US Supreme Court Holds That Bankrupt Companies Cannot Rescind Trademark Licenses

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On May 20, 2019, the U.S. Supreme Court ruled in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 587 U.S. ___, that a debtor's ability to reject executory contracts under Section 365(a) of the Bankruptcy Code does not permit the debtor to rescind trademark licenses. In concluding that trademark licensees cannot unilaterally be deprived of their rights to use a debtor's mark, the Court resolved a long-standing circuit split that the International Trademark Association had referred to as "the most significant unresolved legal issue in trademark licensing."

Background

Section 365(a) of the Bankruptcy Code provides that a debtor or trustee undertaking a Chapter 11 reorganization may, subject to court approval, assume or reject any "executory contract" — that is, a contract in which some performance remains due on both sides. Accordingly, a debtor or trustee seeking to administer a bankruptcy estate and pay off creditors will determine whether the executory contract is worth maintaining, and the decision to continue or reject that contract is granted broad deference by bankruptcy courts. Section 365(g) provides that if the executory contract is rejected, it constitutes a "breach" by the debtor, and the counterparty may sue and seek damages from the estate. As a practical matter, however, the counterparty is unlikely to be compensated in full because the breach is deemed to have occurred prior to the bankruptcy filing and therefore the counterparty will hold a general unsecured claim in the bankruptcy case.

The rule that executory contracts may be rejected is subject to a number of important statutory exceptions. Most pertinent to the current decision, Section 365(n) provides that a licensee "of a right to intellectual property" may opt to retain its rights under the applicable license so long as the licensee is fulfilling its own obligations under the license (*e.g.*, paying all required royalties). "Intellectual property," however, is expressly defined by Chapter 11 of the Bankruptcy Code to include materials such as trade secrets, inventions and other patentable materials, and works of authorship protected by copyright. Notably, the statute makes no mention of "trademarks" (or "trade dress"). The exclusion of "trademarks" from the statute, among other concerns, led to a circuit split as to whether debtors and trustees had unfettered discretion to reject ongoing trademark licenses, and the implications of such a rejection.

In the current dispute, Mission Product Holdings (Mission) held an exclusive license to distribute certain clothing and accessories made by Tempnology under the brand name "Coolcore" and a nonexclusive license to use the "Coolcore" trademarks around the world. Although the license was set to expire in July 2016, Tempnology filed for Chapter 11 bankruptcy in September 2015 and was permitted by the bankruptcy court to reject the license agreement with Mission. Critically, the bankruptcy court further concluded that the rejection of the license revoked Mission's right to use the "Coolcore" marks going forward.

The Bankruptcy Appellate Panel reversed, concluding that, as per Section 365(g), Tempnology had breached the agreement, and outside of bankruptcy the breach of an agreement does not eliminate rights that a contract had already conferred on the nonbreaching party.

On further appeal, the Court of Appeals for the First Circuit reversed again, reinstating the termination of the license pursuant to the bankruptcy court's decision below. In so ruling, the First Circuit focused on the absence of any reference to "trademarks" from

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Section 365(n) as well as a policy determination that permitting a trademark license to continue would force the licensor to keep monitoring its licensees' activities to ensure quality control — which the court viewed as a "burdensome obligation" from which a debtor or estate should be released when restructuring.

Supreme Court Decision

In an 8-1 decision authored by Justice Elena Kagan, the Supreme Court reversed the First Circuit, finding that "both Section 365's text and fundamental principles of bankruptcy law" compelled the conclusion that rejection of an executory contract operates only as a breach, not as a rescission that permits unilateral revocation of an ongoing trademark license.

From a textual perspective, the Court focused on Section 365(g) and explained that "breach," as used in the Bankruptcy Code, is no different than what the term means in general contract law. Accordingly, the consequences of a breach of a license in bankruptcy by virtue of a rejection are no different from the consequences of any other breach of a license: The debtor can stop performing its remaining obligations under the agreement but cannot rescind a license that already has been conveyed, and the licensee may continue to do whatever the license authorizes.

The Court further noted that if it adopted the "rejection-as-rescission" approach advocated by Tempnology, it would circumvent the Bankruptcy Code's "stringent limits" on avoidance actions — the exceptional cases in which trustees or debtors may unwind pre-bankruptcy transfers that undermine the bankruptcy process (such as where there are fraudulent or preferential conveyances on the eve of bankruptcy). If trustees or debtors could use rejection to rescind previously granted interests, the Court reasoned, it would effectively broaden the statutory rights to avoidance that are enumerated in different sections of the Bankruptcy Code and subject to higher burdens.

