Trademark Licensees' Rights Survive Bankruptcy Rejection

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In Mission Product Holdings, the Supreme Court Endorses "Rejection-as-Breach" Rule and Interprets Broadly the Contract Rights that Survive Rejection

On May 20, 2019, the United States Supreme Court resolved one of the most important outstanding issues at the intersection of bankruptcy and intellectual property law, namely whether, under Section 365 of the Bankruptcy Code, a debtor-licensor's rejection of a trademark license terminates rights of the licensee that would survive the licensor's breach under applicable non-bankruptcy law. In an 8-1 decision in Mission Product Holdings, Inc. v. Tempnology, LLC,[1] the Court held that rejection does *not* terminate the licensee's rights because a "rejection breaches a contract but does not rescind it." The Court therefore adopted what it called a "rejection-as-breach" rule—holding that any contract rights that would survive a breach under non-bankruptcy law also survive a rejection in bankruptcy—and repudiated what it called a "rejection-as-rescission" rule.

The Supreme Court's expansive articulation of the rejection-as-breach rule could have implications that extend well beyond the trademark or intellectual property context, because this rule suggests that contractual rights under a rejected contract may survive in a more robust form than was often assumed and that counterparties to a rejected contract may continue to exercise such rights *in addition to* filing a claim in the bankruptcy case.

Background

Lubrizol, Sunbeam, and Section 365(n)

The background to the Mission case was a split of authority in the Circuit Courts of Appeals with respect to the issue of whether rejection of a trademark license terminates the licensee's rights.

This split had its origins in a broader debate between Congress and the courts with respect to the effect of rejection of intellectual property licenses more generally. This issue was most famously

[1] No. 17-1657, 2019 WL 2166392 (May 20, 2019).

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addressed by the Fourth Circuit in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,[2] which held that rejection of a *patent* (as opposed to a trademark) license "deprive[d] [the licensee] of all rights" under the license. Although Section 365(g) provided that rejection constitutes a "breach" rather than the termination of a contract, the Lubrizol court interpreted this provision as meaning merely that the licensee would "be entitled to treat rejection as a breach and seek a money damages remedy; however, [the licensee] could not seek to retain its contract rights in the [licensed] technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract."[3]

Congress reacted to Lubrizol by enacting Section 365(n) of the Bankruptcy Code, which sought "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy."[4]

Section 365(n)(1) only applies to "intellectual property" as defined in the Bankruptcy Code, however, and the Bankruptcy Code definition does not include trademarks.[5] Congress intentionally chose to exclude trademarks from the definition of "intellectual property" protected by Section 365(n), because "trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts."[6]

Thereafter, the treatment of trademark licenses following rejection remained an open issue. This issue was subsequently addressed by the Seventh Circuit in Sunbeam Products, Inc. v. Chicago American Mfg., LLC (In re Lakewood Eng'g & Mfg.),[7] which held that Congress's decision not to include trademarks in the Bankruptcy Code definition of "intellectual property" did not imply that Congress had adopted Lubrizol's reasoning in the case of trademark licenses; rather, this omission was "just an omission." Sunbeam went on to disagree with Lubrizol, holding that rejection of a

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[2] 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057, 106 S. Ct. 1285, 89 L. Ed. 2d 592 (1986).

[3] Id. at 1048.

[4] S. Rep. No. 100-505, at 1 (1988), reprinted in 1988 U.S.C.C.A.N. 3200, 3200 ("S.Rep.").

[5] Section 101(35A) of the Bankruptcy Code defines "intellectual property" to mean "(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." 11 U.S.C. § 101(35A).

[6] S. Rep. at 3204.

