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SUPREME COURT HOLDS THAT REJECTION OF A TRADEMARK LICENSE ONLY CONSTITUES A BREACH AND DOES NOT RECIND THE LICENSE

by Howard J. Berman[1]
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I. Introduction

In an 8-1 decision authored by Justice Kagan, the Supreme Court recently held in *Mission Product Holdings, Inc. v. Tempnology, LLC*[2], that the rejection of a trademark license agreement by a Chapter 11 debtor does not result in the rescission or termination of the license; the rejection of a trademark license only results in a breach of the agreement with the same rights the counterparty would have outside of bankruptcy.[3] Thus, all of the rights that would normally survive a breach of contract stay in place. [4]

The decision is significant because it finally puts to rest the highly criticized decision in *Lubrizol Enterprises v. Richmond Finishers*[5], where the Fourth Circuit held that the rejection of a patent license resulted in the revocation of the license. Now trademark licensees who often invest significant capital in marketing and selling products under the licensed trademark, should be able to use the trademark despite the rejection of the license agreement.

II. Facts

Tempnology, LLC ("Tempnology") made various products that were designed to stay cool during exercise under the "Coolcore" trademarks and logos. Tempnology and Mission Product Holdings, Inc. ("Mission") entered into an agreement under which Tempnology granted Mission (i) an exclusive license to distribute certain products in the United States, and (ii) a non-exclusive license to use Tempnology's trademarks and logos in the United States and around the world. Soon after filing for Chapter 11 relief, Tempnology moved to reject its agreement with Mission under Section 365(a) of the Bankruptcy Code.

III. Section 365 of the Bankruptcy Code

Under Section 365(a), a debtor has the right, subject to the court's approval, to assume or reject any executory contract or unexpired lease. Generally, contracts that are favorable to a debtor's business will be assumed. In contrast, contracts that are not profitable or burdensome to a debtor's business will be rejected. Upon the rejection of an executory

contract, the debtor is relieved from its obligations to perform under the contract, and under section 365(g) of the Bankruptcy Code, the counterparty to the rejected contract will have a pre-petition unsecured damage claim for breach, which in most instances will get paid in pennies on the dollar. Thus, the use of the rejection power is an extraordinary device in assisting many debtors in restructuring their businesses.

In response to *Lubrizol,*[6] Congress enacted Section 365(n) of the Bankruptcy Code to give holders of intellectual property the right to continue to use a patent license if a debtor rejected the license under Section 365.[7] But Congress did not include trademarks to be part of the definition of intellectual property, leaving trademarks without special protection afforded to other intellectual property licenses.[8] In addition, Congress subsequently amended Section 365 of the Bankruptcy Code to protect the rights of lessees of real property (Section 365(h)(1)); timeshare interests (Section 365(h)(2)); and real property sale contracts and timeshare interests (Sections 365(h)(2) and (i)).[9]

IV. The Proceedings Below

In its motion to reject, Tempnology asserted in the bankruptcy court that its agreement with Mission hurt its ability "to derive revenue from other marketing and distribution opportunities" due to the agreement's exclusive distribution rights.[10] Applying the deferential business judgment rule, the bankruptcy court approved the rejection of the agreement. Tempnology then sought declaratory relief that the rejection of the trademark license terminated Mission's rights to use the Coolcare trademarks. The bankruptcy court, relying on the negative inference that since trademarks were omitted from the definition of intellectual property, Congress did not intend for trademarks to have the same protection as other intellectual property in Section 365(n). Therefore, the rejection of a trademark license resulted in the revocation of the right to use the marks and logos. Relying on the Seventh Circuit's opinion in *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC,*[11] where the court held that rejection is merely a breach and not the "functional equivalent of a rescission, rendering void the contract," the Bankruptcy Appellate Panel reversed.[12] But the First Circuit reinstated the bankruptcy court's decision, concluding that the rejection of the trademark license eliminated the rights of the licensee.[13] The court endorsed the negative inference created by the omission of trademarks from the protections contained in 365(n) and focused on the special characteristics of trademarks: the licensor's the duty to monitor for quality control the products containing the mark or risk the cancelation of the mark. In the First Circuit's view, the debtor's need to eliminate its continuing obligation of monitoring for quality control after rejecting the trademark license would frustrate the whole purpose of rejection – to relieve the debtor of burdensome obligations and provide the debtor with a fresh start.[14]

V. The Supreme Court's Decision

In reversing the First Circuit and concluding that the rejection of an executory contract does not terminate it but merely operates as a breach, with all of the rights that would survive outside bankruptcy, the Supreme Court examined the text of Section 365. The Court noted that Section 365(a) provides the debtor with the option to either assume or reject an executory contract and that Section 365(g) explains the consequences of rejection: a breach that is deemed to occur right before the filing of a bankruptcy petition.[15] Because the term "breach" is not a specialized term that is defined in the Bankruptcy Code, the Court concluded that "it means in the Code what it means in contract law outside bankruptcy" and that rejection only operates

as a breach.[16] The Court then examined non-bankruptcy contract law in the context of a lease of equipment. If the lessor breached, the counterparty would have the right elect to continue to use the equipment provided it continued to pay for its use while suing for any damages resulting from the breach, or the counterparty could terminate the contract and return the equipment. But the Court explained that the right to terminate is only one for the counterparty to exercise; the lessor cannot terminate the contract and get its equipment back due to its own breach. In the bankruptcy context, the Court stated that the same consequences should apply: "The debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed. So the licensee can continue to do whatever the license authorizes."[17]

