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Licenses in Bankruptcy: Will "Mission" be Accomplished?

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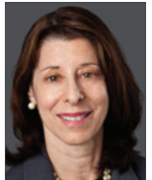

This column has discussed on several occasions the emergence of intellectual property as a critical asset class, and the related challenges for lenders from the evolving, and sometimes contradictory, IP collateral rules under federal and state law. Not surprisingly, judges in bankruptcy cases have also struggled to forge a clear and consistent path for the treatment of IP assets under the Federal Bankruptcy Code.

One of the areas of greatest controversy has been licensing of IP. Licensing enables widespread development, use and exploitation of IP by owners. In 1988, licensees were the beneficiaries of a new provision in the Federal Bankruptcy Code—section 365(c)—that allowed licensees to use licensed IP even after the debtor "rejected" the license. But one of the largest categories of intellectual property was noticeably omitted from that provision, namely trademarks.

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That omission has generated confusion nationwide among lower courts. And in the wake of a U.S. First Circuit Court of Appeals decision in January of this year, there is now a clear split among the U.S. federal circuit courts as to whether a licensee of trademarks can or cannot continue to use those trademarks after the license has been rejected by a bankrupt licensor. The conflicting views on this issue across jurisdictions have created significant and unnecessary risks for the finance markets.

Today's column reviews this recent decision of the First Circuit in *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, (No. 16-9016 (1st Cir. Jan. 12, 2018)), as well as the opposing view of the Seventh Circuit.

Background

First, some explanatory background. The general rule (contained in section 365(a) of the Bankruptcy Code) is that a debtor in bankruptcy is permitted to reject any "executory" contract, a term not defined in the Code but which case law has interpreted to mean a contract not fully performed on both sides. Rejection by the debtor is deemed a breach by the debtor as of the date immediately prior to its filing of a bankruptcy petition (365(g)). As a result, the aggrieved contract party is left with a pre-petition breach of contract claim against the debtor.

There are of course exceptions to this general rule and one of those is section 365(n) of the Code.

Section 365(n) was not part of the original 1978 Bankruptcy Code. It was enacted ten years later as a result of a 1985 Fourth Circuit Court of Appeals case ruling in *Lubrizol Enters. v. Richmond Metal Finishers,* 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol*, the court held that the sole remedy for rejection of a contract under section 365(g) was damages and that the alternative remedy of specific performance was not available. In so doing, the court distinguished between the remedies available under common law to a party against a non-bankrupt counterparty (which could include specific performance) and those

against a bankrupt counterparty (solely damages).

By adopting section 365(n), Congress restored to the licensee of intellectual property the rights it would have had if its licensor had not filed for bankruptcy, meaning the licensee could retain its rights to the licensed IP under the rejected contract for the duration of that contract. At the same time, Congress expanded the Bankruptcy Code definition of "intellectual property" to cover trade secrets, patents and patent applications, copyrights, and certain "mask works" (three-dimensional images for electronic circuits) that can be protected under federal copyright laws (section 101(35A)). What it did not cover, however, was trademarks.

The reason for that omission is somewhat obscure. But that of course has now sown the seeds of division among federal courts.

"Mission"

Mission harkens back to 2012.

Tempnology made exercise-related cooling accessories, such as headbands, socks and towels, designed to be able to be refrigerated. These were marketed under the names "Coolcore" and "Dr. Cool." Its products were supported by various registered and pending patents and trademarks.

In 2012 Tempnology and Mission Product Holdings, Inc. entered into a co-marketing and distribution agreement under which Tempnology gave Mission (i) distribution rights in the United States for certain of its manufactured products, (ii) a perpetual, non-exclusive license to its intellectual property other than trademarks and (iii) a non-exclusive, non-transferable limited license for its trademarks during the term of the agreement.

Following some contractual disputes and an arbitration, it was determined that Mission was entitled to its distribution and trademark rights until July 1, 2016. However, Tempnology filed for bankruptcy on Sept. 1, 2015 after experiencing significant net operating losses in 2013 and 2014.

Tempnology moved to reject the agreement with Mission and that motion was approved by the bankruptcy court as to the trademark and distribution rights, the debtor conceding that the perpetual license to intellectual property other than trademarks was preserved. Mission appealed to the Bankruptcy Appellate Panel for the First Circuit, which affirmed the bankruptcy court's ruling on the distribution rights but disagreed with the bankruptcy court when it came to the trademark license. Instead, the Panel looked to a 2012 ruling by the Seventh Circuit in the case of *Sunbeam Prods. v. Chicago American Mfg.,* (686 F.3d 372 (7th Cir. 2012) *cert denied,* 568 U.S. 1076 (2012)), the only other circuit court to specifically address this issue.