[7] 686 F.3d 372, 375 (7th Cir. 2012).

trademark license does not "vaporize" the rights of the licensee to use the licensed trademark and that rejection should not be used as a form of "avoidance power" to render void a licensee's rights to use a trademark.[8]

The Circuit Split (Mission vs. Sunbeam)

Despite the differences between the reasoning of Lubrizol and Sunbeam with respect to the treatment of intellectual property licenses, those two cases did not result in a direct split in circuit authority, because only Sunbeam dealt with trademark licenses. A direct circuit split arose in 2018, however, when the First Circuit, in Mission Product Holdings, Inc. v. Tempnology, LLC,[9] applied Lubrizol, rejected Sunbeam, and held that rejection of a trademark license rendered unenforceable the licensee's right to use the trademark.

The debtor in the Mission case, Tempnology, LLC, marketed clothing and accessories under the brand name "Coolcore" and related trademarks. In 2012, Tempnology gave Mission Product Holdings, Inc. a non-exclusive license to use the trademarks both in the United States and around the world. In September 2015, Tempnology filed for Chapter 11 bankruptcy protection and moved to "reject" the licensing agreement. The Bankruptcy Court approved the rejection, and Tempnology sought a declaratory judgment that its rejection of the contract also terminated the rights it had granted Mission to use the trademarks. The Bankruptcy Court agreed, holding that Tempnology's rejection of the licensing agreement revoked Mission's right to use the marks. But the Bankruptcy Appellate Panel reversed, relying on the reasoning of Sunbeam. The First Circuit in turn rejected both Sunbeam and the Bankruptcy Appellate Panel's reasoning, endorsed Lubrizol, and reinstated the Bankruptcy Court decision terminating Mission's license.

The Supreme Court granted certiorari to resolve the resulting split between the First Circuit (in Mission) and the Seventh Circuit (in Sunbeam). Through its May 20 decision, the Supreme Court resolved that split in favor of the Seventh Circuit's Sunbeam decision by reversing and remanding the First Circuit's ruling in Mission, and in the process, also rejecting the reasoning of Lubrizol.

Analysis

The Supreme Court arrived at its conclusion that rejection does not rescind a licensee's right to use a licensed trademark primarily by relying on Section 365(g) of the Bankruptcy Code, which defines rejection as a "breach." From this language—and by way of an elaborate hypothetical involving a photocopier—the Court derived its "rejection-as-breach" rule and repudiated a "rejection-as-rescission" rule. The Court also held that (i) the existence of provisions—such as 365(n)—that expressly preserve rights under some types of rejected contracts does not give rise to a negative

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[8] Id. at 377.

[9] 879 F.3d 389 (1st Cir. 2018).

inference that rights are *not* preserved under contracts that do not benefit from such special protections, and (ii) concerns unique to the trademark context are effectively irrelevant given that Section 365(g) applies universally both to trademark licenses and other types of contracts.

Section 365(g) is Controlling

The Court started its analysis with the text of the Bankruptcy Code, focusing especially on Section 365(g), which states that rejection "constitutes a breach of [an executory] contract" that is deemed to occur "immediately before the date of the filing of the petition." The Court pointed out that "breach" is not a specialized bankruptcy term, and took the position that this term therefore has the same meaning under the Bankruptcy Code as under non-bankruptcy contract law.

The Court then attempted to illustrate the non-bankruptcy meaning of "breach" by describing a hypothetical in which a dealer leases a photocopier to a law firm and agrees to service it every month in exchange for the firm's commitment to pay a monthly fee. If the dealer decided to breach the lease by ceasing to service the machine, the law firm would have the option *either* (i) to continue paying for use of the copier and sue the dealer for damages, *or* (ii) to terminate the contract, halt its own payments, and return the copier, while suing for any damages incurred.

The point of this hypothetical was that it is the *law firm's* choice, as the party suffering the breach, to decide whether to terminate the contract; the dealer, as the breaching party, has no ability to terminate the agreement based on its own breach. In other words, "The contract gave the law firm continuing rights in the copier, which the dealer cannot unilaterally revoke." The Court maintained that the result would be the same if the dealer in the hypothetical filed for bankruptcy and rejected the photocopier lease. The law firm would still have the option *either* to continue *or* to terminate the contract, while in either case *also* filing a claim in the bankruptcy case for any damages.

