AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

By Andrew C. Helman and John G. Loughnane

Trademarks and Bankruptcy: Mission to Harmonize Continues

Andrew C. Helman
Marcus | Clegg
Portland, Maine

John G. Loughnane
Nutter McClennen & Fish LLP; Boston

Andrew Helman is an attorney with Marcus | Clegg in Portland, Maine. John Loughnane is an attorney with Nutter McClennen & Fish LLP in Boston.

In *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*,[1] the Bankruptcy Appellate Panel (BAP) for the First Circuit recently held that a debtor/licensor's rejection under § 365 of the Bankruptcy Code of a trademark license agreement did not "vaporize" the rights of the nondebtor licensee. As a result, if a licensee's nonbankruptcy rights include the ability to continue to use a trademark despite the licensor's breach, then rejection by a debtor/licensor will not automatically terminate those rights.

The BAP's decision is important because it adopted the reasoning of *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*,[2] which (broadly speaking) held that rejection is a breach of contract but does not terminate a trademark license or strip the nondebtor licensee of its post-breach rights under applicable nonbankruptcy law. This should provide solace for trademark licensees grappling with inconsistent judicial views of their post-rejection rights due to the Bankruptcy Code's omission of trademarks from the type of intellectual property (IP) licenses protected under § 365(n).

Even though a further appeal is pending, *Tempnology* is an important decision not only for bankruptcy lawyers but also for IP and transactional lawyers. The decision highlights the need, at the outset of a licensing transaction, for parties to negotiate and clearly memorialize their rights and obligations in the event of a breach by the other party. Clear drafting is always important, but it takes on added significance when bankruptcy law leaves parties to their nonbankruptcy rights.

Section 365's Basics

Before turning to the facts of the case, it is helpful to review a few provisions of § 365 in order to understand the issues that were before the BAP. Broadly speaking, § 365 governs the rights and obligations of debtors and executory contract counterparties.[3] For example, § 365(a) authorizes a trustee or debtor in possession (DIP) to assume or reject any executory contract or unexpired lease of the debtor, and § 365(g) details the effect of rejection in most instances. In particular, § 365(g) provides that "rejection ... constitutes a breach of such contract or lease" as of the date that is "immediately before the date of the filing of the petition."[4] In other words, once a contract is rejected, it is as though the debtor has breached the contract and cannot be compelled to perform.

Congress has provided special rules for those pre-petition contracts in which a nondebtor obtains an interest that allows it to possess or use property of a debtor, such as licensees of certain types of IP, lessees of real or personal property and purchasers of real property. Broadly speaking, this group of nondebtor contract parties can either continue to use the property in which they claim an interest, or they can treat the contract as terminated under certain circumstances.[5]

More specifically, following rejection of a license agreement,[6] a licensee of a debtor's "intellectual property" (as defined in the Bankruptcy

1 559 B.R. 809 (B.A.P. 1st Cir. 2016), *appeal pending* (1st Cir. Case No. 16-9016).
2 686 F.3d 372 (7th Cir. 2012).

3 The Bankruptcy Code does not define the term "executory contract," but it is widely regarded as "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." Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973).
4 11 U.S.C. § 365(g)(1). However, § 365(g) provides different timing rules for those contracts assumed during the course of a case and subsequently rejected. *See, e.g.*, 11 U.S.C. § 365(g)(2).
5 For a more complete description of the relevant rules, which differ from one another in certain respects, *see* 11 U.S.C. § 365(h) (real property lease), (i) (real property purchaser), (n) (IP license) and (p) (personal property lease).
6 While license agreements often constitute executory contracts under the Countryman definition of an "executory contract" discussed in n.2, it is not always the case. However, in order to focus on the implications of rejection, this article only addresses those license agreements that are executory.

Code) can treat the license as terminated *if* the trustee's or DIP's rejection "would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity."[7] Alternatively, the licensee can elect, for the balance of the parties' contract,

> to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law).[8]

While a licensee exercising the latter option, commonly known as a § 365(n) election, is free to use the licensed IP without interference from a trustee or DIP, it must continue to make any contractually required royalty payments.[9] The rub is that § 365(n)'s protections are limited to the forms of "intellectual property" included within the Bankruptcy Code's definition for that term: a "(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; to the extent protected by applicable nonbankruptcy law."[10] Notably, trademarks are excluded from this definition.

