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Supreme Court Settles Dispute Over Effect of Trademark License Rejection in Bankruptcy

By Stuart I. Gordon and Matthew V. Spero*

The U.S. Supreme Court has issued a decision explaining the rights that a trademark licensee retains after the licensor files for bankruptcy and rejects the trademark licensing agreement as an executory contract.

The U.S. Supreme Court, in *Mission Product Holdings, Inc. v. Tempnology, LLC*,[1] has ruled that a debtor-licensor that rejects a trademark licensing agreement under Section 365 of the Bankruptcy Code[2] does not deprive the licensee of its rights to use the trademark.

In resolving an issue that has divided federal courts, commentators, and practicing attorneys for much of this past decade, the Supreme Court ruled that the rejection operates as a breach of the licensing agreement, but does not rescind it. Accordingly, the Supreme Court concluded that all the rights that ordinarily survive a contract breach under otherwise applicable non-bankruptcy law remain in place following a Section 365 rejection of a trademark licensing agreement.

REJECTION UNDER SECTION 365

Section 365(a) of the Bankruptcy Code provides that a debtor or a bankruptcy trustee, subject to the approval of the bankruptcy court, "may assume or reject any executory contract." A contract is an executory contract if "performance remains due to some extent on both sides."[3] An executory

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[1] *Mission Product Holdings, Inc. v. Tempnology, LLC*, 2019 U.S. LEXIS 3544 (May 20, 2019).

[2] 11 U. S. C. § 365(a).

[3] *NLRB v. Bildisco & Bildisco*, 465 U. S. 513, 522, n.6 (1984) (internal quotation marks omitted).

contract represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform).

Under Section 365(a), in bankruptcy, the debtor (or bankruptcy trustee) can decide whether to keep the contract in effect after its bankruptcy filing. If so, the debtor will assume the contract, fulfilling its obligations while benefiting from the counterparty's performance. If not, the debtor will seek to reject the contract, repudiating any further performance of its duties. The bankruptcy court generally will approve that choice, under the deferential "business judgment" rule.[4]

According to Section 365(g), the rejection of an executory contract constitutes a "breach of such contract." Thus, the non-debtor counterparty has a claim against the debtor's bankruptcy estate for damages resulting from the debtor's non-performance. That claim is a pre-petition claim because the rejection is deemed to occur "immediately before the date of the filing of the [bankruptcy] petition," rather than on the actual post-petition rejection date.[5] By giving the counterparty a pre-petition claim, Section 365(g) places that party in the same position as the debtor's unsecured creditors.

THE *MISSION PRODUCT* CASE

Mission Product involved a company called Tempnology, LLC, which manufactured clothing and accessories designed to stay cool when used in exercise. Tempnology marketed those products under the brand name "Coolcore," using logos, labels, and other trademarks to distinguish its own gear from other athletic apparel.

In 2012, Tempnology entered into a contract with Mission Product Holdings, Inc., that gave Mission Product an exclusive license to distribute certain Coolcore products in the United States. The contract also granted Mission Product a non-exclusive license to use the Coolcore trademarks in the United States and around the world. The agreement was set to expire in July 2016.

In September 2015, Tempnology filed a petition for relief under Chapter 11 of the Bankruptcy Code in a bankruptcy court in New Hampshire. Shortly thereafter, Tempnology filed a motion in the bankruptcy court to reject the licensing agreement it had with Mission Product under Section 365(a).

The bankruptcy court approved Tempnology's rejection of its executory

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4 *Id.* at 523.

5 11 U. S. C. § 365(g)(1).

licensing agreement with Mission Product. As a result, Tempnology could stop performing under the contract and Mission Product could assert a pre-petition claim in Tempnology's bankruptcy case for damages resulting from Tempnology's rejection of the licensing agreement.

Tempnology contended that its rejection of the contract also terminated the rights it had granted Mission Product to use the Coolcore trademarks, and it sought a declaration to that effect from the bankruptcy court.

To persuade the bankruptcy court to rule in its favor, Tempnology pointed out that Section 365 states that a counterparty to specific kinds of agreements may keep exercising contractual rights after a debtor's rejection.

For example, Tempnology noted, Section 365(h) provides that if a bankrupt landlord rejected a lease, the tenant did not have to move out; instead, the tenant could stay and pay rent (just as the tenant did before the rejection) until the lease term expired.

Tempnology also observed that Section 365(n) set out a similar rule for some types of intellectual property licenses: If a debtor-licensor rejected such an agreement, the licensee could continue to use the property (typically, a patent), so long as it continued to make whatever payments the contract demanded.

Tempnology, however, pointed out that neither Section 365(n) nor any similar provision covered trademark licenses. Therefore, it reasoned, under a trademark licensing agreement a different rule had to apply: The debtor's rejection must extinguish the rights that the agreement had conferred on the trademark licensee.

The bankruptcy court agreed with Tempnology, holding that Tempnology's rejection of the Mission Product trademark licensing agreement revoked Mission Product's right to use the Coolcore marks.[6]

The Bankruptcy Appellate Panel ("BAP") for the U.S. Court of Appeals for the First Circuit reversed,[7] relying to a large extent on a decision by the U.S. Court of Appeals for the Seventh Circuit[8] concerning the effects of rejection on trademark licensing agreements.

