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Expert Analysis

Trademark Licenses and Intellectual Property Distribution Rights in Bankruptcy

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In a 2-1 decision, the U.S. Court of Appeals for the First Circuit reversed its Bankruptcy Appellate Panel's adoption of the *Sunbeam* rule, and held that a trademark licensee of a debtor-licensor is not entitled to continuing performance, after the debtor-licensor rejected the underlying contract. In its decision, which deepens the circuit split on the issue, the First Circuit favored the Fourth Circuit's view in *Lubrizol* and refused to apply the Seventh Circuit's analysis in *Sunbeam*. *In re Tempnology*, No. 16-9016, 2018 WL 387621 (1st Cir. 2018).

Assuming, Rejecting, Electing—What Does It Mean? Section 365(a) of the Bankruptcy Code allows a Chapter 11 debtor, subject to court approval, to assume or reject any executory contract. While a rejected contract leaves the non-debtor party with a prepetition damages claim for breach of contract under §365(g), it does not allow it to compel the debtor to continue performing. However, under §365(n), if the contract at issue is one "under which the debtor is a licensor of a right to intellectual property," the licensee may elect to "retain its rights … to such intellectual property," thereby preserving its ability to continue using the licensed IP. This IP exception was Congress's reaction to a 1985 Fourth Circuit decision, where the court held that the term "executory contract" encompassed IP licenses, and that under §365(g) the effect of rejection was to terminate an IP license altogether. See *Lubrizol Enterprises v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985).

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In conjunction with the enactment of §365(n)'s IP exception, Congress also amended §101(35A) to define Intellectual Property as one of the following: trade secret; invention, process, design, or plant; patent application; plant variety; a protected work of authorship; or protected mask work. Trademarks were purposefully left out, in order "to allow the development of equitable treatment of this situation by bankruptcy courts." See S. Rep. 100-505, 5.

In 2012, the Seventh Circuit accepted the invitation and held that while under §365(g) rejection constitutes a breach of contract that "frees the estate from the obligation to perform," this process does not imply "that any rights of the other contracting party have been vaporized." Following this reasoning, the Seventh Circuit held that while rejection converts a debtor's duty to perform into a liability for pre-petition damages, it leaves in place the counterparty's right to continue using a trademark licensed to it under the rejected

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agreement. *Sunbeam Prod. v. Chicago Am. Mfg.*, 686 F.3d 372 (7th Cir. 2012).

'In re Tempnology': Facts and Prior Decisions. Tempnology—a company whose business was making specialized products designed to remain cool even when used during exercise—entered into an agreement with Mission Product Holdings (Mission), granting the latter three distinct sets of rights: (x) non-exclusive rights to Tempnology's IP (not including trademarks); (y) distribution rights to certain of Tempnology's manufactured products; and (z) license to use Tempnology's trademark (together, the Agreement). Several years after the Agreement was signed, Tempnology filed for bankruptcy under Chapter 11 and immediately moved to reject the Agreement under §365(a). The Bankruptcy Court granted the motion, subject to Mission's election to retain its rights under §365(n). Once the Agreement was rejected, a dispute arose between Tempnology and Mission with respect to the latter's remaining rights under §365(n): While Tempnology conceded that Mission retained the rights in the first category (rights to Tempnology's IP), the parties disagreed with respect to the two remaining categories: (y) distribution rights; and (z) the trademark license.

The Bankruptcy Court agreed with Tempnology, holding that Mission did not retain either the exclusive distribution rights or its rights under the trademark license. As to distribution rights, the court reasoned that §365(n) only protects IP rights, and the exclusive distribution could not be labeled as such. With respect to the trademark license, the Bankruptcy Court held that it is not protected because the definition of "intellectual property" set forth in §101(35A) does not include trademarks. Mission appealed.

The Bankruptcy Appellate Panel for the First Circuit (BAP) agreed with the Bankruptcy Court that Mission's exclusive distribution rights were not retained under §365(n). It reached a different conclusion, however, with respect of the trademark license. While the BAP agreed that the trademark license was not protected under 365(n), it had a different view of the resulting rights. Relying on *Sunbeam*, the BAP held that because §365(g) deems the effect of rejection to be a breach of contract, and a licensor's breach of a trademark agreement outside of bankruptcy does not necessarily terminate the licensee's rights, rejection under §365(g) likewise does not necessarily eliminate those rights. Thus, the BAP reversed the Bankruptcy Court's determination that the trademark license was no longer protected. An appeal was taken.

