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First Circuit Holds That Trademark Licensee Loses Right to Use Trademarks When Debtor-Licensor Rejects License

The United States Court of Appeals for the First Circuit recently addressed two questions critically important to trademark licensees: (1) can a trademark licensee use section 365(n) of the Bankruptcy Code to retain licensed trademarks (and exclusive distribution rights) following a debtor-licensor's rejection of its license and (2) if not, can a licensee otherwise continue to use the licensed trademarks post-rejection? *In re Tempnology, LLC*, 2018 WL 387621 (1st Cir. Jan. 12, 2018). The Court held that section 365(n) does not apply to trademarks (or distribution rights) and, in a split (two-to-one) decision, ruled that a licensee's right to use licensed trademarks terminates upon rejection of its license. In so ruling, the Court expressly rejected a contrary decision by the United States Court of Appeals for the Seventh Circuit in *Sunbeam Products, Inc.* v. *Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), creating a circuit split.[1]

Background

In 2012, Tempnology, LLC ("Tempnology") and Mission Product Holdings, Inc. ("Mission") entered into an agreement (the "Agreement") that, among other things, granted Mission (1) the exclusive right to distribute certain cooling fabric products manufactured by Tempnology, (2) a non-exclusive, perpetual license to Tempnology's patent and other non-trademark intellectual property, and (3) a limited, non-exclusive license to use Tempnology's trademark and logo for the purpose of performing its obligations, and exercising its rights, under the Agreement. The Agreement was terminated in 2014, triggering a two-year wind down period. Under the Agreement, Mission was entitled to retain its distribution and trademark rights until 2016 and its other intellectual property rights in perpetuity.

In September 2015, Tempnology commenced a voluntary chapter 11 case and moved to reject certain of its contracts, including the Agreement, pursuant to section 365(a) of the Bankruptcy Code. Mission objected, arguing that section 365(n) of the Bankruptcy Code allowed Mission to retain both its intellectual property licenses and its exclusive distribution rights under the Agreement. The bankruptcy court granted the motion to reject the Agreement, "subject to [Mission's] election to preserve its rights under 11 U.S.C. § 365(n)." Litigation regarding the scope of Mission's section 365(n) rights – and the legal

[1] For a full summary of *Sunbeam*, see our August 2012 Client Alert.

consequence of rejection for Mission – ensued. The dispute centered on Mission's exclusive distribution rights and the Tempnology trademark license.[2]

The bankruptcy court held that section 365(n) did not apply to Mission's distribution and trademark rights and that rejection of the Agreement extinguished such rights. The Bankruptcy Appellate Panel for the First Circuit affirmed the bankruptcy court's rulings regarding the scope of section 365(n) but overruled the bankruptcy court's ruling regarding the effect of rejection, holding that a licensee's right to use trademarks does not necessarily terminate upon rejection. Tempnology appealed.

Scope of Section 365(n) and Consequence of Rejection

Under section 365(n) of the Bankruptcy Code, when a debtor-licensor rejects an "intellectual property" license, the non-debtor licensee has the option to retain its rights to "intellectual property" under the license as they existed before the bankruptcy filing, subject to certain limitations. The retained rights include enforcing exclusivity provisions of such license but exclude all other rights to specific performance of the license.[3] If a licensee elects to retain its rights under the license, the licensee must, among other things, continue to pay the royalties due under the agreement.

Congress enacted section 365(n) in response to the Fourth Circuit's 1985 decision in *Lubrizol Enterprizes, Inc.* v. *Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). In *Lubrizol*, the court held that a debtor's rejection of a patent license extinguished the licensee's rights in the patented technology. Congress was concerned that the harsh result in *Lubrizol* would adversely impact the technology industry as a whole.

Section 365(n), however, only applies to certain types of "intellectual property." *See* 11 U.S.C. § 101(35A). Trademarks are not among the enumerated categories of protected intellectual property and the legislative history indicates that their absence was intentional. *See In re Exide Techs.*, 607 F.3d 957, 966-7 (3d Cir. 2010), *citing* S. Rep. No. 100-505, at 5. The Senate Committee Report on the bill for section 365(n) stated that:

> [T]he bill does not address the rejection of executory trademark[s], . . . 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,

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2 Tempnology conceded that section 365(n) protected some of Mission's intellectual property rights under the Agreement.