The Court next applied its "photocopier" hypothetical to the trademark context, noting that many trademark licenses resemble the hypothetical photocopier lease in that the licensor not only grants a license, but also provides associated goods or services during the term of the license, with the licensee agreeing to pay royalties or fees. Because rejection "constitutes a breach" under Section 365(g), a licensor that chooses to reject a trademark license in bankruptcy can take whatever actions would lead to a "breach" in the non-bankruptcy context, such as ceasing to provide whatever additional goods or services the license agreement requires. The debtor-licensor's breach (failing to provide additional goods and services) does not revoke the license—the licensee can continue to use the licensed intellectual property in whatever manner the license authorizes.

In addition to its hypothetical, the Court also invoked the "general bankruptcy rule"—familiar from cases such as Board of Trade of Chicago v. Johnson,[10] that the "estate cannot possess anything more than the debtor itself did outside bankruptcy." Under this rule as interpreted in Mission, whatever rights a debtor licensor granted to a licensee pre-bankruptcy do not even enter the bankruptcy estate created by Section 541 of the Bankruptcy Code.

The Supreme Court therefore appears to have assumed that a trademark license conveys an interest in *property* to the licensee rather than a mere contract right. In any event, the Court also used this "general bankruptcy rule" to justify, on a policy level, its selection of the "rejection-as-breach" rule over the "rejection as rescission" rule.

In the Court's view, the "rejection-as-breach" rule has the salutary effect of "prevent[ing] a debtor in bankruptcy from recapturing interests it had given up." Conversely, a "rejection-as-rescission" approach would effectively permit debtors to use rejection as a *de facto* avoidance power to avoid prepetition transfers of rights or property, thereby circumventing the Code's stringent limits on the types of "avoidance" actions that can be brought under Sections 544–553 of the Bankruptcy Code to return property to the estate.

Rejection of Negative Inference Argument

The Court rejected the debtor's arguments that would have circumvented the plain language of Section 365(g) and the Board of Trade rule and permitted the rescission of the trademark. Specifically, the Court held that the omission of trademarks from Section 365(n) (with its protections of intellectual property licensees) does not give rise to a negative inference that trademark licenses may be rescinded by rejection.

As noted above, Section 365(n) expressly provides that licensees of some intellectual property—but not trademarks—can choose to retain contractual rights after rejection. In the Court's view, the existence of these specialized provisions was insufficient to justify interpreting rejection in a bankruptcy case as generally having broader consequences than a breach under non-bankruptcy law.

Moreover, the Court noted that each of the more specialized subsections of Section 365 "emerged at a different time" and "responded to a discrete problem," in most cases by correcting a judicial ruling that interpreted a rejection as terminating contract rights. The Court cited a scholarly article to support its conclusion that "What the legislative record [reflects] is that whenever Congress has been confronted with the consequences of the [view that rejection terminates all contractual

[10] 264 U.S. 1, 15 (1924) (proceeds of sale of seat on exchange subject to exchange claims per Board of Trade rules; creditors can do no better inside bankruptcy than they could do outside bankruptcy).

rights], it has expressed its disapproval."[11] Therefore, the Court concluded that Congress merely enacted these more specialized provisions, as and when needed, "to reinforce or clarify the general rule that contractual rights survive rejection."

The Court focused, in particular, on Congress's enactment of Section 365(n) as a reaction to Lubrizol, noting that after the Fourth Circuit had held that a debtor's rejection of an executory contract worked to revoke its grant of a patent license, Congress sprang into action to ensure the continuation of patent licensees' rights. In the Court's view, Congress's repudiation of Lubrizol with respect to patent contracts did not demonstrate any intent to *ratify* Lubrizol's approach for other types of contracts, and instead constituted one example of Congress's rejection of the "rejection-as-rescission" rule.

