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Mission Products: The Supreme Court Finally Confirms That the Rejection of a Trademark License in Bankruptcy Does Not Operate as Termination

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Resolving a long-standing controversy about the treatment of trademark licenses in bankruptcy cases, the U.S. Supreme Court concluded in 2019 that the rejection (in bankruptcy) of a trademark license by a bankrupt licensor (or its bankruptcy trustee) under Section 365 of the Bankruptcy Code does not terminate the non-debtor licensee rights to continue to use the mark. By an 8-1 decision, the Court, in *Mission Products Holdings, Inc. v. Tempnology, LLC*, 587 U.S. __, 139 S. Ct. 1652 (2019), emphatically confirmed that a licensor's "rejection" of an unexpired trademark license under federal bankruptcy law operates only as a breach of the license, not as termination, and that the licensee may continue to use the mark.

Background

For decades, the federal bankruptcy law has contained provisions that permit a debtor-in-possession or bankruptcy trustee to "assume" or "reject" executory contracts and unexpired leases. An executory contract is one for which material performance remains due from both sides as of commencement of the bankruptcy case. Section 365(g) of the Bankruptcy Code enacted in 1978 provides that rejection of an executory contract or unexpired lease "constitutes a breach of such contract or lease … immediately before the date of the filing of the petition." As a result of that treatment, the breach is equivalent to a pre-bankruptcy breach of the contract, for which the aggrieved non-debtor party has the right to file a proof of an unsecured claim for damages arising from the breach (rejection). With the recognition that unsecured claims occupy the lowest rank of creditor claims, in most bankruptcy cases those unsecured claims will receive distribution of only a fraction of their face amounts.

Although the language of Section 365(g) appears clear on its face, in 1984 the U.S. Fourth Circuit Court of Appeals in Richmond held in the case of *Lubrizol Enterprises., Inc. v. Richmond Metal Finishers, Inc.*[1] that a Chapter 11 debtor-licensor's rejection of a patent license operated to terminate the licensee's further right to use the patent. To hold otherwise, according to the circuit court, would impose significant burdens on the debtor and deprive it of the ability realize higher returns for the benefit of its creditors by selling or re-licensing the patent.

Lubrizol prompted a series of conflicting decisions involving various kinds of intellectual property. Four years later, however, Congress amended Section 365 of the Bankruptcy Code to provide that where a debtor-licensor rejects a license of four particular kinds of intellectual

1 756 F.2d 1043, 1048 (4th Cir. 1985).

property – patents, copyrights, mask works or trade secrets – the licensee has the option either to treat the license as terminated or to continue to use the intellectual property for the balance of its term, subject to the licensee's continued payment of royalties to the debtor-licensor or its successor. If the licensee elects to retain its rights, however, it waives any right of setoff against the debtor-licensor or its successor for the remaining term of the license.

Although the 1988 amendment clarified the treatment of the four categories of intellectual property identified above, the amendment specifically did not include trademarks. Congress did so to, according to the legislative history, "postpone action on trademark licenses to allow the development of equitable treatment of this situation by bankruptcy courts."[2]

For the 30 years since the amendment of Section 365 to address intellectual property licenses, the federal courts wrestled with the consequences of a debtor-licensor's rejection of a trademark license. Although a number of federal circuit courts concluded in non-trademark cases that, as a general rule, rejection of an executory contract did not constitute termination, but was only a breach, before 2012 no federal circuit court addressed the specific question as it related to a trademark license. In *Sunbeam Products v. Chicago American Manufacturing, LLC*,[3] the U.S. Seventh Circuit Court of Appeals in Chicago held that rejection of a trademark license was no different from the rejection of any other executory contract: It operated only as a breach of the license, leaving the non-debtor licensee whatever rights it would have had if the breach occurred outside of the context of a bankruptcy case.

Five years later, in the case that led to the Supreme Court's decision, the U.S. First Circuit Court of Appeals in Boston took the opposite view, holding that a debtor-licensor's rejection of a trademark license resulted in the loss of the licensee's right to continue to use the mark.[4] This led the Supreme Court to accept review of the *Mission Products* case to address the direct split in circuit court authority on the question.

<u>Summary of the *Mission Products* Decision</u>

In an opinion by Justice Elena Kagan, the Supreme Court flatly rejected the First Circuit's position, instead siding with and building upon the *Sunbeam* precedent of the Seventh Circuit. Justice Kagan first reviewed the Bankruptcy Code's provisions governing the rejection of executory contracts. Finding the language of Section 365(g) clear and unambiguous, the Court was swayed by the fact that, under the statutory language, rejection was not designed to give the breaching licensor any better rights than it would have had if the breach occurred outside of bankruptcy. Although Section 365(g) provides that rejection is treated as a "breach," the

2 S. Rep. No. 100-505, 100th Cong., 2d Sess. 5 (1988).

3 686 F.3d 372 (7th Cir. 2012).

4 *In re Tempnology, LLC*, 879 F.3d 389, 394–95 (1st Cir. 2018).

Court emphasized that the consequences of that breach requires the bankruptcy court faced with a rejection motion to determine the effect of the breach under applicable state law. The key issue here was whether, the licensee, in addition to its right to file a claim for damages, also had the right to continue to use the trademark.

Of particular importance to the Supreme Court – assuming that the license did not contain special terms or was not subject to special state statutes that would affect the particular subject matter - a non-bankrupt licensor's breach does not end the rights given to the counter-party under a contract. Absent such special circumstances (particular terms or particular applicable law), only the non-debtor counterparty would be entitled either to end the contract or to continue to exercise its contractual rights. Justice Kagan reasoned, therefore, that bankruptcy law does not give a bankrupt-licensor (or its bankruptcy trustee) greater rights than if the breach occurred outside of a bankruptcy case.

