2019 Bankruptcy Truisms: "Rejection" of an Executory Contract Means "Breach," and Not "Rescission," and a Trademark Is Not a Type of Intellectual Property

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The Supreme Court recently held, in *Mission Product Holdings, Inc. v. Tempnology, LLC*,[1] that a debtor-licensor's choice in bankruptcy to reject an executory trademark licensing agreement does not necessarily deprive the non-debtor licensee of its rights to use the trademark moving forward. The Supreme Court determined that the licensor's choice to reject an executory contract under 11 U.S.C. § 365(a) functions as a breach of contract and has the same effect as a breach outside of bankruptcy, instead of unwinding the rejected contract as if it never existed. Specifically, the Supreme Court found that Mission Product Holdings, Inc.'s ("MPH") right to use the trademark "Coolcore," which was granted to it by Tempnology, LLC ("Tempnology") pursuant to a nonexclusive license, was not necessarily disturbed by Tempnology's rejection of the license in its bankruptcy proceeding.

The Supreme Court's decision is significant not only for bankruptcy attorneys, but also for other attorneys who deal with contracts and contract disputes in their practice, whose clients' post-rejection rights may be affected by the decision.

Circuit Split Before *Tempnology*

The Supreme Court's decision was a highly-anticipated ruling in the bankruptcy world because it ended a long-running split in circuit authority regarding the consequences of a debtor's rejection of a trademark license agreement.

Bankruptcy Code Section 365 Background

The statutory underpinning of the *Tempnology* decision is section 365(a) of the Bankruptcy Code,[2] which gives a debtor the ability to assume or reject executory contracts and unexpired leases. But what is considered an "executory contract"? The term is not defined in the Bankruptcy Code. The leading definition is the so-called Countryman definition, which observes that the term executory contract "generally includes contracts on which performance remains due to some extent on both sides."[3]

It is a contract between a debtor who has filed for bankruptcy and a non-debtor party, where both parties to the agreement still have obligations remaining on their respective sides.[4] These types of agreements constitute both an asset (the debtor's right to the non-debtor's future performance under the agreement) and a liability (the debtor's own obligations to perform under the agreement).[5]

Some examples of an executory contract include a vehicle lease where the lessor owns the vehicle and allows the lessee to keep possession of its vehicle day by day or month by month. Or, relevant to the *Tempnology* decision, an intellectual property license, pursuant to which a licensee can continue to use the intellectual property only within the defined scope of the license, and the licensor must continue to refrain from suing the licensee for licensed uses of the intellectual property.[6] Or, to cite the example provided in Justice Kagan's majority decision, a dealer who leases a photocopier to a law firm and agrees to service it every month, in exchange for the firm committing to pay a monthly fee.[7]

The choice of whether to assume or reject an executory contract under section 365(a) is governed by the bankruptcy court's application of the deferential "business judgment" rule.[8] Section 365(a) gives the debtor or its trustee the option, once a bankruptcy case is commenced, to decide whether the debtor's executory contract is beneficial to the bankruptcy estate moving forward.[9] If the contract is seen as a "good deal," then the debtor or its trustee may seek to assume the contract.[10] If the contract is assumed, the debtor must cure any defaults and fulfill its obligations under the agreement.[11] The debtor, in turn, benefits from the non-debtor counterparty's performance under the agreement.[12] If the contract is seen as a "bad deal," then the debtor will likely decide to reject the contract, which essentially means the repudiation of the debtor's duties moving forward.[13]

The effect of rejecting an executory contract is governed by section 365(g), which provides that rejection of a contract constitutes a breach of that agreement. Accordingly, the non-debtor party will have a claim against the debtor's estate for damages arising from the debtor's nonperformance under the contract.[14] The debtor's breach is deemed to occur "immediately before the date of the filing of the [bankruptcy]," instead of on the actual rejection date.[15] This puts the non-debtor party to the rejected executory contract in the same position as the debtor's other unsecured creditors.[16]

The Bankruptcy Code expressly protects rights to certain types of intellectual property.[17] "Intellectual property" is defined as: "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17."[18] Licensees of these types of intellectual property retain contractual rights after rejection.[19] Notably missing from the Bankruptcy Code's definition of "intellectual property" is "trademark."[20]

Fourth Circuit's Decision in *Lubrizol* and Congressional Response

Section 365(n) was enacted by Congress in response to the threat posed to the technology industry by the Fourth Circuit's 1985 ruling in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*[21] That decision held that if a debtor rejects an executory intellectual property license, the non-debtor licensee is deprived of its right to use the license moving forward. The court further found that the licensee's only remedy in this situation would be to file a claim for money damages. The licensee would not be able to seek specific performance of the license agreement upon rejection.[22]

