Tempnology: Trademark License Rejection in Chapter 11

On May 20, 2019, the U.S. Supreme Court issued a long-awaited decision resolving a split among the circuit courts of appeals on the treatment of trademark licenses after rejection. In Mission Product Holdings, Inc. v. Tempnology LLC, the Court held that the contractual rights of a trademark licensee continue after rejection of an underlying agreement. This decision might have implications for the effectiveness of rejection to facilitate the reorganization of distressed trademark licensors. Trademark licensors, their licensees and stakeholders of companies with significant trademark holdings should take note of the decision and monitor legal developments in its aftermath.

Facts and Procedural History

The respondent, Tempnology LLC, manufactured chemical-free cooling fabrics for exercise clothing and accessories. Tempnology marketed its products under the “Coolcore” name. In 2012, it granted an exclusive license to distribute its products in the U.S. to the petitioner, Mission Product Holdings Inc., and granted Mission a nonexclusive license to use the Coolcore trademarks both in the U.S. and globally.

In mid-2014, Mission sought to exercise its rights to terminate the distribution license, causing financial pressure on Tempnology. Mission’s actions, coupled with competition from other exercise clothing manufacturers, pushed Tempnology to file for relief under chapter 11 in September 2015.

Shortly after petition filing, Tempnology sought to reject the licensing agreement. The bankruptcy court approved the proposed rejection, which permitted Tempnology to stop performing under the contract and Mission to assert a pre-petition claim for damages. However, Tempnology also believed the bankruptcy court’s approval resulted in termination of the rights it had granted Mission to use the Coolcore trademarks.

Further litigation followed, and the bankruptcy court granted declaratory judgment in favor of Tempnology, finding that Tempnology’s rejection of the contract revoked Mission’s right to use the Coolcore trademarks. The bankruptcy court’s analysis focused on 11 U.S.C. § 365(n), which provides that the licensee of certain types of intellectual property may continue to use the property after the debtor/licensor rejects the license agreement, provided it continues to make payments under the contract. Because § 365(n) does not cover trademarks, the bankruptcy court held that a “negative inference” arises rendering trademark licensees’ rights extinguished upon rejection.

The Bankruptcy Appellate Panel (BAP) reversed. In its opinion, the BAP examined § 365(g), which provides that the rejection of a contract “constitutes a breach.” It also relied heavily on the Seventh Circuit opinion, Sunbeam Products Inc. v. Chicago Am. Mfg. LLC, which holds that rejection gives rise to a pre-petition damages claim but does not terminate the contract or otherwise “vaporize ... the counterpart’s rights.” In line with Sunbeam, the BAP held that Mission could continue to use the Coolcore marks.

The First Circuit rejected this view and reinstated the bankruptcy court’s decision terminating Mission’s license, agreeing with the bankruptcy court’s reasoning that a negative inference arose from § 365(n). Finding that under trade-
mark law, it is critical that a licensor continue to monitor and exercise quality control over the use of the trademark, the First Circuit reasoned that if Mission’s right to use the Coolcore trademarks were not terminated, Tempnology would need to continue monitoring the use of the marks. However, this would frustrate Congress’s key goal for rejection, which is to release the debtor’s estate from burdensome obligations.

The Supreme Court granted certiorari to resolve the split between the First and Seventh Circuits. In an 8-1 opinion, the Court affirmed the Seventh Circuit’s reasoning and reversed the First Circuit’s decision.

Supreme Court’s Decision

The majority first rejected Tempnology’s argument that this particular issue was moot, holding that Mission presented a claim for money damages in the form of lost profits arising from its inability to use the Coolcore trademarks following the rejection. The fact that Mission voluntarily refrained from using the marks was inconsequential because Mission adhered to the bankruptcy court’s ruling.

The majority also rejected Tempnology’s argument that Mission could not recover because Tempnology had recently distributed all of its assets, and noted that Mission can seek to unwind prior distributions should it prevail. In reaching its conclusion, the majority’s opinion examined three arguments: (1) whether rejection constituted a breach or rescission of the contract; (2) whether a negative inference arose from § 365(n)’s treatment of non-trademark intellectual property licenses; and (3) whether special features of trademark licenses compelled treatment of rejection as rescission.

Rejection Should Be Treated as a Breach, Not Rescission

The majority framed the first question as whether rejection has the same consequences as a contract breach outside of bankruptcy, or whether rejection has the effect of rescinding the contract. In the first view, rejection as breach, the counterparty has a claim for damages, but its rights under the contract remain in place. In the second view, rejection as rescission, rejection will terminate the contract and all rights under it (with exceptions expressly set out in the Bankruptcy Code). The majority embraced the rejection-as-breach view, which is consistent with the text of § 365 and fundamental principles of bankruptcy law.