Although the Court recognized that "trademarks" are not mentioned in Section 365(n) or elsewhere in the enumerated exceptions to the rejection rule, it refused to draw a "negative inference" that the absence of that term meant that trademark licensees lacked certain contractual rights. Tempnology's argument in this regard, the Court opined, relied on the improper premise that the ordinary consequence of rejection is termination of contractual rights previously granted. Indeed, the Court thought little of the litany of exceptions in the statute, describing them as a "mash-up of legislative interventions" that "say[ ] nothing much of anything about the content of Section 365(g)'s general rule." Rather, the exceptions reflected the fact that any time Congress has been "confronted with the consequences" of a view that rejection terminates all contractual rights, it has "expressed its disapproval" when dealing with the specific context at hand.

Finally, the Court rejected the argument that the special features of trademark law mandated that licensors should be permitted to rescind trademark rights in bankruptcy. While seeming to acknowledge some potentially "serious … trademark-related concerns," the majority found that adopting a "breach-as-rescission" construction of Section 365 simply to address the trademark concept would be "allow[ing] the tail to wag the Doberman." As part of the balance struck in Section 365, trademark licensors — like any other debtors that are parties to executory contracts — must make economic decisions about the value of the license and determine whether to make investments to preserve the value of the brand(s) and mark(s) being licensed. While the debtor may escape its own future contractual obligations if it deems that worthwhile, it may not simply do away with the license entirely.

In dissent, Justice Neil Gorsuch did not address the merits of the dispute or the nature of Section 365(g). Instead, he concluded that Mission lacked Article III standing because the case was moot; after the ruling of the bankruptcy court, the term of the license agreement expired. The majority dismissed this position on the grounds that Mission presented theories under which it may have a claim for money damages.

Looking Ahead

The Supreme Court's decision rests at the intersection of trademark and bankruptcy law, and will have broad implications in both areas.

Implications for Trademark Law

With respect to trademark (and trade dress) law, the decision provides much-needed certainty both for debtors and licensees regarding how ongoing trademark licenses will be treated during restructuring. Trademark licensees — particularly licensees that have very long-term and/or exclusive licensing arrangements — will have additional comfort that their reliance on a licensed trademark in building a business will not be eviscerated by an untimely bankruptcy by the licensor. When determining whether rejection is beneficial to the bankruptcy estate, debtors and trustees will have consistent rules across all jurisdictions regarding what rejection of a trademark license will and will not accomplish. As a practical matter, this may lead to higher licensing fees to account for the greater risk on the part of the licensor, or greater emphasis on attempts to contract around this risk (to the extent that is permissible).

It must be noted, however, that the Court largely bypassed the policy arguments of both sides to the dispute in favor of a textual analysis and in so doing may have glossed over important consequences of its decision. For example, the majority notes that debtors may continue to "escape all of [their] future contract obligations" through rejection when making a value judgment as to whether to expend resources on quality control, but it does not directly address the concern that failure to provide such quality control risks the loss of trademark rights entirely because it may constitute impermissible "naked licensing." Similarly, to the extent that a licensee is continuing to use a trademark without any meaningful supervision from the mark owner, it could create consumer confusion regarding the mark owner's actual relationship to the products or services at issue. It will behoove parties to trademark licenses to attempt to address these issues in advance via detailed and forward-thinking contract provisions.

Implications for Restructuring

In reviewing its executory contracts, a debtor has an important decision to make: which ones are valuable and worth keeping and which ones are not and worth rejecting. The Supreme Court's holding that a nondebtor licensee may continue to use the debtor's trademarks post-rejection if the agreement and applicable nonbankruptcy law so provide may have a significant impact on a debtor's decision to assume or reject. This means that a debtor needs to understand what rights nondebtor counterparties may have under the contract pursuant to applicable nonbankruptcy law in order to make an informed decision to assume or reject. The ruling could have broad implications on a debtor's decision to assume or reject many types of agreements, including those outside of trademark licenses, like options contracts, among others. In each situation, a debtor needs to evaluate both the benefit of its own nonperformance and the potential cost of the nondebtor continuing to operate under the contract, should it choose to do so post-rejection.

With respect to trademarks specifically, the Court's ruling may result in a debtor realizing less value for its assets in a sale pursuant to Section 363 of the Bankruptcy Code or under a plan of reorganization. A purchaser would likely pay less in such transaction if it is acquiring assets from a debtor whose rejected licenses continue to be subject to licensees' rights to use the debtor's trademarks following the sale.

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