Congress amended the Bankruptcy Code in 1988 after the *Lubrizol* decision by adding section 365(n). Specifically, section 365(n) provides that licensees of rejected intellectual property licenses have two options when a debtor-in-possession or trustee rejects their license agreement: (A) the licensee can treat the agreement as terminated and assert a claim for damages, or (B) the licensee can retain the right to use the licensed intellectual property moving forward for the duration of the license, with certain limitations. However, these special protections added to the Bankruptcy Code by Congress omitted trademarks from the definition of rejected "intellectual property" licenses.[23] Other kinds of intellectual property, such as trade names and service marks, are also not included in the definition of "intellectual property" pursuant to section 101(35A). As a result, since Congress's amendment in 1988, courts have had to interpret and decide the impact of a debtor's rejection of a trademark license in bankruptcy on their own. This has led to inconsistent outcomes and, ultimately, a circuit split.

Seventh Circuit's Decision in *Sunbeam*

In 2012, the Seventh Circuit expressly rejected the Fourth Circuit's approach to trademark licenses, in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC,*[24] and held that rejection did not terminate the licensee's rights to use the trademark. The Seventh Circuit focused its decision on its reasoning that outside of bankruptcy, a licensor's breach does not function to terminate a licensee's right to use the licensed intellectual property. The court explained the impact of section 365(g), discussed above,[25] pursuant to which it reasoned: "What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place." As a result, it found that rejection of an agreement in bankruptcy should have the same effect as the breach of an agreement outside of the bankruptcy context—i.e., the breach does not eliminate the rights the contract has already given to the non-breaching party. The Seventh Circuit allowed the non-debtor trademark licensee to continue using the licensed trademarks despite the debtor licensor's rejection of the trademark license.

What Happened in First Circuit's Decision in *Tempnology*

In November 2015, the New Hampshire bankruptcy court issued a decision regarding cold-weather clothing innovation company Tempnology and its marketing and distribution agreement with MPH. Tempnology manufactured clothing and accessories designed to stay cool when used during exercise. It marketed its products under the brand name "Coolcore," and used trademarks (such as logos and labels) to distinguish its products from other athletic apparel.[26]

In its 2012 agreement with MPH, Tempnology had granted MPH an exclusive right to distribute certain cooling material products that Tempnology manufactured, the Coolcore products, and a non-exclusive license to use the Coolcore trademark. Tempnology filed a petition for chapter 11 bankruptcy in September 2015, before its contract with MPH was set to expire in July 2016. With one of its first motions in its bankruptcy case, Tempnology asked the bankruptcy court to allow it to reject the licensing agreement with MPH because it had hindered its ability to derive revenue by other marketing and distribution opportunities.[27] The bankruptcy court approved the proposed rejection. This rejection meant two things on which the parties agreed: Tempnology could stop performing under the agreement, and MPH could assert a pre-petition claim in the bankruptcy proceeding for damages resulting from Tempnology's non-performance and rejection of the contract.

However, Tempnology returned to the bankruptcy court for a declaratory judgment that its rejection of the contract with MPH also meant that Tempnology had terminated the rights to use the Coolcore trademarks it had granted to MPH.[28] Tempnology based this argument on section 365(n), which sets out the rule for "intellectual property" licenses, as defined by section 101(35A). Again, pursuant to section 365(n), if the debtor-licensor rejects the agreement, then the licensee can continue to use the property so long as the licensee makes whatever payments the contract demands. Tempnology pointed out that because section 365(n) does not explicitly protect trademark licenses in the same way,[29] a different rule must apply. Specifically, argued Tempnology, a debtor-licensor's rejection must terminate the rights conferred on the trademark licensee. The bankruptcy court agreed with this "negative inference" proposed by Tempnology and ruled that Tempnology's rejection of the agreement meant that MPH lost its trademark license rights moving forward upon such rejection.[30]

The First Circuit Bankruptcy Appellate Panel (the "BAP") reversed, relying on the Seventh Circuit's decision in *Sunbeam*.[31] The BAP held that Tempnology's rejection of the agreement did not result in termination of the license because, just as breach of an agreement does not eliminate contract rights already conferred on the non-breaching party outside of bankruptcy, a rejection does not terminate the contract or "vaporize" the counterparty's rights.[32] Accordingly, the BAP determined that MPH could continue using Tempnology's Coolcore trademarks.

The First Circuit Court of Appeals rejected the BAP's reasoning, including its reliance on the *Sunbeam* decision.[33] Instead, the First Circuit held that, upon Tempnology's rejection of the agreement, MPH's rights under the license were terminated. The First Circuit's decision endorsed the bankruptcy court's section 365(n) "negative inference" reasoning, and also pointed out that special features of trademark law would make it unfair to allow a licensee to retain rights to a mark once the licensing agreement is rejected.[34] MPH filed a petition for *certiorari*, which was granted.