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The First Circuit—Trademark Licensee Is Not Entitled to Post-Rejection Performance. In a 2-1 decision, the First Circuit affirmed the Bankruptcy Court's decision that a trademark licensee is not entitled to protection pursuant to 365(n), upon rejection of the underlying contract. Noting that this is an issue of first impression in the First Circuit, the court refused to apply the Seventh Circuit's analysis in *Sunbeam*. Instead, it chose to adopt the Fourth Circuit's approach in *Lubrizol*, holding that the rejection "left Mission with only a pre-petition damages claim in lieu of any obligation by [Tempnology] to further perform" with respect to the trademark license.

The First Circuit reasoned that in defining the IP eligible for the protection of §365(n), "Congress expressly listed six kinds of intellectual property … . Trademark licenses (hardly something one would forget about) are not listed" and are therefore not entitled to protection. In addition, the court addressed the unique nature of trademark licenses, which place a serious burden on the licensor to monitor and supervise the licensee. This nature, the court held, does not comport with "Congress's principal aim in providing for rejection," i.e., to "release the debtor's estate from burdensome obligations that can impede a successful reorganization." The court explained that "[t]rademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner. They signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill." Therefore, the "licensor's monitoring and control … serve to ensure that the public is not deceived as to the nature or quality of the goods sold." Placing such a restriction on a debtor's ability to free itself from its executory obligations would therefore "depart from the manner in which section 365(a) otherwise operates."

In so holding, the First Circuit critiqued the Seventh Circuit's *Sunbeam* analysis, finding that it "largely rests on the unstated premise that it is 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." The court disagreed, noting that "the effective licensing of a trademark requires that the trademark owner monitor and exercise control over the quality of the goods sold to the public under cover of the trademark." Here, the court found, the Seventh Circuit's view 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 or risking the permanent loss of its trademarks, thereby diminishing their value to Debtor." Finding that such a result would "ignore[] the residual enforcement burden it would impose[,]" the First Circuit concluded that trademark licenses do not survive rejection.

The Dissent. Judge Torruella concurred in part and dissented in part. The dissent touched only the trademark license issue. Judge Torruella disagreed with the "majority's bright-line rule that the omission of trademarks from the protections of section 365(n) leaves a non-rejecting party without any remaining rights to use a debtor's trademark and logo." Instead, Judge Torruella found that the legislative history of §365(n) suggests that courts should favor an equitable treatment of trademark licenses in a rejection context. Judge Torruella therefore concluded that the rejection of the executory contract by Tempnology "does not rescind the Agreement and eviscerate any of Mission's remaining trademark rights." Instead, the judge found, "the effect of [Tempnology's] rejection on Mission's trademark license should be guided by the terms of the Agreement, and non-bankruptcy law, to determine the appropriate equitable remedy of the functional breach of contract."

Exclusive Distribution Rights Also Do Not Survive Rejection. Like the Bankruptcy Court and the BAP before it, the First Circuit panel unanimously held that Mission's exclusive distribution rights did not survive the rejection of the Agreement. In this context, Mission argued that its exclusive distribution right is, de facto, a provision that renders its right to use Tempnology's IP exclusive. That is, because Mission has an exclusive right to sell certain products made using Tempnology's IP, no one else can use the IP. Hence, Mission reasoned, the exclusive distribution right is an "exclusivity provision" of the IP rights.

The First Circuit rejected this argument and held that "[t]he only thing that is exclusive [here] is the right to sell certain products, not the right to practice, for example, the patent that is used to make those products." The court explained that "[a]n exclusive right to sell a product is not equivalent to an exclusive right to exploit the product's underlying intellectual property." Therefore, the court affirmed the holdings of the courts below and concluded that this bucket of rights is not protected post-rejection.

Conclusion and Implications. In *Tempnology*, the First Circuit positioned itself within the circuit split regarding the relationship between trademark licenses and rejection of executory contracts. It held that "rejected" trademark licensees are left only with a pre-petition damages claim, and that they are not entitled to retain their rights under §365(n) of the Bankruptcy Code. Trademark licensees and distribution rights subject to First Circuit jurisdiction and elsewhere should understand the economic impact of their licensor's potential bankruptcy and explore options to structure the transaction in a manner that better protects their rights. The split opinion as well the circuit split concerning the treatment of trademark licenses in bankruptcy, is likely to lead to a request for re-hearing and potentially en banc review, and eventually to a petition for the Supreme Court to resolve the circuit split.