Rejection equals breach, not termination: Trademark licensor cannot use bankruptcy to terminate license

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Being a participant in a bankruptcy case is often described as taking a trip down the rabbit hole in Alice in Wonderland: Down is up and up is down. On rare occasions, the U.S. Supreme Court steps into that rabbit hole to resolve a controversy that has bedeviled practitioners, courts and scholars and says, paraphrasing the Cheshire Cat, "You're all mad there."

In *Mission Product Holdings Inc. v. Tempnology LLC, NKA Old Cold LLC*, which was decided on May 20, the Supreme Court ruled that a trademark licensor that files for bankruptcy cannot offensively use the bankruptcy process to deprive a trademark licensee of its rights under the license. The decision protects the rights trademark licensees have acquired and their investment in them.

As the King said to Alice: "Begin at the beginning ... and go on till you come to the end: Then stop."

A TRADEMARK LICENSE IS AN EXECUTORY CONTRACT

An executory contract is one where obligations remain to be performed on both sides of the agreement. A trademark license is an executory contract. Section 365 of the Bankruptcy Code allows a debtor to assume or reject any executory contract.

If a debtor rejects the contract, Section 365(g) provides that the rejection constitutes a breach that is deemed to occur immediately before the date the bankruptcy was filed. This means that once the brand owner/debtor has rejected a trademark license, the licensee has a general unsecured claim that, if paid at all, will be paid in bankruptcy dollars — often the equivalent of Weimer Republic Reichsmarks.

This is of little comfort to the licensee because what the licensee wants is to be able to continue to use the trademark and sell products. And that was the rub because the circuit courts were not in agreement on the effect of rejection on the right of the licensee to continue to use the trademark.

In *Mission Product*, the debtor argued that its rejection also terminated the license and the rights of Mission to use its trademarks. Mission disagreed.

THE *MISSION PRODUCT HOLDINGS* DECISION

The Supreme Court held that rejection of a license agreement does not deprive the licensee of its rights to use the trademark under the agreement. Rather, the high court decided, rejection constitutes a breach of contract as opposed to a termination or rescission of the rights of the licensee to use the mark.

Rejection, the court held, has the same effect as breach of that agreement outside of bankruptcy: The debtor and counterparty do not revert to pre-contract positions.

Under basic contract law, a breach gives the nonbreaching party the right to sue for damages caused by the breach and the right to either terminate or continue with the contract. The option belongs to the nonbreaching contract counterparty, not the breaching party.

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Justice Elena Kagan, who authored the majority opinion, wrote: "The debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed. So the licensee can continue to do whatever the license authorizes."

Tempnology had argued that the Intellectual Property Bankruptcy Act of 1988, codified in Section 365(n) of the Bankruptcy Code to expressly address the rights of licensees of intellectual property when the debtor-licensor rejects an intellectual property license, does not include trademarks.

Under Section 101(35A) of the Bankruptcy Code, "intellectual property" is defined as six categories of IP, including trade secrets, patents and copyright protected material, but not trademarks.

This must mean, Tempnology asserted, that because Congress had created post-rejection rights for only certain parties, a different rule had to apply to all others. "The debtor's rejection must extinguish the rights that the agreement had conferred on the trademark licensee," Tempnology argued.

In response to that argument, which had been made by legions of bankruptcy lawyers and courts before, eight justices of the Supreme Court, like a parent with a small uncomprehending child, collectively shook their heads and held that there was no basis for this "negative inference."

The absence of trademarks from Section 365(n) is irrelevant: A trademark license is an executory contract. Therefore, its treatment in bankruptcy is governed by the general provisions of Section 365, and Section 365(n) does not matter, according to the majority opinion.

Attention also must be paid to Justice Sonia Sotomayor's concurring opinion, which highlighted "two potentially significant features" of the holding.

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First, Justice Sotomayor noted that the decision did not grant every trademark licensee the unfettered right to continue using the mark post-rejection. She stated that a case-by-case inquiry must be made to determine whether, in fact, the licensee's rights would survive a breach under applicable non-bankruptcy law.

Second, she said the court's holding "confirms that trademark licensees' post-rejection rights and remedies are more expansive in some respects than those possessed by licensees of other types of intellectual property."

Specifically, she noted that an intellectual property licensee of the type of IP covered by Section 365(n) and identified in Section 101(35A) that elects to retain its rights to the licensed IP post-rejection "must make all of its royalty payments; the licensee has no right to deduct damages from its payments even if it otherwise could have done so under nonbankruptcy law. §365(n)(2)(C)(i). This provision and others in Section365(n) do not govern trademark licenses."

Justice Sotomayor suggested that exactly how trademark licensees are to be treated differently from licensees of other forms of intellectual property may ultimately be up to Congress.

IMPACT ON LICENSEES AND LICENSORS

What is the effect of the *Mission Product* holding?

- A debtor/licensor cannot use rejection as a sword to give it the opportunity to rid itself of an unprofitable trademark license.
- If a debtor/licensor rejects a trademark license, the licensee has the option to assert a damage claim due to rejection of the license and give up the right to use the mark or to continue to use the mark through the end of the license term.
- If the licensee opts to continue to use the mark, it must meet its obligations under the contract, which normally means it has to pay whatever royalty payments are due and otherwise preserve the mark, which the debtor can enforce.
- Based upon Justice Sotomayor's comments, the licensee would also retain the right to seek damages for the debtor's breach and potentially deduct damages from payments owed post-rejection, if it would have that right under nonbankruptcy law.
- Justice Kagan made clear that "the debtor can stop performing its remaining obligations under the agreement," and consequently the licensee cannot compel the debtor to specifically perform or otherwise comply with its obligations under the license agreement. For example, the debtor would not be required to take action to prevent infringement of the mark or defend infringement claims. (The debtor's obligations to maintain quality control generally of its marks imposed by statute are unrelated to any specific license and not affected by rejection.)
- *Mission Product* decided only the effect of a debtor/trademark *licensor's* rejection of a license agreement. The reverse issue — what happens if a debtor/trademark *licensee* rejects a license agreement — has been long settled. If the debtor rejects a contract, including a trademark license, it is exercising its business judgment that the contract does not benefit its estate and it wants to be relieved of its obligations. In virtually all situations, the court accepts the debtor's business judgment and lets the debtor off the hook. Once it rejects, it no longer has the right to obtain the benefit of the contract and converts its burden under the contract from performance and payment to a damage claim held by the contract counterparty.

All one can do is to agree with Alice: curiouser and curiouser!

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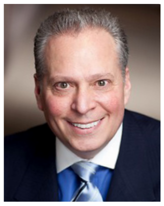 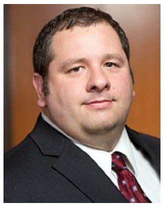 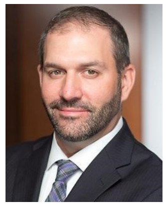

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