> In the wake of Mission Prod. Holdings v. Tempnology, there is now a clear split among the federal circuit courts as to whether a licensee of trademarks can or cannot continue to use those trademarks after the license has been rejected by a bankrupt licensor. The conflicting views on this issue across jurisdictions have created significant and unnecessary risks for the finance markets.

Sunbeam held that section 365(g) treats rejection of a contract in bankruptcy as a "common law" breach and therefore the licensee has whatever rights it would if a non-bankrupt debtor breached the license agreement. Those include damages but also the continued right to use the licensed IP.

On appeal, the First Circuit in a 2-1 decision affirmed the Bankruptcy Appeal Panel's determination as to the distribution rights but overruled it as to the trademarks, holding that Mission's right to use to Tempnology's trademarks did not survive rejection of the agreement. The latter ruling is the one that has generated the most discussion.

The Court's Analysis

In its analysis, the Mission court first observed that trademarks were clearly not within the six categories of intellectual property enumerated in section 365(n), noting wryly that trademarks are "hardly something one would forget about."

It then turned to legislative history for a possible explanation, quoting from the Senate Report relating to 365(n). Interestingly, that report states that Congress would "postpone congressional action" on trademark licenses and "allow

the development of equitable treatment of this situation by bankruptcy courts." (S. Rep. No. 100-105 (1988) at 5, *as reprinted in 1988 U.S.C.C.A.N.* 3200, 3204). The court also acknowledged the notion espoused by the Seventh Circuit in the Sunbeam decision that rejection converted a debtor's duty to perform into a liability for pre-petition damages, and relieved the licensor, but not the licensee, of its obligations under a license agreement

The issue, as articulated by the First Circuit, is whether rejection of a license agreement means that the debtor is free from obligation but that the other contracting party retains its rights, guided by the agreement and non-bankruptcy law (*i.e.*, a common law breach). Or does it mean instead that the contract is terminated and the debtor is liable solely for pre-petition monetary damages (*i.e.*, a "statutory" breach under section 365(g))?

From the perspective of the First Circuit majority, the answer seems clear: Congress did not allow trademarks within the "protective ambit" of 365(n) and equitable treatment is not available when the statute itself does not provide for such treatment (mere mention in a Senate Report is insufficient). Its conclusion: leave "trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise."

The Mission court took particular notice of the fact that effective licensing of trademarks requires monitoring and quality control. In its view, the Seventh Circuit failed to address the dilemma posed by freeing the debtor from continuing obligations under a trademark license while preserving the licensee's right to use the trademark; the Sunbeam decision would force the debtor to choose between using its resources to protect its trademarks or risking loss of their value.

Takeaways

Congress was obviously concerned with the special nature of trademarks, noting in the Senate Report that "trademark…relationships depend to a large extent on the quality of the products or services sold by the licensee." (S. Rep. 100-105 at 5). It then seemingly threw up its hands. By refusing to address the knotty problem of how to treat trademark licenses in bankruptcy, Congress attempted to kick the issue over to the courts.

While judges may ponder whether omitting trademarks was an endorsement of Lubrizol, or an invitation to the judiciary to fill the gap with creative solutions, the real result is what one would expect: confusion and inconsistency in the law.

But some courts are clearly reluctant to step in where Congress has failed to do so. While judges may ponder whether omitting trademarks was an endorsement of *Lubrizol*, or an invitation to the judiciary to fill the gap with creative solutions, the real result is what one would expect: confusion and inconsistency in the law.

On June 11, 2018, Mission filed a petition for a writ of certiorari with the Supreme Court for review of the First Circuit Court decision in regard to the question of whether its distribution rights constitute a "right to intellectual property" within the meaning of section 365(n) of the Bankruptcy Code, as well as whether the rejection of a license agreement under section 365 terminates rights of the licensee that would survive the licensor's breach under non-bankruptcy law.

Although Tempnology filed a waiver indicating it did not intend to file a response, the Supreme Court directed it to so file. Thereafter, The International Trade Mark Association submitted an *amicus* brief supporting Mission's petition. On July 24, 2018, Tempnology was granted an extension to Sept. 7, 2018 to respond to the requested petition for certiorari.

This interesting, important and difficult issue may yet (and hopefully will) make it to the US Supreme Court for adjudication and much needed certainty across all jurisdictions.

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