More particularly, § 365(a) provides that a debtor, upon approval by the bankruptcy court, may “assume or reject any executory contract.” Section 365(g) further provides that rejection “constitutes a breach of [an executory] contract” deemed to have occurred “immediately before the date of the filing of the petition.” The term “breach” is not defined in the Bankruptcy Code and takes on the same meaning as in contract law outside of bankruptcy.

To illustrate its point, the majority discussed an example of a breach of an agreement to lease a copier and service the equipment with a law firm and its effects. Once the dealer stops providing servicing during the lease term, the firm has two options: (1) continue payments and sue the dealer for damages; or (2) stop payments, return the copier and sue for damages. The choice to pick an option is the law firm’s only; the dealer cannot retrieve the copier because the firm continues to have rights in it. The majority then applied the hypothetical to the bankruptcy context.

If the dealer files for bankruptcy and rejects the service contract, the law firm can keep up the contract or walk away, and it can sue for damages either way. (The majority noted that in bankruptcy, the firm’s right was limited to a pro rata claim because § 365(g) deems the rejection to have happened pre-petition.) Either way, the majority noted, the choice belongs to the law firm. Therefore, the majority thus reasoned that in bankruptcy, a rejection is akin to a breach of contract outside of the bankruptcy arena.

The majority then discussed a trademark license hypothetical where the licensor agrees to provide a license and associated goods and services, in exchange for royalties or fees. If the licensor breaches the trademark license, then, just like the law firm in the previous hypothetical, the licensee may continue making royalty payments or walk away. Either way, it has continuing rights in the license. Because § 365(g) deems rejection to “constitute a breach,” the debtor cannot treat the license as rescinded.

The majority maintained that this rule is in line with the fundamental principle that the estate cannot possess anything more than the debtor did itself outside bankruptcy. By contrast, the majority reasoned, the rejection-as-rescission approach would circumvent the Bankruptcy Code’s limits on avoidance actions. In other words, rescission would function as avoidance because it would roll back a prior transfer. This result would circumvent the Code’s strict limits on U.S.C. § 548 avoidance actions, which require actual or constructive fraud.

No Negative Inference Arises from the Exclusion of Trademark Licenses in § 365(n)

The majority then turned to Tempnology’s main argument that a negative inference arises from § 365(n). Section 365(n) provides that licensees of certain intellectual property, excluding trademarks, retain contractual rights after rejection. It is similar to § 365(h) and (i), which provide that certain purchasers and lessees of real property and timeshare interests can continue to exercise rights after a debtor has rejected the lease or sales contract. Tempnology relied on these provisions to argue that the ordinary consequence of rejection must be something other than survival of contractual rights, otherwise the general rule would swallow the exceptions.

The majority dismissed these arguments as unpersuasive because they did not explain how to read one of the main provisions, § 365(g), which provides that rejection “constitutes a breach.” The majority recognized that the exceptions in § 365(h), (i) and (n) arose as a result of legislative

---

7 139 S. Ct. at 1660.
8 Id.
9 Id. at 1661.
10 Id.
11 Id.
12 Id. (citing Field v. Mans, 516 U.S. 59 (1995)).
intervention for discrete problems. The majority maintained that the exceptions reinforce or clarify the general rule that contractual rights survive the rejection.

The majority also noted that § 365(n) was enacted after the decision by the Fourth Circuit Court of Appeals in Lubrizol Enterprises v. Richmond Metal Finishers, which held that the debtor’s rejection of a patent license revoked the license. To avoid the result in Lubrizol, Congress enacted § 365(n) to make clear that patent licensees’ rights remain in effect after rejection. By contrast, the majority noted, trademark licenses continued to fall within the general rule with other contracts and held that a negative inference does not arise from the ratification of § 365(n).

Special Features of Trademark Licenses Do Not Compel a Different Result

The majority then turned to Tempnolgy’s final argument: A trademark licensor has a continuing duty to monitor and exercise quality control over the use of the trademark. Tempnolgy argued that absent monitoring, the trademark will naturally decline in value and might eventually become invalid. The argument went that if rejection does not terminate the license, then the debtor remains saddled with the costs of monitoring, which will impede the reorganization and undermine a fundamental purpose of the Bankruptcy Code.

