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Does the US Bankruptcy Code Protect Trademark Licensees? *In re Tempnology, LLC* May Provide an Answer[1]

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Synopsis

Section 365(n) of the US Bankruptcy Code ('Bankruptcy Code') provides certain protections to a licensee of intellectual property rights if such licence is rejected by the debtor – namely, to (i) treat the licence as terminated and assert a claim for pre-petition damages, or (ii) retain its intellectual property rights under the licence. Trademarks, however, are not included in the definition of 'intellectual property' under the Bankruptcy Code, and there is currently a circuit split as to whether trademark licensees can benefit from the Bankruptcy Code's protections if their licence is rejected by a bankrupt licensor. The uncertainty may soon be resolved by the US Supreme Court, which granted *certiorari*[2] in the case *Mission Product Holdings, Inc. v Tempnology, LLC (In re Tempnology, LLC)*.[3]

Section 365(n) and the definition of 'intellectual property'

The Bankruptcy Code provides the debtor with the ability, subject to court approval, to assume or reject any executory contract or unexpired lease.[4] A rejection of an executory contract or unexpired lease constitutes a breach of the underlying contract or lease, leaving the non-debtor party with a pre-petition damage claim.[5] In 1985, before section 365(n) was enacted, the Fourth Circuit considered what the effect of the rejection of an intellectual property licence was, and concluded that the licensee loses the ability to use the licensed intellectual property and can only seek money damages.[6] The result of that decisions was met with scrutiny. Congress noted that the decision had a 'chilling effect on licenses of intellectual property', and that 'businesses [were] becoming reluctant to rely on licensed technology knowing that the license could be taken away if the licensor files bankruptcy'.[7] In 1988, Congress added section 365(n) to the Bankruptcy Code to respond to a 'particular problem arising out of recent court decisions [and] make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off'.[8] Under section 365(n), licensees of a bankrupt licensor have the option to continue using the intellectual property after rejection for the duration of the agreement and any period for which such contract may be extended by the licensee as of right under applicable non-bankruptcy law, provided certain conditions are met.[9] Congress also amended the definition

Notes

1 The views expressed herein are solely those of Ms Zerjal, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.

2 *Mission Prod. Holdings v Tempnology, LLC*, 139 S. Ct. 397 (2018).

3 879 F.3d 389 (1st Cir. 2018).

4 11 U.S.C. § 365(a). The Bankruptcy Code does not define what an 'executory contract' is, but it is generally accepted that under those contracts, each party owes performance. *In re Tempnology, LLC,* 879 F.3d at 395 (internal citations omitted).

5 11 U.S.C. § 365(g).

6 *Lubrizol Enterprises, Inc. v Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985) ('Even though § 365(g) treats rejection as breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party … Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a)'.)

7 H.R. Rep. No. 100-1012, at 6 (1988).

8 S. Rep. No. 100-505, 1, 5.

9 In full, section 365(n) provides:

> (1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect –
>
> (A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as 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; or
>
> (B) 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), as such rights existed immediately before the case commenced, for –
>
> (i) the duration of such contract; and

of 'intellectual property', which includes, among other things, copyrights, patents, and trade secrets, but does not expressly include trademarks.[10] In a Senate Report, Congress clarified that the silence on trademarks was deliberate.[11] It stated that '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 these 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.'[12] The First Circuit has taken this as grounds for the negative inference that trademark licensees are not owed protections under section 365(n).[13] The Seventh Circuit, on the other hand, has held that the omission of trademarks from this list is 'just an omission' and that it 'does not affect trademarks one way or the other.'[14]

The Circuit split

Third Circuit. In 2010, the Third Circuit was the first circuit court to consider the application of section 365(n) to trademark licences. While the agreement at issue was ultimately not found to be an executory contract, and thus not subject to the protections of section 365(n), Judge Ambro noted in his concurring opinion that the enactment of section 365(n) neither codified nor disapproved *Lubrizol* in the context of trademarks. In Ambro's view, section 365 should allow a bankrupt trademark licensor to free itself of burdensome duties, but should not let licensors take back trademark rights they had bargained away; to do so would be to make 'bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.'[15]