Supreme Court's Holding that Rejection of a Trademark License Constitutes a Breach of the Contract, but Does Not Rescind the Contract

In its resolution of the division between the First and Seventh Circuits, the Supreme Court reversed the First Circuit and held, in an 8-1 decision, that a debtor-licensor's rejection of a trademark license in bankruptcy constitutes a breach of the license and not a termination. The Supreme Court found that upon rejection of the trademark licensing agreement, the rights that would ordinarily survive contract breach remain in place. Accordingly, such rejection does not revoke the rights previously granted to non-debtor licensees under the trademark license. Specifically for the parties involved, the Supreme Court found that MPH's right to use the trademark was not necessarily disturbed by Tempnology's rejection of the license agreement.

The Supreme Court relied on a textual interpretation of the Bankruptcy Code's provisions on rejection, finding that the statutory text "does much of the work."[35] First, the Supreme Court focused on section 365(g), which says that rejection of an executory contract is a breach of the agreement deemed to occur immediately before the petition date. Second, because "breach" is not a defined or specialized bankruptcy term, the Supreme Court found that it means in bankruptcy what it means in contract law outside of bankruptcy. Therefore, the Supreme Court reasoned that, upon rejection of a trademark license agreement, even though the debtor-licensor can stop performing its remaining obligations under the agreement, the debtor "cannot rescind the license already conveyed."[36] This means that "the licensee can continue to do whatever the license authorizes."[37]

The Supreme Court found that under relevant state law, the breach of an agreement gives the aggrieved party the "choice" to terminate the agreement and make a claim, or to continue to rely on the agreement and set off damages for the breach against its own continuing obligations under the agreement. Thus, MPH had the choice to rely on the agreement and continue to use the trademark upon Tempnology's breach.

Justice Kagan found that section 365 aligns with the general bankruptcy rule that the "estate cannot possess anything more than the debtor itself did outside bankruptcy,"[38] and explicitly rejected the idea that any "negative inference" arises from the fact that trademark licenses do not fall within the definition of intellectual property governed by section 365(n). The Supreme Court further reasoned that the "negative inference" argument "pays too little heed" to the main provisions governing rejection in section 365(g), and too much attention to a "mash-up of legislative intervention" in sections 365(h), 365(i), and 365(n).[39]

Effects of *Tempnology* on Parties to Executory Contracts and Unexpired Leases Generally

At first glance, the Supreme Court's ultimate ruling in *Tempnology* might seem to resolve only a very specific split in circuit authority regarding a non-debtor trademark licensee's rights post-rejection. However, the Supreme Court held that its analysis applies to all executory contracts, not just trademark licenses: "rejection of a contract – any contract – in bankruptcy operates not as a rescission but as a breach."[40] Thus, for any contracting parties, bankruptcy courts will have to look to the consequences of breach under applicable non-bankruptcy law to fully decide the effects of a post-petition rejection.

Additionally, as the Supreme Court admits in its reasoning, in some cases the protections now awarded to licensees post-rejection by virtue of this decision could mean that certain debtors re-think choosing to reorganize their businesses through a chapter 11 in the first place. Indeed, the decision diminishes the utility of rejection under section 365, because it does not give licensors of certain intellectual property the automatic benefit of halting the licensee's use of the intellectual property. Second, disputes over post-rejection rights to licensees could likely lead to higher chapter 11 costs, making the bankruptcy filing too expensive for certain debtors.

Moreover, although this ruling may seem disadvantageous to licensors, because a licensee is able to continue to use a trademark or license even after the debtor-licensor's rejection of the relevant agreement, it is important to keep in mind that this is only true if the licensee is entitled to such rights under applicable non-bankruptcy law. As Justice Sotomayor stated in her concurring opinion: "The Court does not decide that every trademark licensee has the unfettered right to continue using licensed marks postrejection … the baseline inquiry remains whether the licensee's rights would survive a breach under applicable non-bankruptcy law." Therefore, parties to executory contracts should understand that, while *Tempnology* provides that rejection in bankruptcy does not eliminate the licensee's rights that would survive breach in non-bankruptcy law, bankruptcy courts will still review each agreement on a case-by-case basis to determine specific post-rejection rights. This means that the decision should not be seen as an immediate advantage to all intellectual property licensees, because bankruptcy courts will be paying attention to the specific terms of a contract and/or state law to determine the licensee's rights. Moreover, licensors could tailor their agreements moving forward to include contractual mechanisms to protect the licensors in light of the licensees' post-rejection rights. Similarly, parties contracting with potential debtors should be mindful of the effects of a breach, which will be implicated in the event of a rejection of an executory contract under section 365 of the Bankruptcy Code.

