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Will Rejection of a Trademark License by a Bankrupt Licensor Bar the Non-debtor Licensee From Continuing to Use the Mark?

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By the time you read this, the Supreme Court of the United States will have heard argument in *Mission Product Holdings Inc. v. Tempnology LLC,*[1] in which the Court is expected to decide whether the rejection of a trademark license agreement by a debtor-licensor bars the non-debtor licensee from continuing to use the mark. So, what is the issue and how do we think the Court will analyze it? The one question on which the Court granted certiorari is: "Whether, under § 365 of the Bankruptcy Code, a debtor-licensor's 'rejection' of a license agreement—which 'constitutes a breach of such contract,' 11 U.S.C. § 365(g)—terminates rights of the licensee that would survive the licensor's breach under applicable nonbankruptcy law."[2]

Rejection of Agreements and the Interplay With Intellectual Property

Generally, rejection under § 365 of the Bankruptcy Code gives a debtor the ability to free itself of contracts and leases that are burdensome or not economically advantageous to it.[3] This should make logical sense—a company struggling financially can shed agreements that are causing or contributing to its financial predicament. In a Chapter 11 case, this right of the debtor is typically subject to the court's approval based on a two-part inquiry: (1) is the contract executory, meaning does performance remain due on both sides such that nonperformance by either would constitute a material breach of the agreement; and (2) did the debtor properly exercise its business judgment in deciding to shed the agreement?[4] If the answer to both questions is yes, then the debtor will typically be allowed to legally breach the contract and discontinue performance.[5] When a contract is rejected, it is treated as breached immediately before the date of the filing of the bankruptcy petition and the counterparty can file a claim against the bankruptcy estate, typically an unsecured claim for damages.[6] Because unsecured claims are subordinate in payment to secured claims, to the costs of administration of the estate (e.g., legal and other professional fees), and to priority claims (e.g., taxes), the unsecured claim for damages is unlikely to be paid in full.

Congress did create special circumstances in which the non-debtor counterparty has enhanced statutory rights. For example, if a debtor rejects an unexpired lease of real property under which the debtor is the landlord, "the lessee [tenant] may treat such lease as terminated by the rejection … [or] retain its rights under such lease … for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law."[7] In other words, the non-debtor tenant is "entitled to remain under the same rental terms as are set forth in the lease."[8]

Specific to intellectual property (IP) issues, and central to the *Mission Product* case, Congress provided that if a debtor rejects an executory contract under which the debtor is a licensor of a right to use IP, the licensee under such contract may elect to either treat the contract as terminated or "retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) … for (i) the duration of such contract; and (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law."[9] So, why might a non-debtor trademark licensee not be able to continue its use of the mark? Answer—a gap in the statutory language.

A Short History Preceding *Mission Product*

In 1985, the Court of Appeals for the Fourth Circuit decided *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*[10] As recently succinctly stated by noted bankruptcy scholar Bill Rochelle, author of the American Bankruptcy Institute's *Rochelle's Daily Wire*, "In *Lubrizol*, the Fourth Circuit held that rejection of an executory license for intellectual property precludes the non-bankrupt licensee from continuing to use the license. The decision prompted Congress three years later to add § 365(n) and the definition of 'intellectual property' in § 101(35A). Together, they allow a non-debtor to continue using patents, copyrights and trade secrets despite rejection of a license."[11] However, when the definition of IP became a part of the Bankruptcy Code it did not include trademarks: "The term 'intellectual property' means—(A) trade secret; (B) invention, process, design, or plant protected under Title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under Title 17; or (F) mask work protected under Chapter 9 of Title 17; to the extent protected by applicable nonbankruptcy law."[12] Thus, Congress did not add trademarks to the list of IP that a non-debtor licensee may continue to use despite rejection of a license agreement. *Lubrizol's* application to trademarks has not been overturned in the Fourth Circuit.

In the years following *Lubrizol*, and the addition of § 365(n), a circuit split has developed over whether a trademark licensee's rights survive rejection under § 365. For example, the Court of Appeals for the Seventh Circuit in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC* disagreed with the Fourth Circuit,[13] and stated: "outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property."[14] The court focused on the language in the Bankruptcy Code regarding the effect of a rejection of an agreement and stated "what § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance."[15] Thus, the court concluded that a rejection does not terminate the licensee's right to continue to use the trademark. The First Circuit's later decision in *Mission Product* disagreed with the Seventh Circuit in *Sunbeam*.