Facts and Procedural Posture of *Tempnology* Before the BAP

The basic dispute in *Tempnology* centered on the effect of the debtor/licensor's rejection of a license agreement with its licensee, Mission Product Holdings Inc., in connection with a sale of substantially all of the debtor's assets shortly after filing a voluntary petition for reorganization under chapter 11.[11] Mission objected to the debtor's sale motion and rejection motion, and argued that any sale of the debtor's assets would be subject to its rights under the parties' license agreement.[12] More specifically, Mission contended that its § 365(n) election allowed it to retain its license to certain of the debtor's IP (including trademarks). Mission also contended that its election allowed it to retain certain exclusive product-distribution rights.[13]

The bankruptcy court entered an order granting the debtor's rejection motion subject to Mission's "election to preserve its rights under 11 U.S.C. § 365(n)."[14] The debtor subsequently filed a motion to clarify the scope of Mission's post-rejection rights. Specifically, the debtor sought an order determining that Mission's rights were limited to the non-trademark IP license between the parties.[15] The debtor further sought a ruling that the exclusive product-distribution rights and any rights to use the debtor's trademarks did not survive rejection.[16] Mission objected based on the contention "that its § 365(n) election also protected its exclusive product-distribution rights and the right to use the Debtor's trademark ... for the remainder of the wind-down period."[17] Following a non-evidentiary hearing, the bankruptcy court granted the debtor's motion and ruled that

> (1) Mission's election pursuant to § 365(n) protected Mission['s] rights as non-exclusive licensee only as to any patents, trade secrets, and copyrights as were granted to Mission in section 15(b) of the Agreement (the section identifying the property subject to the IP License); (2) Mission's election pursuant to § 365(n) provided no protectable interest in the Debtor's trademarks or trade names; and (3) Mission's election pursuant to § 365(n) provided no protectable interest in the Debtor's "Exclusive Products" and the "Exclusive Territory" as those terms were defined in the Agreement.[18]

In so ruling, the bankruptcy court reasoned that (1) the licensee's distribution rights were unrelated to the IP license itself and were therefore unprotected under § 365(n), and (2) § 365(n) did not protect the licensee's trademark rights because Congress excluded trademarks from the definition of "intellectual property" in § 101(35A) of the Bankruptcy Code.[19]

The bankruptcy court rejected the reasoning of cases like *In re Crumbs Bake Shop Inc.*,[20] which held that it is "improper to draw a negative inference" from the omission of trademarks from § 101(35A) and that "bankruptcy courts must exercise their equitable powers on a case-by-case basis to determine whether trademark licensees may retain their rights under § 365(n)."[21] Mission appealed from the bankruptcy court's order.

The BAP's *Tempnology* Decision

On appeal, the BAP reversed the bankruptcy court "to the extent [that it] ruled that Mission's rights in the Debtor's trademark ... terminated upon the Debtor's rejection of the Agreement," but it affirmed all other aspects of the bankruptcy court's ruling.[22] The BAP considered three judicial views on the rights of nondebtor trademark licensees following rejection of a license agreement by a debtor/licensor.

First, like the bankruptcy court, "Some courts reasoned by negative inference that the omission of trademarks from § 101(35A) means that trademark licenses are not afforded any protection under § 365(n) and therefore electing licensees have no rights to use trademarks post-rejection."[23] According to the BAP, this view is articulated in cases like *In re Old Carco LLC*.[24] Thus, as the bankruptcy court reasoned:

> Under the maxim *expression unius est exclusion alterious*, the expression of one thing is the exclusion of other things ... the omission of trademarks from

