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News & Types: Intellectual Property & Technology Update

U.S. Supreme Court Finally Speaks Regarding Trademark Licenses in Bankruptcy

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On May 20, 2019, the U.S. Supreme Court issued its long-awaited decision in *Mission Products Holdings, Inc. v. Tempnology, LLC nka Old Cold LLC*, (Case No. 17-1657, U.S. Supreme Court, May 20, 2019) ("*Tempnology*"). The U.S. Supreme Court decided that a trademark licensee can continue to use a trademark license even when a bankrupt trademark licensor rejects the license agreement.

For many years, we have been following courts of appeal decisions regarding the status of trademark licenses in bankruptcy. See our June 21, 2010 update: "Bankruptcy of Licensor Threatens Twenty Year Old Trademark License in M&A Transaction" and our July 18, 2012 update: "7th Circuit Creates Conflict Among Federal Courts Regarding Ability of Bankrupt Trademark Licensor to Reject License Agreement; U.S. Supreme Court May Need to Decide."

For the most recent update that discussed the history of this issue and the First Circuit Court of Appeals decision in *Tempnology*, see our May 2, 2018 update: "Trademark Licensees in Limbo Again?"

As a brief history, in 1985, the 4th Circuit Court of Appeals held that, when an intellectual property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. (*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc*., 756 F.2d 2043 (4th Cir. 1985)). The *Lubrizol* decision was heavily criticized, since it permitted an intellectual property licensor to get out of a license agreement through bankruptcy. Even the 4th Circuit acknowledged, in the opinion, that permitting rejection of an intellectual property license could have a "chilling effect" on the willingness of potential licensees to contract with licensors in financial difficulty.

Three years later, Congress amended the Bankruptcy Code to overturn *Lubrizol*. Congress amended Section 365 (dealing with executory contracts) by adding Section 365(n) of the Bankruptcy Code to permit an intellectual property licensee, faced with a bankrupt licensor's attempt to reject the contract, to either treat the contract as terminated or to retain rights under the contract. But, in a notable omission, the definition of "intellectual property" in Section 365(n) did not include trademark rights. The Senate Report that accompanied the Bankruptcy Code amendment stated that omission of trademarks was not because Congress felt trademark licensees should not be protected. Rather, it was because trademark licenses depend on quality control of the products sold by the licensee and this was an area beyond the scope of the amendment. The

Senate Report went on to say that Congress "postpone[d] action on trademark licenses to allow the development of equitable treatment of this situation by bankruptcy courts" (S. Rep. No. 100-505).

In a Risk Management Update of June 21, 2010 we discussed a 3rd Circuit Court of Appeals decision on this issue. (*In re: Exide Technologies*, 607 F.3d 957 (3rd Cir. 2010)) The 3rd Circuit opinion held that the trademark license was not an "executory" contract under the Bankruptcy Code and, therefore, Exide (the licensor) could not reject it. It found that EnerSys (the licensee) had "substantially performed" its obligations under its agreement with Exide. It acknowledged Exide’s obligation to observe quality standards, but found this obligation was "minor." In a concurring opinion, Judge Ambro found another basis to conclude that EnerSys retained the trademark license rights. Judge Ambro cited the Senate Report described above and agreed that the omission of trademarks was not because Congress felt trademark licenses should not be protected. Judge Ambro concluded that the court could have used its equitable power to deny Exide's efforts to reject the trademark license.

Then in 2012, Judge Easterbrook seemed to put this issue to rest. (*Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012)). Judge Easterbrook explicitly rejected the holding in *Lubrizol*. He noted that no other court of appeals had agreed with *Lubrizol*. He also rejected any notion of applying notions of equity. The rights of a trademark licensee are not "vaporized" when the licensor enters bankruptcy. So a licensor's rejection of the trademark license would not result in the inability of the licensee to use the trademark.

The First Circuit Court of Appeals decision in *Tempnology* rejected Sunbeam's holding, leading to resolution by the U.S. Supreme Court in its *Tempnology* decision.

The competing positions in *Tempnology* were pretty straight-forward. One side favored trademark licensors that entered bankruptcy. Permitting a bankrupt licensor to reject the trademark license agreement terminated the rights of the licensee, permitted the licensor to capture value in favor of the bankrupt licensor and relieved the licensor of further obligations of monitoring or policing the licensee under the trademark license agreement. The other side favored the trademark licensees and would permit the licensees to continue to use the trademark under the trademark license agreement even in the face of the licensor's bankruptcy.

The U.S. Supreme Court came down on the side of the trademark licensees, thus rejecting the First Circuit's position in its Tempnology decision and supporting Judge Easterbrook's position in *Sunbeam*. Writing for the 8 – 1 majority (more on the dissent below), Justice Kagan held that a rejection of a trademark license agreement by a bankrupt licensor does not deprive the rights of the licensee under the agreement.