Mission Product Case Background

Tempnology LLC was a material innovation company that, among other things, developed chemical-free cooling fabrics.[16] On Sept. 1, 2015, Tempnology filed for relief under Chapter 11 of the Bankruptcy Code. The next day, Tempnology filed an omnibus motion to reject executory contracts, including a comarketing and distribution agreement that Tempnology had entered into with Mission Product three years earlier. The agreement, among other things, granted Mission Product a right to use Tempnology's trademark and logo.[17] The bankruptcy court entered an order allowing Tempnology to reject the agreement subject to Mission's election to retain its rights under § 365(n). Tempnology moved for a determination of the applicability and scope of Mission's rights under § 365(n) and argued, among other things, that § 365(n) did not cover the trademark license. The bankruptcy court held that Mission did not retain rights to use Tempnology's trademarks and logos post-rejection because "the omission of trademarks from the definition of intellectual property in § 101(35A) indicates that Congress did not intend for them to be treated the same as the six identified [IP] categories."[18]

Mission appealed to the Bankruptcy Appellate Panel (BAP) for the First Circuit.[19] The BAP affirmed in part and reversed in part. The BAP adopted the Seventh Circuit's interpretation of the effect of rejection and held that because § 365(g) deems the effect of rejection to be a breach of contract, and a licensor's breach of a trademark agreement outside the bankruptcy context does not necessarily terminate the licensee's rights, rejection under § 365(g) likewise does not necessarily eliminate those rights.[20]

The First Circuit reversed the BAP and stated "the approach taken by *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens."[21] The court noted that Congress' principal aim in providing for rejection was to "release the debtor's estate from burdensome obligations that can impede a successful reorganization."[22] Some of the burdens that the court identified were the licensor's obligations to control quality of the goods sold to the public under cover of the trademark and that a licensor's failure to monitor and exercise such control may result in a "naked license" or an abandonment of the trademark.[23] If Mission retained rights to Tempnology's trademarks that were not terminated by rejection, it would create a burden on Tempnology because Tempnology would be required to continue to monitor and exercise control over its trademarks or risk the validity of its trademarks.[24]

How Might the Supreme Court Decide *Mission Product*?

To predict how the Court may decide *Mission Product*, it might be instructive to look at Supreme Court bankruptcy decisions from 2017 and 2018 that focused on statutory construction.[25]

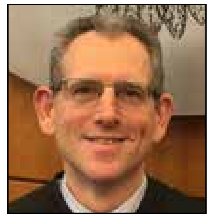
Certain prepetition conduct by a debtor can result in particular debts surviving the debtor's discharge. Section 523(a)(2)(A) can be used to bar discharge of debts arising from "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's … financial condition," and § 523(A)(2)(B) can be invoked to preclude discharge of debts arising from a written, materially false "statement … respecting the debtor's … financial condition." In *Lamar, Archer & Cofrin LLP v. Appling*, the Court addressed whether a debtor's oral statement concerning a single asset can be a "statement respecting the debtor's financial condition" under § 523(a)(2)(B).[26] The Court stated "our interpretation of the Bankruptcy Code starts 'where all such inquiries must begin: with the language of the statute itself.'"[27] After citing *Ransom v. FIA Card Services N.A.*,[28] the Court stated "the relevant statutory text is the phrase 'statement respecting the debtor's financial condition.' Because the Bankruptcy Code does not define the words 'statement,' 'financial condition,' or 'respecting,' we look to their ordinary meanings."[29] The majority opinion delivered by six justices held that any statement about a single asset can be a "statement respecting the debtor's financial condition" and therefore must be in writing to be actionable; the remaining three justices joined in the bulk of the opinion; there was no dissent.

The Bankruptcy Code also gives debtors and trustees the ability to recover certain types of pre-bankruptcy payments and other transfers. In *Merit Management Group LP v. FTI Consulting Inc.*, the Court considered the extent of a securities-related exemption from a trustee's avoidance powers under chapter 5 of the Bankruptcy Code.[30] The safe harbor found in § 546(e) can shield from recovery certain transfers "made by or to (or for the benefit of) a … financial institution."[31] The issue before the Court was whether this safe harbor applies to a transfer in which a financial institution was an intermediary in the transaction. The underlying dispute was a bankruptcy trustee suing a shareholder who received funds in the leveraged buyout of a nonpublic company. The parties had structured the transaction so that the purchase price for the stock initially came from an investment bank and was transferred to a commercial bank acting as escrow agent, which then paid the $16.5 million to the selling shareholder. After discussing the history of Congress amending the "securities safe harbor exception over the years, each time expanding the categories of covered transfers or entities" and finding that the plain language of the Code provides a reasoned answer, the Court in a unanimous opinion concluded that the plain meaning of § 546(e) dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid, here the $16.5 million the shareholder received, and not whether any transfer in the chain of transfers may fit within the definition of an exempted transfer to or for the benefit of a financial institution.[32]

