King & Spalding
Client Alert

JUNE 28, 2018

For more information, contact:

Arthur Steinberg
+1 212 556 2158
asteinberg@kslaw.com

Kathleen McCarthy
+1 212 556 2345
kmccarthy@kslaw.com

Scott Davidson
+1 212 556 2164
sdavidson@kslaw.com

Michael Handler
+1 212 556 2286
mhandler@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

Supreme Court Asked to Resolve Circuit Split On Whether Licensee Trademark Rights Survive Rejection in Bankruptcy

On June 11, 2018, Mission Product Holdings, Inc. ("MPHI"), a developer of chemical free cooling fabrics, petitioned the U.S. Supreme Court for a writ of certiorari to resolve a circuit split on whether a licensee's right to use a trademark survives bankruptcy rejection of the underlying licensing agreement by the debtor-licensor. In *Mission Prod. Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*[1], the First Circuit held that a licensee's rights under a rejected trademark license do not survive rejection by the debtor-licensor. This result was consistent with the Fourth Circuit's ruling on this issue, but contrary to the Seventh Circuit's ruling. If the Supreme Court grants the certiorari petition, its ruling will resolve this long-standing circuit split on the rights (or lack thereof) of a trademark licensee where the license agreement has been rejected in bankruptcy by the debtor-licensor.

REJECTION OF EXECUTORY CONTRACTS GENERALLY

Section 365 of the Bankruptcy Code provides a debtor with the right to assume (or assume and assign) or reject an executory contract. An executory contract is a contract in which both sides still have unperformed obligations; a trademark licensing agreement is typically found to be an executory contact. Under Section 365(g)(1) of the Bankruptcy Code, the rejection of an executory contract is deemed to constitute a breach of the agreement immediately before the petition date. The executory contract counterparty then has a general unsecured claim for damages based on such breach.

The Bankruptcy Code contains special provisions regarding "intellectual property" executory contracts. If a debtor-licensor seeks to reject an executory contract involving the license of "intellectual property", Section 365(n) of the Bankruptcy Code gives the licensee the right to either treat the contact as terminated or retain its rights to license the "intellectual property". Importantly, "intellectual property" is defined under Section

101(35A) of the Bankruptcy Code as "(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." Notably missing from this definition are trademarks. The legislative history of Section 365(n) supports Congress' intent to exclude trademarks from the scope of Section 365(n) "to allow the development of equitable treatment of this situation by bankruptcy courts." [2]

CURRENT SPLIT AMONG THE CIRCUIT COURTS

As noted above, there is a circuit split on whether a licensee's rights under a rejected trademark license survives rejection by the debtor-licensor. In 1985, the Fourth Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[3] held that a debtor-licensor's rejection of an agreement to license intellectual property terminated the licensee's right to continue using the intellectual property post-rejection, allowing the debtor to sell or license it to a third party without any limitations imposed by the license previously granted. The court reasoned that "[e]ven though § 365(g) treats rejection as 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.... Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a)."[4] In response to the Lubrizol decision, Congress added Section 365(n) to the Bankruptcy Code with respect to intellectual property licenses.

The Seventh Circuit in *Sunbeam Prods., Inc. v. Chicago Am. Manuf., LLC*[5] expressly rejected the Lubrizol approach and held that rejection of a trademark license agreement did not terminate the licensee's rights in the trademark. Specifically, the Seventh Circuit rejected *Lubrizol's* interpretation of Section 365(g), explaining – "[w]hat § 365(g) does by classifying rejection as [a] breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place…. The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized." [6] The court concluded that because outside of bankruptcy a licensor's breach does not terminate a licensee's right to use intellectual property, the debtor could not terminate that right through its rejection of the licensing agreement in bankruptcy.