7 11 U.S.C. § 365(n)(1)(A). Lessees and purchasers of a debtor's real estate have similar rights. 11 U.S.C. § 365(h) and (i).
8 11 U.S.C. § 365(n)(1)(B) (parenthetical in statutory text). The licensee can also continue to use the debtor's IP for any time period during which the contract can be extended at the licensee's election. *Id.*
9 11 U.S.C. § 365(n)(2).
10 11 U.S.C. § 101(35A).
11 *Mission Prod. Holdings*, 559 B.R. at 813.
12 *Id.*
13 *Id.*
14 *Id.* at 814.
15 *Id.*
16 *Id.*
17 *Id.* Mission also contended that an adversary proceeding was required because a determination of its rights following a § 365(n) election was a determination of its property rights in the debtor's IP. *Id.* The bankruptcy court disagreed, and the BAP affirmed this ruling.
18 *Id.* (parenthetical in original).
19 *Id.*
20 522 B.R. 766 (Bankr. D.N.J. 2014).
21 *Mission Prod. Holdings*, 559 B.R. at 813.
22 *Id.* at 825.
23 *Id.* at 819.
24 *Id.* at 813. *See also In re Old Carco LLC*, 406 N.T. 180 (Bankr. S.D.N.Y. 2009).

> the definition of intellectual property in § 101(35A) indicates that Congress did not intend for them to be treated the same as the six identified categories.[25]

Second, "[o]ther courts have expressed the view that reasoning by negative inference is inappropriate in the context of the rejection of trademark licenses and the scope of the § 365(n) election."[26] These courts "rely on the legislative history of § 365(n), concluding that 'Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case-by-case basis, whether the trademark licensees may retain the rights listed under § 365(n).'"[27] Under this view, while a court can use § 365 "to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization[, t]hey should not ... use it to let a licensor take back trademark rights it bargained away" because that would make "bankruptcy more of a sword than a shield."[28]

However, the BAP rejected both of these views and followed the Seventh Circuit's reasoning in *Sunbeam Products*. That case dismissed the negative-inference reasoning of cases like *In re Old Carco LLC* based on its view that "an omission is just an omission. The limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or the other."[29] Further, the Seventh Circuit nixed the equity-based approach of cases like *Crumbs Bake Shop* for the reason that "[r]ights depend ... on what the [Bankruptcy] Code provides rather than on notions of equity."[30] The Seventh Circuit instead focused on § 365(g) and the consequences of rejection under § 365(a):

> 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. After rejecting a contract, a debtor is not subject to an order of specific performance. The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which [might] be written down in common with other debts of the same class. *But nothing about this process implies that any rights of the other contracting party have been vaporized*.[31]

The BAP found *Sunbeam Products*'s reasoning persuasive and adopted it, concluding that while trademarks are not "encompassed in the categories of intellectual property entitled to special protections under § 365(n), the Debtor's rejection of the Agreement did not vaporize Mission's trademark rights under the Agreement."[32] Thus, the BAP determined that Mission retained whatever rights to the debtor's trademark as it was otherwise entitled to under applicable nonbankruptcy law following a breach of the parties' agreement.

Conclusion

As the *Tempnology* case demonstrates, there is no shortage of legal arguments on the effect of rejection of a trademark license in light of the fact that the Bankruptcy Code's definition of "intellectual property" does not include trademarks. Even so, it is important to recognize that the BAP's decision has the added benefit of placing the parties to licensing agreements in control of their rights following a breach by a debtor/licensor, although the BAP might not have the last word on this issue due to an appeal of its ruling pending before the First Circuit. In the meantime, in order to benefit from the BAP decision, trademark licensors and licensees must negotiate and agree, at the outset of a licensing transaction, upon clearly defined rights following a breach of the license agreement by a licensor. abi

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25 *Id.* at 820.
26 *Id.* at 819.
27 *Id.* at 820 (quoting *In re Crumbs Bake Shop Inc.*, 522 B.R. at 772).
28 *Id.* at 820.
29 *Id.* (quoting *Sunbeam Prods.*, 686 F.3d at 375).
30 *Id.* (quoting *Sunbeam Prods.*, 686 F.3d at 376 (edit supplied by BAP)).
31 *Id.* (quoting *Sunbeam Prods.*, 686 F.3d at 377 (internal citations omitted; emphasis added)).
32 *Id.* at 822-23.