The Bankruptcy Code also allows bankruptcy cases to be dismissed, either by request of the debtor or by other parties. In *Czyzewski v. Jevic Holding Corp.*, the issue was: Can a bankruptcy court approve a "structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent? [The Court's] simple answer to this complicated question is 'no.'"[33] Here, again, the Court paid homage to traditional rules of statutory construction and stated "we can find nothing in the statute that evinces this intent. The Code gives a bankruptcy court the power to 'dismiss' a Chapter 11 case. But the word 'dismiss' itself says nothing about the power to make nonconsensual priority-violating distributions of estate value. Neither the word 'structured,' nor the word 'conditions,' nor anything else about distributing estate value to creditors pursuant to a dismissal appears in any relevant part of the Code."[34] Six justices joined this opinion; two dissented, not based on the reasoning of the majority, but because they believed that certiorari was improvidently granted.

Following these examples of statutory construction from just the past two years and given a statute that has a relevant history of amendments in response to court decisions, the Court could reasonably conclude that by leaving trademark agreements out of the specific IP definition, Congress decided not to extend the same protections to trademark licensees as it did to other IP licensees. Further support for this statutory construction is that the language referenced above from § 365(h) allowing lessees of debtor/landlords to remain in possession of the leased premises is substantially similar to the provisions of § 365(n) allowing other IP licensees of debtor/licensors to continue usage of the licensed IP. The Court could further state that if this result is unfair or unreasonable, it is for Congress to remedy by further amending the statute.

Of course, there are a number of additional ways by which the Court could analyze the case that are beyond the scope of this article. We will all find out together. ⊙




Hon. Alan S. Trust is a U.S. bankruptcy judge for the Eastern District of New York. Michael A. Pantzer is a law clerk to Judge Trust. None of the statements contained in this article constitute official policy of any judge, court, agency, or government official or quasi-governmental agency.

Endnotes

[1] *Mission Prod. Holdings Inc. v. Tempnology LLC*, Case No. 17-1657 (S. Ct.). Oral argument was set for Wednesday, Feb. 20, 2019. *See* Supreme Court of the U.S., https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/17-1657.html (last visited Feb. 6, 2019).

[2] Petition for Writ of Certiorari, *Mission Prod. Holdings Inc. v. Tempnology LLC*, 2018 WL 2967405 (June 11, 2018) (No. 17-1657); *Mission Prod. Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 397 (2018) (granting certiorari).

[3] 11 U.S.C. § 365(a). The statute provides these powers to the "trustee." Generally, in Chapter 11 cases, the debtor-company acts as the trustee. *See* 11 U.S.C. § 1107(a).

[4] *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993); *In re Exide Techs.*, 607 F.3d 957, 962 (3d Cir. 2010), *as amended* (June 24, 2010).

[5] *See* 11 U.S.C. § 365(g)(1).

[6] *See* 11 U.S.C. § 502(g)(1).

[7] 11 U.S.C. §§ 365(h)(1)(A)(i), (ii).

[8] *See In re Revel AC Inc.*, 909 F.3d 597, 602 (3d Cir. 2018) (citations omitted).

[9] 11 U.S.C. § 365(n).

[10] *Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc.,* 756 F.2d 1043 (4th Cir. 1985).

[11] Bill Rochelle, *Supreme Court to Decide Whether Rejection Terminates Use of a Trademark*, Am. Bankr. Inst.: Rochelle's Daily Wire (Oct. 29, 2018), https://www.abi.org/newsroom/daily-wire/supreme-court-to-decide-whether-rejection-terminates-use-of-a-trademark.

[12] 11 U.S.C. § 101(35A).

[13] *Sunbeam Prods. Inc. v. Chicago Am. Mfg. LLC,* 686 F.3d 372, 378 (7th Cir. 2012); *see also In re Exide Techs.*, 607 F.3d 957, 967 (3d Cir. 2010) (Ambro, J., concurring) (bankruptcy court should use equitable powers to provide debtor with a fresh start without stripping trademark licensee of its rights).

[14] *Sunbeam,* 686 F.3d at 376.

[15] *Id.* at 377.

[16] *In re Tempnology LLC*, 541 B.R. 1, 2 (Bankr. D.N.H. 2015).

[17] *Id.* at 3.

[18] *Id.* at 8.

[19] Several circuits have BAPs; appeals of bankruptcy court decisions are directly made to a bankruptcy appellate panel unless a party elects to have the appeal heard by a district court; the BAP typically comprises three bankruptcy judges. The First Circuit is one such circuit and an appeal in that circuit is automatically heard by the BAP unless a party files an election to have the appeal heard by the district court. An appeal from a BAP then goes to the circuit court of

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