

Dealer's Choice: First Circuit Allows Licensor to Reject Trademark License in Bankruptcy

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One of the purposes of the Bankruptcy Code is to allow companies an opportunity to get back on their feet. The U.S. Court of Appeals for the First Circuit recently furthered that purpose by providing debtors with the opportunity to walk away from trademark licensing agreements they signed before entering bankruptcy.

When a company seeks protection from its creditors under Chapter 11 of the Bankruptcy Code, the bankruptcy trustee, or the company itself as a debtor-in-possession, typically will ask the bankruptcy court for permission to "reject" burdensome contracts under 11 U.S.C. § 365(a) ("Section 365(a)").[1] The ability to reject burdensome contracts is a powerful tool for a company seeking to reorganize under Chapter 11. It frees the company from any obligations to perform under the rejected contract and generally leaves the other contracting party with only a claim for damages instead of a claim to enforce the terms of the contract.

For some time, many have questioned whether Section 365(a) protects trademark licensees if a trademark license is rejected. In January, the First Circuit removed all doubt on the issue: In *Mission Product Holdings, Inc. v. Tempnology, LLC* (*In re Tempnology, LLC*),[2] the First Circuit held that trademark licenses are "unprotected from court-approved rejection." That is, the First Circuit has confirmed that licensors undergoing Chapter 11 reorganization can reject trademark licenses under Section 365(a).

Businesses operating in Chapter 11 certainly will welcome the ruling as it allows them to regain control over their trademarks. Trademark licensees, however, likely will view the decision with alarm because of the practical consequences. Indeed, under the First Circuit's decision, the investment trademark licensees make in the licensed trademarks will be lost if those licenses are ultimately rejected in bankruptcy.

Of course, the First Circuit's decision in *Tempnology* may not be the last word. A Supreme Court decision or even congressional action ultimately could change the landscape. But for now, *Tempnology* stands as one of the clearest decisions yet on the ability of a trademark license to be rejected in bankruptcy.

The Law

Section 365(a) provides that a debtor, "subject to the court's approval," may "assume or reject any executory contract or unexpired lease of the debtor."Although not expressly defined in the Bankruptcy Code (11 U.S.C. *et. seq.*), executory contracts are considered to be contracts "on which performance is due to some extent on both sides."[3]

Section 365(a) permits a debtor to assume beneficial contracts and to reject contracts that may hinder its financial recovery.[4] It provides an "elixir for use in nursing a business back to good health" by allowing a trustee or debtor-in-possession to "prescribe it as an emetic to purge the bankruptcy estate of obligations that promise to hinder a reorganization."[5]

More than three decades ago, the U.S. Court of Appeals for the Fourth Circuit was asked to apply this legal framework to an intellectual property license granted by a debtor. In *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, the Fourth Circuit held that the term "executory contract" in Section 365(a) encompassed intellectual property licenses[6] and that under Section 365(g), the rejection of such a license required termination of that license. [7]

Three years later, in 1988, Congress softened the blow to intellectual property licensees by enacting a new section of the Bankruptcy Code: Section 365(n).[8] That Section provides that a licensee of intellectual property has the right to: (1) treat the license as terminated and assert a claim for pre-petition damages (a remedy the licensee already held under Section 365(g)); or (2) retain its intellectual property rights under the license. In doing so, Congress amended the definition of "intellectual property" to mean:

(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.[9]

"Trademarks" are noticeably absent from that definition. And in *Tempnology*, the First Circuit faced the issue of whether trademarks should be included in that definition.