The Supreme Court also rejected the debtor-licensor's contention that Congress' exclusion of trademarks from the 1988 amendment could be read by negative inference that trademarks remained subject to treatment different from patents, copyrights, trade secrets and mask works. Even with the special provisions for those categories of intellectual property, Congress did not change the plain reading of Section 365(g) under which rejection constitutes only a "breach." Although, as a result of this holding, debtors and trustees may lose the ability to generate additional value for bankruptcy estate from a sale or re-licensing of trademark, that consequence follows naturally from the plain language of the statute. Rejection does not "relieve the debtor of the need … to make economic decisions about preserving the estate's value."

Finally, the Court dismissed the debtor-licensor's concern that, as a matter of public policy, rejection necessarily must lead to termination of the license because a bankrupt debtor-licensor otherwise would be required to continue to spend the time and resources to regulate the quality of the goods and services marketed and sold under the license – at potentially significant expense to the bankruptcy estate – in order to avoid loss of the mark. Notwithstanding the Bankruptcy Code's goal of fostering reorganization, Justice Kagan admonished that the law "does not permit anything and everything that might advance that goal."

In a concurring opinion, Justice Sonia Sotomayor agreed with the majority opinion but contemplated a number of issues that may arise in the future that the decision does not anticipate. First, Justice Sotomayor noted that rejection does not cut off rights of licensees under applicable nonbankruptcy law, "special terms in a licensing contract or state law could bear on that question in individual cases." Meanwhile, in continuing to use the mark after rejection, the licensee will have to comply with the terms of the license in order for the marked goods to be protected under the license. Failure to conform to the license could lead to a claim of infringement.

Second, Justice Sotomayor observed that the ruling makes clear that section 365(n) does not cover trademarks and as a result, the rights of trademark licensees could actually be larger than those of licensees of other intellectual property (such as patents and copyrights). For instance, under Section 365(n), upon rejection of a copyright or patent by the debtor-licensor the licensee may retain its rights but must also make all royalty payments while also losing the right to set off its breach damages from the payments (even if it would have had that right under nonbankruptcy law). With trademarks not being subject to Section 365(n), however, "Congress [is left] with the option to tailor a provision for trademark licenses, as it has repeatedly in other contexts."

<u>Potential Implications</u>

Although the *Mission Products* case focused on the rights of trademark licensees facing licensors' rejection of their licenses, the decision has significant implications for both licensees and licensors.

First, the *Mission Products* decision clarifies an issue that has long befuddled the courts. In doing so, it may clarify and even improve the economic and negotiating position of licensees. But it will also add expense to the administration of bankruptcy estates, because the licenses can no longer be escaped through rejection and, to sell or re-license the licenses, the debtor-licensor will either have to cut a bargain with the existing licensee or incur the expense of administering the license while at least continuing to receive the stream of royalties from further use of the mark.

Debtors can no longer presume that by rejection of a license they can simply resell the right to use intellectual property to a third party – free and clear of claims and interests pursuant to Section 363 of the Bankruptcy Code – for value that will benefit the debtor and its creditors. As a result, it may be likely that trademark licenses will be assumed and/or assigned either separately or as part of a larger pool of assets to be sold, instead of being rejected.

At the same time, in the negotiation of trademark licenses, both licensors and licensees should expect to engage in negotiation about the consequences and effects of rejection (perhaps with language drawn from the provisions of Section 365(n) of the Bankruptcy Code relating to rejection of patent and copyright licenses).

Although *Mission Products* only directly addressed the treatment of a rejected trademark license, the decision cements the general proposition that, unless the contract contains special provisions or is subject to special non-bankruptcy law, rejection of executory contracts in bankruptcy is no different in effect from the treatment of a non-bankruptcy breach. What is missing from the decision is any clear indication of particular contract terms or non-bankruptcy laws that could might limit a licensee's right to continued use of the mark.

The decision also removes a potential cloud on ability of trademark licensees to finance their operations by making clear that as a general rule they will retain their rights to continue to use the mark in the event of the licensor's bankruptcy.

Finally, licensors and licensees will face a new dynamic for negotiation of trademark licenses (although not necessarily so different from the regime that had existed for patents and copyrights for more than 30 years). Licensees may seek provisions more protective of their rights in case of the licensor's bankruptcy, while the licensor may now have to address the implications of having to continue to bear the burden and expense of quality control monitoring and oversight. The manner in which quality control is exercised is ordinarily left to the licensor and is an essential provision of a trademark license. Prior to license negotiations, the licensee with a long track record may be more selective, choosing licensors who are financially stable; entrepreneurs who are entering the market may find that balance sheet comfort is as important as a launching new brand when negotiating licenses. Indeed, to defray the cost of a debtor's quality control following rejection, it is plausible that the license negotiations could lead to terms requiring the licensee to pay a higher royalty or to defray or even undertake some part of quality control functions in the event of rejection so as to reduce the risk of the licensor's abandonment of the mark.

The *Mission Products* case provides trademark licensees with assurances that their rights to use a trademark cannot be unilaterally terminated merely by rejection of a trademark license agreement in bankruptcy. At the same time, this decision will no doubt have an impact on trademark license negotiations, how licensors craft termination provisions going forward, the value of trademark rights subject to licenses in a bankruptcy, and what actions a licensor may take to preserve rights in its trademarks after rejection of a license agreement.

Thus far, there has been little discussion of *Mission Products* in later decisions. Several lower courts have specifically embraced the *Mission Products'* holding that rejection is treated only as a breach of contract, recognizing that the case did not change the basic test of what makes a contract or license "executory."