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Circuit courts clash over the post-rejection use of trademarks

By Peter C. Blain

The treatment of trademark licenses under the U.S. Bankruptcy Code (the Code) 11 U.S.C. § 101-1532, has been the source of controversy. Recently, the First Circuit Court of Appeals decided *Mission Product, Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC)*, 879 F.3d 389 (1st Cir. 2018), ruling that licensees under trademark license agreements which are rejected pursuant to Code section 365(a) have no right to use the marks post-rejection. This decision rejects the holding of *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), wherein the Seventh Circuit Court of Appeals ruled that rejection does not "vaporise" the right of the licensee to use the mark or terminate the license agreement; but instead merely constitutes the debtor's breach, freeing the licensee to use the mark post-rejection. Given the value of trademarks in the commercial world today, this issue cries out for resolution by the U.S. Supreme Court.

How Did We Get Here?

As originally enacted in 1978, Code section 365 permitted debtors to reject executory contracts of all types which were burdensome to the debtor. Applying this provision on its face in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), the Fourth Circuit Court of Appeals authorised the debtor to reject a patent license agreement, thereby divesting the patent licensee of any and all rights of use post-rejection. This decision set off a firestorm, prompting Congress to amend the Code by adding section 365(n), which permits licensees of intellectual property, such as patents and copyrights, to continue to use the technology notwithstanding rejection.

However, trademarks were omitted from the Code definition of "intellectual property" in Code section 101, and thereby from the protections of section 356(n). Congress's omission of trademarks was intentional. Congress observed that to enforce a trademark, the licensor must monitor the quality of the licensee's goods associated therewith, making trademarks different from other forms of intellectual property. The legislative history of Code section 365(n) explains that this unique aspect of trademarks mandated further study: "Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and *allow the development of equitable treatment of this situation by bankruptcy courts*." S. Rep. No. 100-505, at 5 (1988), *as reprinted* in 1998 U.S.C.C.A.N. 3200, 3204, (emphasis added).

The *Sunbeam* Decision: Rejection Does Not Cut Off a Licensee's Right of Use

The Seventh Circuit in *Sunbeam* was the first circuit court of appeals grapple with the consequences of a debtor's rejection of a trademark license agreement. There, the court acknowledged that Code section 365(n)'s omission of trademarks was to "allow time for further study, not to approve *Lubrizol*." *Sunbeam Prod., Inc. v. Chic. Amer. Mfg.*, 686 F.3d. at 375. However, the court rejected the Congress's suggestion that the treatment of trademark licensees be left to the equitable discretion of bankruptcy courts, as bankruptcy courts are not free to fashion equitable solutions in the face of specific Code sections. *Id.* "Rights depend… on what the Code provides rather than on notions of equity." *Id.* at 376.

However, here, said the court, the Code itself provided guidance. The real issue at stake was the consequences of rejection of the license agreement, which are set forth in Code section 365(g). *Id.* The court observed that, outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property. *Id.* Code section 365(g) classifies rejection as the debtor's breach of the license agreement, and the court concluded that in bankruptcy, just as outside of it, the other party's rights remain in place. *Id.* at 377. *Lubrizol* mistakenly equated rejection of a license agreement with an avoiding power, like avoidance of a preference under Code section 547. Rejection, by contrast, '"merely frees the estate from the obligation to perform"' and '"has absolutely no effect upon the contract's continued existence."' *Id.* (quoting *Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007).

The *Tempnology* Court Takes the Opposite Position

The bankruptcy court in *Tempnology* held that Code section 365(n) deliberately omitted from its ambit trademark licenses, leaving trademarks unprotected from rejection and the licensee with no right to use the marks post-rejection. On appeal, the First Circuit Bankruptcy Appellate Panel (BAP) reversed, following the rationale of *Sunbeam*. On further appeal, in a 2-1 decision, the First Circuit Court of Appeals reversed the BAP and affirmed the bankruptcy court.

The First Circuit chronicled the history of *Lubrizol* and (in response thereto) Congress's enactment of Code section 365(n). *Mission Prod, Holdings, Inc. v. Tempnology, LLC*, 879 F.3d at 396-397. The court noted that Sunbeam was the only circuit court decision to consider the issue, and agreed with the *Sunbeam* court that rejection of a contract does not "vaporise" it. *Id.* at 402.

However, the *Sunbeam* court ignored the unique nature of trademarks. Unlike patents or other forms of intellectual property, trademarks are the public's assurance of the quality of the goods bearing the mark. As such, licensors are required to monitor and exercise control over the quality of the goods sold to the public under the mark. *Id.* (citing 3 J. McCarthy, McCarthy on Trademarks & Unfair Competition § 18:48 (5th ed. 2017)). Failure to exercise control over the quality of the goods sold jeopardizes the validity of the mark. *Id.* That is why Congress struggled with including trademarks in the Code's definition of "intellectual property," ultimately omitting trademarks altogether from its ambit. To follow *Sunbeam* would force the debtor to choose between performing executory obligations even though the license agreement was rejected, or risking permanent loss of its trademarks. *Id.* at 403.

The dissent adopted *Sunbeam*'s view that rejection constitutes a breach rather than a termination of the license agreement, and therefore does not abrogate the licensee's right to use the marks post-rejection. Additionally, the dissent argued that the

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majority ignored the Congressional directive to use equity to prevent bankruptcy from becoming "….more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve." *Id.* at 407 (quoting *In re Exide Techs.*, 607 F.3d 957, 967-68 (3d Cir. 2010) (Ambro, J. concurring).

The majority rejoined, criticising the dissent's reliance upon the perceived Congressional directive to bankruptcy courts in the legislative history to fashion "equitable treatment" for licensees where trademark license agreements are rejected. Where Congress invited equitable discretion, said the majority, it specifically did so in the Code. *Id.* at 403. Even "sitting in the chancellor's chair," the majority would find the equities favored the rejecting debtor. Converting a trademark right to prepetition damages still allows the licensee to sell the products without the mark where the relationship with the licensor has ended and the quality conveyed by the mark may not be accurate. This protects the public's interest in not being misled as to the goods purchased. Moreover, the court found "unappealing" the prospect of saddling bankruptcy cases with the added cost and delay of attempting to divine the greater or lesser burdens flowing from rejection. *Id.* at 404. Post-rejection use by the licensee was therefore prohibited.

Where Does That Leave Us?

Two Circuit Courts of Appeals have taken opposite positions on an issue that implicates millions of dollars. Licensees invest significant sums manufacturing goods whose value derives from trademarks, and clamor for the assurance that their licensor's financial missteps will not threaten their investment. Struggling licensors want to use the provisions of the Code to escape improvident contractual agreements, and do not want to monitor the quality of goods being produced post-rejection by an unrelated third party. Given the importance of the issue, the U.S. Supreme Court should resolve the conflict and provide the answer.

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