Rejection of Trademark-Specific Arguments

The Court also rejected certain arguments by Tempnology that were unique to the trademark context—in part *because* these arguments were unique to the trademark context. Specifically, Tempnology argued that, unlike in the case of other types of intellectual property licenses, a trademark licensor must monitor and "exercise quality control over the goods and services sold," because otherwise the mark will naturally decline in value and may eventually become invalid. In Tempnology's view, this necessity of expending scarce resources on quality control in order to avoid losing the mark altogether could impede a debtor's ability to reorganize, thereby undermining a fundamental purpose of the Bankruptcy Code.

The Court rejected these arguments in part because Section 365 applies to contracts generally, not only to trademark licenses, meaning that it did not make sense in the Court's view to read Section 365 in light of concerns unique to trademark licenses. The Court also pointed out that, even though the Code aims to make reorganizations possible, it does not permit anything and everything that might advance that goal.

Section 365, in the Court's view, allows a debtor to escape all of its *future* contract obligations while only paying damages at the same rate as other prepetition unsecured claims, but it does not grant the debtor an exemption from all the burdens that generally applicable law imposes on property owners. In thus delineating the burdens that a debtor may and may not escape, Congress, in the Court's view, weighed not only the debtor's interests, but also the interests and expectations of the debtor's counterparties. The Court acknowledged that the resulting balance may impede some reorganizations, but found that this outcome merely reflected the fact that Section 365's

[11] See Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection", 59 U. Colo. L. Rev. 845, 928 (1988).

treatment of rejection as “breach” expressed a more complex set of aims than Tempnology wanted to acknowledge.

Conclusion

On a basic level, the Supreme Court’s Mission decision resolves the long-standing divide between Lubrizol and Sunbeam, establishing that a trademark licensee can continue using the licensed property even following rejection of the license in the licensor’s bankruptcy. The Mission decision therefore serves to bring the bankruptcy treatment of trademark licenses into line with the bankruptcy treatment of other forms of intellectual property (and of property rights more generally), and also serves to prevent opportunism on the part of debtor-licensors who might be tempted to use bankruptcy as a convenient means to free themselves of existing licenses so that they can remarket their intellectual property in a more lucrative manner.

But the decision is limited to the effect of rejection under the Bankruptcy Code. As Justice Sotomayor observes in her concurrence, special terms in a licensing contract or state law could bear on the question of what rights survive rejection under applicable non-bankruptcy law.[12]

More fundamentally, Mission’s categorical statements about the survival of contract rights under rejected contracts generally—and not only in the intellectual property context—may help to shift the balance of power at least slightly in favor of non-debtor contract counterparties in future bankruptcy cases. While the notion that “rejection constitutes a breach, not a termination” is something of a bankruptcy commonplace, that doctrine has frequently been understood to mean primarily that the rejected contract gives rise to a prepetition damages claim that can be asserted through a proof of claim in the bankruptcy case, *not* that the non-debtor party can actually continue to exercise or enforce its rights under the contract.[13]

However, Mission holds generally, and not only in the trademark context, that “the same counterparty rights survive rejection as survive breach”—a holding that opens the door for counterparties to rejected contracts to argue that they are permitted to continue exercising significant contractual rights notwithstanding the rejection of their contracts.

As a result, contract rejection may be a less effective means of freeing debtors from burdensome contractual obligations than had previously been assumed, especially given that the Supreme Court

[12] Other issues are unexplored by the Court, including the impact of a licensor’s failure to maintain quality control over licensed goods and services and whether the licensee must pay the full amount of royalties or reduce them for damages arising from a licensor’s defaults.

[13] See, e.g., Lubrizol, 756 F.2d at 1048 (“Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party.”).

itself acknowledged that its reading of Section 365 "may . . . impede some reorganizations, of trademark licensors *and others*." [Emphasis added.] By the same token, contract counterparties' leverage and options in post-Mission bankruptcies may expand considerably.

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