supreme Court granted certiorari on the question of whether a debtor-licensor’s rejection of a trademark license agreement terminates a licensee’s rights to use the licensed marks.

Petitioner’s Argument (on behalf of the Non-Debtor Licensee)

— Petitioner’s primary argument was that outside of bankruptcy, the breach of an agreement does not terminate rights that a contract has already

[5] *See* S. Rep. No. 100-505, at 5 *as reprinted in* 1988 U.S.C.C.A.N. 3200, 3204.
[6] *See Sunbeam Prods.*; *See also In re Exide Techs.* (Ambro, J., concurring); *See also In re SIMA Int’l, Inc.*, 2018 WL 2293705 (Bankr. D. Conn. May 17, 2018).
[7] *See In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014) (holding that that Section 365(n) left open the opportunity for bankruptcy courts to exercise their equitable powers to decide whether a trademark licensee retains rights to use the licensed trademarks post-rejection).
[8] *See In re Tempnology*; *See also In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); *See also In re HQ Glob. Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003); *See also In re Richmond Metal Finishers*.
[9] *See In re HQ Glob. Holdings* at 513; *See also In re Tempnology*.
[10] *See In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014); *See also In re Exide Techs.*

conferred on a non-breaching party, so a rejection in bankruptcy cannot do so either. In other words, rejection is not rescission of the agreement. Instead, rejection merely converts a debtor-licensor's breach of its unfulfilled obligations to a pre-petition damages claim.

Respondent's Argument (on behalf of the Debtor-Licensor)

— Respondents, on the other hand, drew a negative inference from Congress's failure to protect trademarks under Section 365(n) of the Bankruptcy Code, arguing rejection terminates the agreement as a whole, including any license rights. Respondents further reasoned that a debtor-licensor's need to continue to monitor quality control (if a licensee's rights persisted) would be contrary to Congress's principal aim of using rejection of contracts as a means of releasing the debtors from burdensome obligations.

SCOTUS Holding

In a 7-1-1 opinion (the dissent did not reach the merits of the trademark question), the Supreme Court held that:

— Because rejection in bankruptcy constitutes a pre-petition breach pursuant to Section 365(g) of the Bankruptcy Code, rejection has the same consequences as a contractual breach outside of the bankruptcy context in that rejection cannot rescind rights that a contract previously granted. In the trademark license context, rejection provides the debtor-licensee with a claim for damages, while preserving the non-debtor licensee's rights under the agreement.

— To illustrate how rejection works under contract law, the Supreme Court employed an analogy of a law firm leasing a photocopier from a dealer. The Court reasoned that if the dealer stopped servicing the machine (materially breaching the agreement), the law firm could, subject to the agreement's contractual terms and state law, (i) continue to pay for use of the photocopier and sue the dealer for damages or (ii) halt its payments, return the photocopier and sue the dealer for damages. However, the *dealer* could <u>not</u> use its own breach as an excuse to unilaterally terminate the agreement. Similarly, if a debtor-licensor rejects its agreement (resulting in a breach of the agreement immediately prior to the filing of the petition), such licensor may not use its own breach as an excuse to terminate the license – instead, licensee may choose how to proceed and collect damages.

The Supreme Court debunked Respondent's arguments, reasoning:

— A debtor-licensor's estate cannot possess more than it did before the bankruptcy filing. If rejection rescinded a licensee's rights, this principle would circumvent the Bankruptcy Code's narrow limitations on "avoidance" actions (cabined to Sections 544 to 553 of the Bankruptcy Code) under which debtors may unwind pre-bankruptcy transactions that undermine the bankruptcy process only in very limited circumstances.

— A negative inference should not be drawn from Congress's failure to expressly protect trademarks under Section 365(n) of the Bankruptcy Code because a negative inference would turn on its head the natural reading of the more general provision of Section 365(g) of the Bankruptcy Code – that rejection merely constitutes a breach. The Supreme Court even went so far as to say that in adding certain protections for licensees, such as Section 365(n), the legislative record may reflect Congress's need to reinforce the general rule that contractual rights survive rejection.

— The specific aspects of trademark law (i.e., a debtor-licensor's need to choose between expending resources on quality control in respect of an unwarranted licensee and risking the invalidation of the licensed trademarks) should not dictate the Supreme Court's general construction of Section 365 of the Bankruptcy Code, which governs a significantly larger scope of contracts than just trademark licenses.

Concurrence

Justice Sotomayor concurred with the majority opinion, agreeing that rejection causes a breach of contract rather than a termination of the rights thereunder, and clarifying her view that a debtor-licensor's rejection of a trademark license agreement *could* result in the rescission of licensee's trademark rights if the contractual terms of the rejected agreement or applicable state law provided for such rescission upon a breach by a debtor-licensor (an unlikely scenario).