The Third and Eighth Circuits have also been presented with whether to follow Lubrizol for trademark licenses, but declined to reach the merits.[7]

FIRST CIRCUIT DECISION IN *MISSION PROD. HOLDINGS INC. V. TEMPNOLOGY*

In a 2-1 decision, the First Circuit followed *Lubrizol*'s interpretation of Section 365(g), and rejected *Sunbeam*, in holding that a licensee's right in a trademark does not survive rejection by the licensor of the underlying licensing agreement.[8] The First Circuit stated that its decision "largely rests on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark".[9] However, in rejecting that premise, the First Circuit noted that "effective licensing of a trademark requires that the trademark owner—here Debtor, followed by any purchaser of its assets—monitor and exercise control over the quality of the goods sold to the public under cover of the trademark."[10] The First Circuit also rejected interpreting Section 365(n) as applying to trademarks.[11]

In a dissenting opinion, Circuit Judge Juan R. Torruella disagreed with the majority's "bright-line rule that the omission of trademarks from the protections of section 365(n) leaves a non-rejecting party without any remaining rights to use a debtor's trademark and logo."[12] Instead, Judge Torruella advocated for following *Sunbeam* in concluding that the licensee's rights to use the licensed trademark "did not vaporize" due to rejection of the licensing agreement.[13] Judge Torruella concluded that "the majority's view that a section 365(a) rejection eliminates a licensee's rights to the bargained-for use of a debtor's trademark effectively treats a debtor's rejection as a contract cancellation, rather than a

contractual breach, putting the court at odds with legislative intent" to allow the development of equitable treatment with respect to the treatment of trademarks in bankruptcy.[14]

CONCLUSION

If the Supreme Court grants MPHI's certiorari petition, we should get a clear pronouncement of a licensee's rights under a rejected trademark license. Congress could also address the issue by amending the Bankruptcy Code to specifically address this issue. If neither of these events occur, uncertainty will remain about the licensee's rights under a rejected trademark license, and the jurisdiction where this issue is presented will remain critically important.

It should be noted that licensees have tried to contract around this issue by tracking the remedies set forth in Section 365(n) of the Bankruptcy Code relating to "intellectual property" and including provisions designating the license as an executory contract until terminated (as compared to being rejected). It remains unclear whether these provisions "move the needle" in dictating how this issue ultimately gets resolved. Alternative contracting techniques include (a) trying to define the license as not being executory so Section 365 is not implicated, and (b) securing the licensee damage claim by a lien in the trademark to create a disincentive to reject the license agreement. For a more in depth discussion of these contracting techniques, contact the authors of this Update.

[1]879 F.3d 389 (1st Cir. 2018).
[2] See Tempnology, 879 F.3d at 401 (quoting S. Rep. No. 100-505, at 5).
[3] Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).
[4] Id. at 1047.
[5] 686 F.3d 372 (7th Cir. 2012).
[6] Id. at 377.
[7] *See Lewis Bros. Bakeries, Inc. v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 751 F.3d 955 (8th Cir. 2014) (ruling that a license agreement was not executory and thus could not be assumed or rejected); *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010) (avoiding issue and ruling that trademark license agreement was not executory; in a concurring opinion, Judge Ambro noted that Congress's decision to leave treatment of trademark licenses to the courts signals nothing more than Congress's inability, when it enacted section 365(n), to devote enough time to consideration of trademarks in the bankruptcy context).
[8] The First Circuit reversed the bankruptcy appellate panel's decision following *Sunbeam*, *see Mission Prod. Holdings, Inc. v. Tempnology LLC (In re Tempnology LLC)*, 559 B.R. 809 (B.A.P. 1st Cir. 2016), and instead affirmed the bankruptcy court's decision, *see In re Tempnology, LLC*, 541 B.R. 1 (Bankr. D.N.H. 2015).
[9] *Tempnology,* 879 F.3d at 402.
[10] Id.
[11]Id. at 401. The Seventh Circuit in Sunbeam also rejected this conclusion as well. See Sunbeam, 686 F.3d at 375.
[12] *Tempnology,* 879 F.3d at 405.
[13] Id.
[14] Id. at 407.