The BAP focused on Section 365(g)'s statement that rejection of a contract constituted "a breach." The BAP explained that, outside bankruptcy, the breach of an agreement did not eliminate rights the contract already had conferred on the non-breaching party. Therefore, it continued, rejection of a trademark

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

[7] *In re Tempnology, LLC*, 559 B.R. 809, 820–23 (B.A.P. 1st Cir. 2016).

[8] *Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC*, 686 F. 3d 372, 376–377 (7th Cir. 2012).

agreement in bankruptcy also did not have that effect. The BAP concluded that rejection converted a debtor's "unfulfilled obligations" to a pre-petition damages claim but did not "terminate the contract" or "vaporize" the counterparty's rights and that Mission Product could continue to use the Coolcore trademarks.

The First Circuit rejected the BAP (and Seventh Circuit) view and agreed with the bankruptcy court's decision terminating Mission Product's license.[9]

In its decision, the circuit court first endorsed the bankruptcy court's inference from Section 365(n) and similar provisions.

It next reasoned that special features of trademark law counseled against allowing a licensee to retain rights to a mark after the licensing agreement's rejection. Under that body of law, the circuit court stated, the trademark owner's "[f]ailure to monitor and exercise [quality] control" over goods associated with a trademark jeopardized the continued validity of its own trademark rights. Therefore, the First Circuit continued, if a licensee could keep using a mark after an agreement's rejection, the licensor would need to carry on its monitoring activities. According to the First Circuit, that would frustrate "Congress's principal aim" in providing for rejection of executory contracts: to "release the debtor's estate from burdensome obligations." One circuit judge dissented, primarily for the Seventh Circuit's reasons.

The Supreme Court granted certiorari to resolve the division between the First and Seventh Circuits.

THE SUPREME COURT'S DECISION

The Court, in an opinion by Justice Elena Kagan, reversed the First Circuit and affirmed the Seventh Circuit's reasoning.

In its decision, the Court explained that rejection of a contract—including a trademark license—in bankruptcy operated "not as a rescission but as a breach." According to the Court, a breach resulting from a rejection under Section 365 had the same consequences as a contract breach outside bankruptcy: It gave the counterparty a claim for damages, while leaving intact the rights the counterparty previously had received under the contract.

The Court explained how a breach of an executory contract worked outside bankruptcy using an example of a dealer that leased a photocopier to a law firm. In the Court's hypothetical, the dealer agreed to service the photocopier every month and, in exchange, the firm committed to pay a monthly fee. Suppose

[9] *Mission Prod. Holdings, Inc. v. Tempnology, LLC (In re Tempnology), LLC*, 879 F. 3d 389 (1st Cir. 2018).

that during the lease term, the dealer decided to stop servicing the machine, thus breaching the agreement in a material way. The Court observed that the law firm had a choice (assuming no special contract term or state law). The firm could keep up its side of the bargain, continuing to pay for use of the copier, while suing the dealer for damages from the service breach. Alternatively, the firm could call the deal off, halt its own payments, and return the copier, while suing for any damages incurred.

The Court emphasized that, in this hypothetical, the choice to terminate the agreement and send back the copier was for the law firm. The dealer had no ability, based on its own breach, to terminate the agreement or to get the copier back just by refusing to show up for a service appointment. The contract gave the law firm continuing rights in the copier, which the dealer could not unilaterally revoke, the Court reasoned.

The Court continued its analysis by assuming that the dealer filed a Chapter 11 petition and decided to reject its agreement with the law firm. As a result, the dealer would stop servicing the copier and the law firm had an option about how to respond: continue the contract or walk away, while suing for whatever damages accompanied its choice. The Court added that, "most important," assuming the law firm wanted to keep using the copier, the dealer could not take it back. "A rejection" of the contract in bankruptcy, the Court said, did "not terminate the contract." Moreover, the Court noted, after a rejection, the debtor and counterparty did not return to their pre-contract positions but the counterparty retained the rights it had received under the agreement.

The same rule, the Court said, applied to "any executory contract" under Section 365, including licensing agreements involving trademarks such as the Tempnology-Mission Product contract. A breach outside bankruptcy did not revoke the license or stop the licensee from doing what the contract allowed it to do, and because rejection under Section 365 constituted "a breach," the same consequences followed in bankruptcy.

The Court was not persuaded by Tempnology's main argument that because Section 365(n) provides that licensees of some intellectual property—but not trademarks—retained contractual rights after rejection, a trademark licensee did not retain those rights.

According to the Court, that simply meant that trademark licensing agreements fell, along with most other contracts, within Section 365(g)'s general rule. "Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g)—that rejection and breach have the same results," the Court stated.

CONCLUSION

The Supreme Court's decision in *Mission Product* should serve as a great relief to trademark licensees facing the prospect of having a licensing agreement rejected (that is, breached) by a licensor in bankruptcy. Trademark licensees often invest significant capital and other resources in reliance on a licensed trademark. The Supreme Court's decision means that a trademark licensee will continue to be able to use a licensed trademark to the extent permitted by the terms in the license or otherwise applicable state law, even if other aspects of the licensing agreement no longer remain in force, following the licensor's decision to reject the agreement under Section 365 of the Bankruptcy Code.