The Court also justified its holding that rejection of an executory contract cannot mean rescission, because Section 365 reflects a general bankruptcy rule that "[t]he estate cannot possess anything more than the debtor itself did outside bankruptcy" and whatever property rights a debtor has as of the petition date are fixed as of that date; such property rights cannot shrink or expand.[18] The Court also noted that if rejection resulted in a recession, it would, in effect, allow a debtor to use rejection as an avoidance action in violation of the Bankruptcy Code's strict limitations on such actions. But by treating rejection as a breach, a debtor is prevented from "recapturing interests it had given up," which is consistent with the general rule that "the estate cannot possess anything more than the debtor itself did outside bankruptcy."[19]

The Court then turned to Tempnology's main argument based on the negative inference when Congress made various changes Section 365 to protect the rights of counterparties to certain types of contracts but not trademark licenses. The Court rejected this negative inference argument for two reasons. First, it cannot be reconciled with the plain language in Section 365(g) that rejection is a breach. In effect, the Court noted that Tempnology wants to rewrite Section 365(g) to say that rejection means termination. Second, as to the exceptions Congress made to Section 365 for certain types of contracts, the Court concluded that these exceptions were enacted merely to "clarify the general rule that contractual rights survive rejection."[20] And as to Section 365(n), which specifically retained the rights of licensees of intellectual property (but not trademarks), the Court emphasized that "repudiation of *Lubrizol* for patent contracts does not show any intent to *ratify* that decision's approach for almost all others."[21]

Lastly, the Court made short shrift of Tempnology's argument that rejection should result in termination due to the special characteristics of trademarks, where the licensor has the duty to monitor for quality control any goods sold under the mark or risk losing its rights to the mark. Otherwise, according to Tempnology, a debtor would be faced with a choice of having to continue to spend funds on quality control or risk losing its trademark, which would impair a debtor's ability to reorganize.[22] In rejecting this argument, the Court noted that while Section 365 gives a debtor a "powerful tool" to assume or reject a contract, it does not provide for an exemption of all burdens that applicable non-bankruptcy law imposes on property owners.[23] Further, the Court concluded that Section 365 does not relieve debtors of the need to make their own business decisions whether to assume or reject a contract and whether it should invest the necessary resources to maintain a trademark.

VI. Conclusion

The Supreme Court's decision in *Mission Product* is important because it finally resolves the question whether rejection

means recession or breach. While the decision is very beneficial to trademark licensees, the decision is a blow to trademark licensors who wish to use Chapter 11 to reject burdensome licenses so they can sell or relicense them to a third party for a higher value to enhance its ability to reorganize. Restructuring entities with large trademark portfolios may become more difficult.

However, as Justice Sotomayor noted in her concurring opinion, not every licensee will have the "unfettered right to continue using the licensed marks postrejection," because any rights to continue to use the mark after rejection could be subject to terms in the agreement or state law that may restrict the use of the mark.[24] For example, a licensee of a rejected trademark license agreement will continue to have to comply with its obligations under the license agreement, including quality standards. One thing is certain: disputes regarding the rights of the parties to a rejected license is likely to be a new source of bankruptcy litigation.

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[2] __ S. Ct. __, 2019 WL 216692 (May 20, 2019).

[3] *See Id*. at *2.

[4] *Id*.

[5] 756 F. 2d 1043, 1045-1048 (4th Cir. 1985).

[6] 756 F. 2d 1043.

[7] *See Mission Prod.,* 2019 WL 2166392 at *7.

[8] *See Id*. The legislative history to Section 365 indicates that Congress left for another day any action on trademarks "'to allow for the development of equitable treatment of this situation by bankruptcy courts.'" *Mission Prod. Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC*), 879 F.3d 389, 401 (1st Cir. 2018).

[9] *See Mission Prod.,* 2019 WL 2166392 at *7. For example, if a debtor as lessor rejects a lease of real property, the tenant is given the right to elect to either terminate the lease or remain in possession.

[10] *See In re Tempnology, LLC*, 879 F.3d at 394.

[11] 686 F. 3d 372, 377 (7th Cir. 2012).

[12] *See In re Tempnology LLC*, 559 B.R. 809, 822-823 (B.A.P. 1st Cir. 2016).

[13] *See In re Tempnology, LLC, 879 F.3d at 401-404.*

[14] *Id*. at 402-403.

[15] *See Mission Prod*., 2019 WL 2166392 at *5.

[16] *Id*.

[17] *Id*. at *6.

[18] *Id*.

[19] *Id*. (citation omitted).

[20] *Id*. at *7 (footnote omitted).

[21] *Id*.

[22] *Id*. at *8.

[23] *Id*.

[24] *Id.* at *9 (citation omitted).