The Factual Background

On November 21, 2012, Tempnology, LLC entered into a Co-Marketing and Distribution Agreement with Mission Product Holdings, Inc. That agreement, among other things, granted Mission a non-exclusive license to use Tempnology's trademarks and logo in its distribution of Temponology's specialized products such as towels, socks, headbands, and other accessories. That agreement also contained a separate provision granting Mission a non-exclusive license to Tempnology's intellectual property *other than* trademarks.[10]

After accruing multi-million dollar net operating losses in 2013 and 2014, on September 1, 2015, Tempnology filed a voluntary petition for relief under Chapter 11. The following day, it moved to reject 17 of its contracts, including its license agreement with Mission. To that end, Tempnology informed the bankruptcy court that it sought to reject its license agreement with Mission because it hindered its ability to derive revenue from other marketing and distribution opportunities. Tempnology alleged that the agreement "suffocated" its ability "to market and distribute its products."

Mission objected, arguing that Section 365(n) allowed Mission to retain its intellectual property license, including its non-exclusive license to Tempnology's trademarks.[11] The bankruptcy court disagreed with Mission, concluding that Congress' decision to omit "trademark" in the definition of "intellectual property" allowed debtors to reject trademark license agreements.[12]

Upon Mission's appeal, the Bankruptcy Appellate Panel for the First Circuit ("BAP") agreed with the bankruptcy court that Tempnology could reject the agreement as a whole, but disagreed as to the effect of the rejection, particularly as it related to the trademark license. Relying on the Seventh Circuit's decision in *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, the BAP held that the rejection of a trademark license did not necessarily eliminate a licensee's right to use the licensed trademarks.[13] The BAP reasoned that a contract rejected in bankruptcy is tantamount to a breach of contract and a licensor's breach of a trademark license would not prohibit a licensee from using a trademark. Thus, the BAP reversed the bankruptcy court's conclusion that Mission no longer had protectable rights in Tempnology's trademarks.[14]

The First Circuit's *Tempnology* Decision

On appeal, the First Circuit held that that Mission's right to use Tempnology's trademarks did not survive Tempnology's rejection of the license agreement.[15] In its decision, the First Circuit pointed out that, in defining the "intellectual property" eligible for the protection of Section 365(n), Congress expressly listed six kinds of intellectual property but omitted trademarks—"hardly something one would forget about."[16]

The First Circuit also rejected the Seventh Circuit's reasoning in *Sunbeam*, observing that *Sunbeam* rested on the "unstated premise" that it was 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."[17] The First Circuit explained that "the effective licensing of a trademark" required that the trademark owner be able to "monitor and exercise control over the quality of the goods sold to the public under cover of the trademark." [18]

In the First Circuit's opinion, the Seventh Circuit's approach would allow Mission to retain the use of Tempnology's trademarks in a manner that would force Tempnology to choose between performing executory obligations arising from the continuance of the license and risking the permanent loss of its trademarks. That kind of restriction on Tempnology's ability to free itself from its executory obligations, even if limited to trademark licenses alone, would depart from the manner in which Section 365(a) otherwise applies and would defeat the benefits of rejection, to wit, releasing a Chapter 11 debtor from burdensome agreements.

Accordingly, the First Circuit declared that it favored the "categorical approach of leaving trademark licenses unprotected from court-approved rejection unless and until Congress should decide otherwise," thereby endorsing a bright-line rule omitting trademarks from the protections of Section 365(n).[19]

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[1] 11 U.S.C. § 365(a).

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

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

[4] *See, e.g.Mason v. Official Comm. of Unsecured Creditors, for FBI Distrib. Corp. & FBC Distrib. Corp.* (*In re FBI Distrib. Corp.*), 330 F.3d 36, 41 (1st Cir. 2003).

[5] *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp.* (*In re Thinking Machs. Corp.)*, 67 F.3d 1021, 1024 (1st Cir. 1995).

[6] *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985).

[7] *Id.* at 1048.

[8] 11 U.S.C. § 365(n).

[9] 11 U.S.C. § 101(35A)

[10] *Tempnology*, 879 F.3d at 392-393.

[11] *Id.* at 394.

[12] *Id.* at 395.

[13] *Id.* at 395; *see also Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012).

[14] *Tempnology*, 879 F.3d at 395.

[15] *Id.*

[16] *Id.* at 401.

[17] *Id.* at 402.

[18] *Id.*

[19] *Id.* at 403.