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U.S. Supreme Court Determines the Effect of Bankruptcy on Trademark Licenses

By Kevin R. Casey

On May 20, the U.S. Supreme Court resolved a split between the First and Seventh Circuits in an 8-1 opinion with significant ramifications on an important legal issue at the interplay between bankruptcy and trademark law in *Mission Product Holdings, Inc. v. Tempnology* (https://www.supremecourt.gov/opinions/18pdf/17-1657_4f15.pdf).

Summary

Tempnology made and owned the intellectual property directed to specialized products such as towels, socks, headbands and other accessories designed to stay at a low temperature even when used during exercise. Tempnology and Mission executed an agreement in 2012, which expired in 2016, that granted Mission (1) distribution rights to some of Tempnology's products, (2) a nonexclusive license to Tempnology's patents, and (3) a nonexclusive license to use Tempnology's trademark and logo to sell and promote the products. After accruing multimillion-dollar operating losses in 2013 and 2014, Tempnology filed for bankruptcy under Chapter 11 of the Bankruptcy Code in September 2015. The following day, Tempnology moved to reject its agreement with Mission under Section 365(a) of the Bankruptcy Code, which allows a debtor-in-possession to "reject any executory contract" that is not beneficial to the company.

Although the parties did not dispute that Mission could insist that the rejection not apply to the patent license in the agreement, it was unsettled in the First Circuit (where the proceedings were brought as a case of first impression) whether Mission could also insist that the rejection not apply to the trademark license. The bankruptcy court found that Tempnology's rejection of the agreement left Mission with only a claim for damages for breach of contract, and no claim that Tempnology was under an obligation to further perform the license agreement. The First Circuit affirmed. The U.S. Supreme Court addressed the following question: Under Section 365 of the Bankruptcy Code, does a debtor-licensor's rejection of a trademark license agreement – which "constitutes a breach of such contract" under 11 U.S.C. § 365(g) – terminate rights of the licensee that would survive the licensor's breach under non-bankruptcy law? In other words, does the debtor-licensor's rejection of a trademark license deprive the licensee of its rights to use the trademark? The Court held "no," and reversed the First Circuit's decision.

The question of how trademark rights should be treated in the context of bankruptcy has split the circuits and has led to uncertainty in the market for trademark licenses. The U.S. Supreme Court resolved the circuit split that traces back to the Fourth Circuit's 1985 decision in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, (https://law.resource.org/pub/us/case/reporter/F2/756/756.F2d.1043.84-1539.html) 756 F.2d 1043 (4th Cir. 1985,). In *Lubrizol*, the Fourth Circuit held that rejection of an executory patent license agreement by a debtor-licensor terminates the license. Although Congress abrogated that result by amending the Bankruptcy Code in 1987 to address patent, copyright and trade secret licenses, 11 U.S.C. § 365(n) (allowing licensees to continue operations under their patent, copyright, or trade secret license), it expressly left open the impact of rejection on trademark license agreements for further study and consideration. *Lubrizol* remained law in the Fourth Circuit with respect to trademark licenses, and courts in some other circuits continued to rely on *Lubrizol* in holding that a trademark licensee's rights are terminated upon rejection.

Among the circuits that have disagreed with the Fourth Circuit is the Seventh Circuit. In *Sunbeam Prods. Inc. v. Chicago Am. Mfg., LLC* (https://caselaw.findlaw.com/us-7th-circuit/1605632.html), 686 F.3d 372 (7th Cir. 2012), the Seventh Circuit held that, although rejection eliminates the debtor-licensor's obligation to perform under the agreement, it does not terminate the licensee's right to continue to use the trademark for the duration of the agreement. Thus, rejection relieves the licensor of any obligations under the agreement and is a breach that may cause harm to the licensee for which the licensee might have a remedy, but the licensee may continue to use the licensed mark. Under the Seventh Circuit's reasoning, rejection does not terminate either the licensee's right to continue using the licensed mark or its obligation to continue to comply with the license. Those obligations might include making royalty payments and maintaining quality control, which the licensor may continue to enforce.

The Solicitor General argued that the Court should adopt the Seventh Circuit's position because, among other reasons, a licensor cannot unilaterally revoke a trademark license outside of bankruptcy. Others suggested a case-by-case approach, which might depend on the language of the particular license at issue. The Court agreed with the Solicitor General and with the Seventh Circuit, against the First and Fourth Circuits, holding that rejection of a trademark license in bankruptcy constitutes a breach by the debtor-licensor and not a rescission. Therefore, all the rights that would ordinarily survive a contract breach (typically including the licensee's right to continue use of the mark) remain in place.

Tempnology's principal counterargument rested on a negative inference drawn from provisions of Section 365 that identified categories of contracts (including other IP contracts) under which a counterparty could retain specified rights after rejection. Tempnology argued that these provisions indicated that the ordinary consequence of rejection must be something other than a breach. The Court was not persuaded, stating that

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Congress did not intend for these provisions to alter the basic conclusion that a rejection operates as a breach of contract.

Practical Ramifications

(a) The International Trademark Association (INTA) characterized the question presented as "the most significant unresolved legal issue in trademark licensing." The decision is definitely a "win" for trademark licensees.

(b) Some question whether the Court's decision will result in "naked" trademark licenses, where the licensor fails to exercise control over the nature and quality of the goods and/or services sold by the licensee under the licensed mark, which can abandon rights in the trademark. The Court acknowledged that its decision might force a debtor to choose between expending scarce resources on quality control and risking the loss of a valuable asset, but dismissed such "trademark-related concerns" as subservient to general bankruptcy law.

(c) Thus, the decision may place the debtor-licensor in the position of choosing between (1) retaining burdensome obligations associated with monitoring quality control, or (2) abandoning a valuable trademark.

(d) It is surprising that trademarks, unlike patents, copyrights or trade secrets, are not considered intellectual property by and are treated differently under the Bankruptcy Code.

(e) From a contractual perspective, the decision will require additional provisions related to after-effects of bankruptcy with regard to a licensor's right to continued use of a licensed trademark. Justice Sotomayor, in her concurring opinion, noted that whether a trademark licensee retains rights to use a licensed mark following a debtor-licensor's rejection must be determined under applicable non-bankruptcy law, and that the result will likely turn on the language of the contract or on state law. For example, a licensor might want to draft its license agreement to permit an actual rescission in the event of a rejection.