This argument overstates the case, the majority held. In the majority’s view, a key purpose of the Code is to facilitate reorganization — but not at all costs. Although rejection is a “powerful tool” for a debtor to shed burdensome contracts and start fresh, it does not grant the debtor an exemption from otherwise applicable law. Rather, the Code aims to balance the legitimate expectations of the debtor and its counterparties. While this might impact the reorganization of some trademark licensors, that is part of the economic calculus that a debtor undertakes when making the decision to reject.

Court’s Decision Does Not Grant Trademark Licensees “Unfettered” Rights to Continue to Use a Rejected License, but It Might Result in More Expansive Post-Rejection Rights for a Licensee

Justice Sonia Sotomayor wrote a short concurring opinion to clarify two “potentially significant” points in the majority’s opinion. First, the concurrence noted that the majority did not decide that a trademark licensee has “unfettered” rights to continue to use a trademark license that has been rejected. Rather, special terms in the license or state law could affect the continuing rights of the licensee.

Next, the concurrence noted that the majority’s opinion signifies that a trademark licensee’s post-rejection rights are more expansive in some regards than for licensees of other intellectual property. Section 365(n), which applies to certain non-trademark intellectual property, has limits on the post-rejection use of the license, including that the licensor has no right to deduct damages from its payments, even if it could have otherwise done so under nonbankruptcy law. The concurrence recognized that the majority’s opinion creates disparate treatment for trademark licenses on the one hand and licenses of other intellectual property on the other hand. The concurrence noted that Congress might seek to remove this disparity through amendments to the Bankruptcy Code, as it has before.

Justice Gorsuch Dissents that the Petition Was Improvidently Granted

Justice Neil Gorsuch dissented to note that the petition was improvidently granted because the original case was moot. He noted that the trademark license expired on its own terms during the dispute, and that the damages claim was uncertain at best. Justice Gorsuch’s view is that if there were uncertainty about mootness, the Court should not have granted the petition.

Implications

The Supreme Court’s decision in Tempnolgy might have ramifications in cases where a chapter 11 debtor seeks to reject a trademark license. While the decision moves the treatment of trademark licenses in chapter 11 into closer parity with the treatment of other types of intellectual property licenses under § 365(n), differences remain, as noted by Justice Sotomayor in her concurrence.

As it currently stands, a trademark licensee could offset damages against ongoing royalty payments, which § 365(n) prohibits for non-trademark intellectual property licensees. The decision might also prompt Congress to take action to align the treatment of trademark licenses with other types of intellectual property licenses, as suggested by Justice Sotomayor.

The decision may encourage distributors and other types of trademark licensees to deal with distressed licensors. A distributor might be more willing to contract with a licensor facing distress knowing that upon a chapter 11 filing, the distributor’s rights in the contract will continue throughout the term of the contract, even if the license is rejected. On the flip side, licensors facing distress due to burdensome trademark license and related obligations may be less willing to enter chapter 11. It was Mission’s attempt to terminate the exclusive distribution contract with Tempnolgy that partly precipitated the chapter 11 filing.

In addition, the Court’s reasoning in dicta that there was a live controversy in part because Mission could seek to unwind prior distributions might affect arguments based on equitable mootness, which is a judicially created abstention doctrine in bankruptcy that acknowledges that appeals from a confirmation order threaten to unwind complex debtor reorganizations. When opponents of a confirmed reorganization plan seek to unwind distributions that might be central to the

20 139 S. Ct. at 1662.
21 Id. at 1665 (citing Brief for Respondent at 59-60).
22 Id.
23 Id.
24 Id. at 1666 (Sotomayor, J., concurring).
25 Id.
26 Id. (citing Brief of American Intellectual Property Law Association as Amicus Curiae at 20-25, which discussed examples of contract terms that could potentially lead a bankruptcy court to limit licensee rights after rejection).
27 Id. (Sotomayor, J., concurring).
28 Id. at 1667 (Gorsuch, J., dissenting).
plan, they could cite this *dicta* to combat the application of equitable mootness to their appeals.\(^\text{29}\)

The ultimate effect of the *Tempnology* decision on the legal landscape for trademark licenses in chapter 11 remains to be seen. While the decision resolves a circuit split, it leaves open the question of further legislative intervention and opens bankruptcy courts to a patchwork of potential treatments of rejected trademark licenses, varying based on contract terms and diverging state law. Trademark licensors, licensees and stakeholders in companies with significant trademark holdings should monitor legal developments following this important decision.  


The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

\(^{29}\) See, e.g., *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. 2015) (ruling that appeal from confirmation order to set aside settlement that was central issue in reorganization plan was equitably moot).