Justice Kagan discussed broad bankruptcy principles that went beyond the narrow trademark issue before the Court. Justice Kagan explained the two "starkly different" approaches to a rejection of a contract in bankruptcy. The first is to treat the rejection as a breach, giving the counterparty a claim for damages and not affecting the rights the counterparty already held outside bankruptcy. The second is to treat the rejection as a rescission, terminating the whole agreement and the rights of the counterparty (except for the damage claim). Justice Kagan and the Court came down emphatically on the "rejection as breach" position:

> "Today, we hold that both [Bankruptcy Code] Section 365's text and fundamental principles of bankruptcy law command the first, rejection-as-breach approach. We reject the competing claim that by specifically enabling the counterparties in some contracts to retain rights after rejection, Congress showed that it wanted the counterparties in all other contracts to lose their rights."

Unlike Judge Easterbrook in the 7th Circuit's *Sunbeam* decision, Justice Kagan did not directly attack the *Lubrizol* decision that led to the conflict among the courts of appeal. But Justice Kagan probably did not need to, since, except for trademarks, Congress had already overruled *Lubrizol*. But by enshrining the "rejection as breach" position as a U.S. Supreme Court holding, Justice Kagan seems to have wanted to avoid future court rulings that could create similar mischief.

At this point, the chances of Tempnology (the licensor) looked bleak. They did not get better as Justice Kagan then dealt with the specific trademark issue.

Tempnology argued from a "negative inference." In overruling *Lubrizol* and in protecting licensees of other forms of intellectual property, Congress specifically and notably did not include trademark licensees. (For further discussion on this, see the updates referenced above.) In addition, in other parts of bankruptcy law, Congress made specific provisions for continuing the rights of counterparties when the other party is in bankruptcy. So doesn't this mean that, except for those specifically enumerated cases, all other rejected contracts in bankruptcy are terminated? Based on the explicit holding above adopting the "rejection-as-breach" position, the answer is no.

Justice Kagan called these bankruptcy provisions continuing the rights of counterparties a "mash-up of legislative interventions" often resulting from correcting judicial rulings (such as *Lubrizol*). It did not mean that Congress in the bankruptcy code intended to adopt the "rejection-as-rescission" approach. Rather, Justice Kagan quoted a bankruptcy scholar who noted, "What the legislative record [reflects] is that whenever Congress has been confronted with the consequences of the [view that rejection terminates all contractual rights], it has expressed its disapproval."

So Justice Kagan dismissed Tempnology's "negative inference" argument that, by not including trademarks in the law protecting licensees of intellectual property from bankrupt licensors, Congress intended trademark licensees to have no such protection. The "rejection as breach" holding concluded otherwise.

The First Circuit's decision in *Tempnology* further emphasized the ongoing obligations of a licensor to monitor and police the use of the trademark. The First Circuit viewed this obligation as an impediment to a successful reorganization by the licensor. Justice Kagan acknowledged these obligations but they still did not warrant an exception to the "rejection-as-breach" holding above. Said Justice Kagan,

> "In thus delineating the burdens that a debtor may and may not escape, Congress also weighed (among other things) the legitimate interests and expectations of the debtor's counterparties. The resulting balance may indeed impede some reorganizations, of trademark licensors and others. But that is only to say that Section 365's edict that rejection is breach expresses a more complex set of aims than Tempnology acknowledges."

Justice Gorsuch had an interesting dissent. His dissent was not about the Court's holding, but whether the U.S. Supreme Court should have even heard the decision. Justice Kagan, in the majority opinion, cited Tempnology's argument that the licensee never used the trademark after rejection by Tempnology and that the assets of the bankruptcy estate had already been distributed, so that a money claim by Mission would be of no value. Justice Gorsuch further noted that the license had already expired. So Justice Gorsuch argued that the U.S. Supreme Court should not have heard the case.

A reader of both the First Circuit opinion and the U.S. Supreme Court opinion can wonder what all the fuss was about. When rejected, the trademark license had only months to run before expiration. Mission, the licensee, had terminated the license even before Tempnology's bankruptcy, triggering a wind-down period of two years, which was ongoing when Tempnology entered bankruptcy. This suggested Mission did not see much value in the license. Whether the case met the legal standard for being moot is an interesting legal argument. But there clearly seemed to be not much at stake. Whether one agrees with Justice Gorsuch or with the majority on the mootness issue, one can appreciate that the Court provided some clarity in resolving the fate of trademark licenses, that had bedeviled courts of appeal for decades.

Issues remain, some of which were pointed out in Justice Sotomayor's brief concurring opinion. Even so, trademark licensees, faced with their licensor's financial stress or bankruptcy, can rest a little easier after the U.S. Supreme Court's opinion in *Tempnology*.