Seventh Circuit. In 2012, the Seventh Circuit followed Judge Ambro's position in *Sunbeam Products, Inc. v Chicago American Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012). There, the debtor Lakewood Engineering & Manufacturing Co. ('Lakewood') outsourced to

Notes

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract –
  (A) the trustee shall allow the licensee to exercise such rights;
  (B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and
  (C) the licensee shall be deemed to waive –
    (i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and
    (ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall –
  (A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property(including such embodiment) held by the trustee; and
  (B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property(including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall –
  (A) to the extent provided in such contract or any agreement supplementary to such contract –
    (i) perform such contract; or
    (ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and
  (B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

10 11 U.S.C. § 101(35A) provides that 'intellectual property' means '(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'.

11 S. Rep. No. 100-505, at 5, 7 (1998). The Report reads that '[t]he bill in no way defines or alters any substantive intellectual property law, it merely refers to those rights that are already protected by applicable nonbankruptcy law'.

12 S. Rep. No. 100-505, at 5 (1988). These same concerns formed the basis of the First Circuit's decision in *Tempnology*.

13 Several other courts have agreed. *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) ('Trademarks are not 'intellectual property' under the Bankruptcy Code … [, so] rejection of licenses by [a] licensor deprives [the] licensee of [the] right to use [a] trademark …'); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) ('[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademark stops on rejection.'); *In re Centura Software Corp.*, 281 B.R. 660, 674-75 (Bankr. N.D. Cal. 2002) ('Because Section 365(n) plainly excludes trademarks, the court holds that [the licensee] is not entitled to retain any rights in [the licensed trademarks] under the rejected … [t]rademark [a]greement.'); *In re Chipwich, Inc.*, 54 B.R. 427, 431 (Bankr. S.D.N.Y. 1985) ('[B]y rejecting the [trademark] licenses[,] the debtor will deprive [the licensee] of its right to use the … trademark for its products.').

14 *Sunbeam Prods. v Chicago Am. Mfg.*, 686 F.3d at 375 (7th Cir. 2012). *See also In re Matusalem*, 158 B.R. 514, 521-22 (Bankr. S.D. Fla. 1993) (suggesting that rejection of a trademark licence would not deprive a licensee of its rights in the licensed mark).

15 *In re Exide Technologies*, 607 F.3d 957, 967 (3rd Cir. 2010).

Chicago American Manufacturing ('CAM') the manufacturing of mechanical fans, which Lakewood would then sell. The contract also allowed CAM to sell these fans if Lakewood did not buy them themselves. Three months into the contract, an involuntary bankruptcy petition was filed against Lakewood, and a court-appointed trustee sold the business to Sunbeam Products. Sunbeam rejected the contract with CAM, but CAM continued to create and sell the Lakewood-branded fans. Sunbeam then brought an action for patent and trademark infringement.[16]

The bankruptcy judge allowed CAM, which invested substantial resources in making the box fans, to continue using the Lakewood's marks on equitable grounds.[17] While the Seventh Circuit found the bankruptcy judge's reasoning 'untenable',[18] it reached the same conclusion by finding that rejection of the underlying licensing agreement did not abrogate CAM's contractual rights.[19] Chief Judge Easterbrook referred to scholarly criticism of the Fourth Circuit's ruling in *Lubrizol*, finding that it confused rejection with the use of an avoiding power. Rejection, in his view, had 'absolutely no effect upon the contract's continued existence'.[20] Judge Easterbrook adopted Judge Ambro's reasoning in *Exide Technologies*, finding that Congress's omission of trademark protections was 'just an omission', one that '[did] not affect trademarks one way or the other'.[21]