The concurrence also noted that, in light of this ruling, a non-debtor trademark licensee's rights and remedies following a debtor-licensor rejection are more expansive in some respects than those possessed by non-debtor licensees of "intellectual property" that fall under Section 365(n) of the Bankruptcy Code (e.g., a patent licensee must, in order to retain its license rights pursuant to Section 365(n), make all of its royalty payments and waive any setoff payments, while a trademark licensee may have the right to set off damages from such royalty payments if it could have done so under non-bankruptcy contract law). In highlighting this discrepancy, the concurrence calls on Congress to tailor a provision of Section 365 of the Bankruptcy Code for trademark rights, demonstrating that even though this circuit split is finally resolved, a legislative solution narrowly tailored to cover trademarks may still be the optimal solution and the Supreme Court's preference.[11]

Dissent

Justice Gorsuch, failing to reach the case on the merits, dissented arguing that the case should not have been accepted, as any claim of relief became moot when the license expired.

Implications of *Tempnology*

Tempnology has finally resolved the longstanding circuit split concerning the effect of a rejection of a trademark license agreement in bankruptcy, infusing certainty into the trademark license landscape and preventing further cherry-picking of venues. Trademark licensees are now more capable of entering into agreements with licensors without carefully conducting due diligence into the finances of such licensors out of fear of losing their carefully negotiated trademark rights.

As noted in the *Tempnology* opinion, debtor-licensors will now be forced to choose between "expending scarce resources on quality control and risking the loss of a valuable asset".[12] Because failure to exercise quality control can result in naked licensing and eventual risk of abandonment of a trademark under non-bankruptcy law, most debtor-licensors will choose to continue to control the quality of the licensed goods and services, at least to the extent required to avoid a claim of abandonment of the trademarks concerned. To provide themselves with additional protection, trademark licensees may wish to negotiate the right to (at least if a licensor fails in its first right) maintain the licensed trademark applications and registrations themselves to prevent abandonment.

In any event, in light of this ruling, certain strategic arrangements and contractual provisions (e.g., trademark security interests and bankruptcy remote special purpose vehicles) previously implemented by licensees to protect their rights in the event of a rejection of a trademark license by a debtor-licensor may no longer be necessary if their sole purpose is to preserve the licensees' rights upon rejection.

Furthermore, if in the past bankrupt estates considered using rejection as a means of increasing the value of their trademark assets because their outbound trademark licenses could be extinguished upon rejection and the trademarks could be sold

[11] The Innovation Act, H.R. 3309, 113th Cong. (2013), a proposed statutory amendment that extends the protections under Section 365(n) of the Bankruptcy Code by expanding the definition of "intellectual property" in the Bankruptcy Code to include trademarks, service marks and trade names, was passed by the House of Representative on December 5, 2013, but not the Senate. The Innovation Act was reintroduced in February of 2015, but has not yet passed.

[12] *Tempnology*, at *8.

unencumbered, this decision renders this practice ineffective.

The decision in also helpful in clarifying non-debtor licensees' rights with respect to non-U.S. intellectual property (including non-U.S. trademarks, patents, copyrights and trade secrets). Because there has been some uncertainty as to whether Section 365(n) of the Bankruptcy Code applies to non-U.S. intellectual property rights in light of how "intellectual property" is defined in the Bankruptcy Code, *Tempnology* clarifies that upon rejection of an intellectual property license by a debtor-licensor, licensed non-U.S. intellectual property will continue in full force and effect, subject to the terms of the agreement and applicable law, in the same way as U.S. licensed trademark rights would.

The Supreme Court's broad application of Section 365(g) also serves as a strong reminder that even in contexts outside of trademark licenses, debtor and non-debtor contracting parties alike must consider the implications that a "rejection-as-breach" approach (and not a "rejection-as-rescission" approach) will have on non-debtor parties' rights. Contracting parties should look to the contractual terms of the applicable agreements as well as applicable non-bankruptcy law to determine what rights survive post-rejection. It is likely that contract counterparties will consider how the Supreme Court's ruling may either create or bolster their ability to preserve ongoing rights if a contract is rejected in bankruptcy. The analysis of a non-debtor's rights post-rejection and the potential cost to a debtor of the non-debtor continuing to operate under the contract should influence whether a debtor ultimately decides to assume or reject the agreement.

Finally, the decision calls into question the significance of Section 365(n) of the Bankruptcy Code, other than in outlining additional requirements by which "intellectual property" licensees must abide. As the concurrence noted, following this decision, trademark non-debtor licensees' rights and remedies following a debtor-licensor rejection are more expansive in some respects than those possessed by non-debtor licensees of "intellectual property", and it appears that only a legislative fix will remedy this discrepancy and clarify the purpose of Section 365(n).

For additional information, click here for our prior memorandum on the circuit split, click here for our prior memorandum on the Eight Circuit's position and here for our prior memorandum on the Seventh Circuit's position.

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