Next, Justice Sotomayor's concurring opinion also raises the issue of the effect of the Supreme Court's decision on parties protected by section 365(n), and how they will be governed by different rules than trademark licensees moving forward: "the Court's holding confirms that trademark licensees' postrejection rights and remedies are more expansive in some respects than those possessed by licensees of other types of intellectual property. Those variances stem from § 365(n)." As discussed above, section 365(n) was Congress's reaction to the Fourth Circuit's decision in *Lubrizol*, and it applies to patents, copyrights, and four other types of intellectual property, but not trademarks. Justice Sotomayor highlights by example that a covered licensee under section 365(n) that chooses to retain its rights post-rejection is required to make all of its royalty payments, but the licensee has no right to deduct damages from its payments even if it otherwise could have done so under non-bankruptcy law. But, the majority's decision means that trademark licensees are arguably at an advantage by virtue of not being a protected party under section 365(n) and could, therefore, in Justice Sotomayor's example, deduct damages from royalty payments if able to do so under relevant non-bankruptcy law. This calls into question whether counterparties covered by section 365(n) are at a comparative disadvantage due to Congress's attempt to protect them from the effects of rejection of their agreements in bankruptcy. As Justice Sotomayor's concurring opinion hints, only time will tell if Congress will step in to address the discrepancy between the treatment of trademark licenses and other forms of intellectual property.[41]

Endnotes

1 139 S. Ct. 1652, Mission Product Holdings, Inc. v. Tempnology, LLC (*In re* Tempnology), 587 U.S. ___, 2019 WL 2166392 (May 20, 2019).

2 Unless otherwise indicated, references to a statutory section are to sections of title 11 of the United States Code (the "Bankruptcy Code").

3 *See* Alan N. Resnick, Collier on Bankruptcy § 365.02[2][a] (16th ed. 2010) ("Professor [Vern] Countryman's definition of executory contracts was expressed as follows: 'a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'"). *See also* N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984).

4 *In re* Tempnology, 2019 WL 2166392, at *2.

5 *Id.*

6 *In re* Golden Books Family Entm't, Inc., 269 B.R. 311, 314 (Bankr. D. Del. 2001) (license found executory where each party had material duty of "refraining from suing the other for infringement of any of the [intellectual property] covered by the license.").

7 *In re* Tempnology, 2019 WL 2166392, at *5.

8 *Id.* at *2.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.* at *3.

15 *Id.*; *see also* 11 U.S.C. § 365(g)(1).

16 Often unsecured creditors only receive a small percentage of their claims. *In re* Tempnology, 2019 WL 2166392, at *3 (citing N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 531-32 (1984)).

17 *Id.* at *3.

18 11 U.S.C. § 101(35A).

19 § 365(n).

20 Resnick, *supra* note 3 § 365.15[2].

21 Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. *(In re* Richmond Metal Finishers, Inc.*)*, 756 F.2d 1043 (4th Cir. 1985).

22 *Id.* at 1048.

23 The Senate Report on section 365(n) noted:

> [T]he bill does not address the rejection of executory trademark, trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of [§] 365 by the Lubrizol court and others, … such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent

on control of the quality of the products or services sold by the licensee. Since such matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.

RESNICK, *supra* note 2 § 365.15[2].

24 Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012).

25 *See* text preceding note 14, *supra*.

26 *In re* Tempnology, 2019 WL 2166392, at *2.

27 *In re* Tempnology, 879 F.3d 389 (1st Cir. 2018).

28 *In re* Tempnology, 2019 WL 2166392, at *3.

29 As discussed in text accompanying note 18, *supra*, "trademark" is not "intellectual property" within the meaning of section 101(35A).

30 *In re* Tempnology, 541 B.R. 1 (Bankr. D.N.H. 2015).

31 *See* discussion at text accompanying note 24, *supra*.

32 *In re* Tempnology, 559 B.R. 809, 820-22 (B.A.P. 1st Cir. 2016) (quoting *Sunbeam Products, Inc.*, 686 F.3d at 377).

33 *In re* Tempnology, 879 F.3d 389.

34 *In re* Tempnology, 587 U.S. ___, 139 S. Ct. 1652, 2019 WL 2166392, at *4 (2019).

35 *Id.* at *5.

36 *Id.* at *6.

37 *Id.*

38 *Id.* (citing Bd. of Trade of Chicago v. Johnson, 264 U.S. 1 (1924)).

39 *Id.* at 7.

40 *Id.* at 5.

41 *Id.* at 9.