First Circuit. In 2018, the First Circuit's decision in *Mission Product Holdings, Inc. v Tempnology, LLC* deepened the circuit split.[22] Mission Product Holdings held certain trademark and exclusive distribution rights pertaining to intellectual property within Tempnology's portfolio. After Tempnology filed for bankruptcy, it moved to reject these executory contracts with Mission. Mission contended that its contractual rights survived rejection under section 365(n). Tempnology asserted otherwise, arguing these rights did not fall under the intellectual property protected by the statute.[23]

The First Circuit broke from the Seventh Circuit and concluded that section 365(n) did not apply to trademark licences, and that Mission's right to use the debtor's trademarks also did not otherwise survive the rejection of the agreement.[24] The First Circuit found that the holding in *Sunbeam* rested on an untenable premise: that it would be possible to free a debtor from any continuing performance obligations under a trademark licence even while preserving a licensee's right to use the trademark.[25] The First Circuit highlighted that trademarks were 'public-facing messages to consumers about the relationship between the goods and the trademark owner'.[26] A licensor must therefore monitor and exercise control over the quality of the goods sold to the public under said trademark, and failure to exercise this control can jeopardise the continued validity of an owner's own trademark rights.[27] Because of the adversarial relationship that often emerges between debtor-licensors and their licensees, quality control for licensed intellectual property becomes an even greater burden in the context of bankruptcy.[28] This would force the debtor to choose between performing a potentially burdensome executory obligations arising from the continuance of the licence, or risking the permanent loss of its trademarks, thereby diminishing their value.[29] Such a restriction would depart from the general ability of the debtor to reject burdensome contracts, and could invite 'further leakage' of rights that would be protected by section 365(n) without being expressly included in the definition of intellectual property.[30]

Judge Torruella dissented in part, siding with the Seventh Circuit's interpretation and concluding that the rejection of the executory contract does not rescind the agreement and eviscerate any of the licensee's remaining trademark rights. Judge Torruella found that Congress has instructed the bankruptcy courts to be guided by the terms of the underlying agreement

Notes

16 *Sunbeam Prods.*, 686 F.3d at 372.
17 *Id.* at 375.
18 *Id.* at 376.
19 *Id.* at 377.
20 *Id.* (internal citations omitted). *See also Thompkins v Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007) (rejection is not 'the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed … [it] merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence').
21 *Sunbeam Prods.*, 686 F.3d at 375.
22 A court in the Second Circuit already declined to follow *Tempnology* and sided with the Seventh Circuit. *In re SIMA Int'l Inc.*, No. 17-21761, 2018 WL 2293705 (Bankr. Conn. May 17, 2018) (Court declined to follow the holding *Tempnology*, electing to 'align[] with the plain language reading' adopted by the Seventh Circuit.)
23 *Mission Prod. Holdings, Inc., v Tempnology, LLC*, 879 F.3d at 394.
24 *Id.* at 395.
25 *Id.* at 402.
26 *Id.*
27 *Id.*
28 *Id.* at 404.
29 *Id.* at 403.
30 *Id.*

and non-bankruptcy law to determine the appropriate equitable remedy of the functional breach of contract.[31]

Who will the Supreme Court side with?

Mission Product's petition for *certiorari* to the US Supreme Court included two questions:

1. Whether, under section 365 of the Bankruptcy Code, a debtor-licensor's 'rejection' of a licence agreement – which 'constitutes a breach of such contract,' 11 U.S.C. § 365(g) – terminates rights of the licensee that would survive the licensor's breach under applicable non-bankruptcy law.
2. Whether an exclusive right to sell certain products practicing a patent in a particular geographic territory is a 'right to intellectual property' within the meaning of section 365(n) of the Bankruptcy Code.

The US Supreme Court certified only the first question. Argument is set for 20 February 2019, and the decision is highly anticipated.

Notes

31 *Id.* at 407.

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