3 Section 365(n)(1)(B) allows a licensee "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) . . . ." 11 U.S.C. § 365(n)(1)(B).

> trademark . . . 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.

S. Rep. No. 100-505, at 5.

Because trademarks are not included in the Bankruptcy Code's definition of "intellectual property," the legal consequences of trademark license rejections for trademark licensees often remain unclear. Some courts impose the *Lubrizol* result – the debtor's rejection of a trademark license extinguishes the licensee's rights. *See e.g. In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003). Others have declined to apply *Lubrizol*, reasoning that rejection is nothing more than a breach of the agreement and that breach alone does not terminate a licensee's rights. *See Sunbeam Prods., Inc.* v. *Chicago Mfg., LLC*, 686 F.3d 372, 277-8 (7th Cir. 2012) (rejection did not terminate counterparty's right to continue to manufacture and sell trademarked fans); *see also In re Exide Techs.*, 607 F.3d 957, 964-8 (3d Cir. 2010) (Judge Ambro, concurring).[4]

The Court's Analysis in *Tempnology*

The Court first considered whether section 365(n) protects Mission's exclusive distribution rights and/or the Tempnology trademark license. The Court unanimously held that section 365(n) does not apply to either the distribution rights or trademark license. The Court reasoned that (1) the distribution rights are not intellectual property and do not qualify for section 365(n) protection merely because they are "exclusive,"[5] and (2) trademarks are not one of the protected categories of "intellectual property" under the Bankruptcy Code.

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4 Additionally, some courts have been able to avoid reaching this issue, by concluding that the agreements at issue before them are not executory and, thus, are not subject to rejection. In those instances, the licensee's rights to use the trademarks under the license agreements continue. *See In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014); *Exide*, 607 F.3d 957 (3d Cir. 2010).

5 Mission offered a number of other arguments in support of extending section 365(n) protection to the distribution rights; however, the Court found none were persuasive. For example, the Court rejected Mission's assertion that the distribution rights were *de facto* exclusive rights to use protected intellectual property (*i.e.*, that the exclusive distribution rights rendered Mission's right to use Tempnology's patents exclusive) because, among other things, Tempnology retained the right to use its intellectual property to make and sell products that were not subject to Mission's exclusive distribution rights. The Court also rejected Mission's assertion that its ruling would "bear on the enforceability of all negative covenants independent of an intellectual property license." The Court maintained that "[i]f a party possesses an intellectual property license, perhaps the

The Court next considered whether rejection of the Agreement extinguishes Mission's right to use Tempnology's trademark. On this issue, the Court was split. The majority adopted a bright-line rule that a trademark licensee's right to use licensed trademarks terminates upon rejection.

In so ruling, the Court expressly rejected the contrary approach adopted by the Seventh Circuit in *Sunbeam* (and followed by the dissenting judge). The Court reasoned that the approach outlined in *Sunbeam* undercuts a debtor's ability to use rejection to shed burdensome obligations under trademark agreements and could limit a debtor's options for a "fresh start." The Court maintained that *Sunbeam* (and Judge Ambro's concurrence in *Exide*) rest on a false premise that it is possible to free a debtor from ongoing performance obligations under an intellectual property license while preserving a licensee's right to use the licensed intellectual property. The Court observed that "effective licensing of a trademark requires the trademark owner – here Debtor, followed by any purchaser of its assets – to monitor and exercise control over the quality of the goods sold to the public under the cover of the trademark."[6] Failure to do so results in a so-called "naked license," jeopardizing the continued validity (and value) of the trademarks. The Court concluded that the *Sunbeam* approach allows a licensee to continue using trademarks in a manner that forces a debtor to choose between (1) performing obligations arising from the continuance of the license or (2) not performing and risking losing (or diminishing the value of) its trademarks. The Court observed that this "restriction on [the debtor's] ability to free itself from its executory obligations . . . would depart from the manner in which section 365(a) otherwise operates."[7]

The Court also rejected the case-specific, equitable approach advocated by the dissent. The Court maintained that the dissent, while "claiming to follow *Sunbeam* . . . seem[ed] to reject its categorical approach in favor of what *Sunbeam* itself rejected – an 'equitable remedy' that would consider in some unspecified manner the 'terms of the Agreement, and non-bankruptcy law.'" The Court criticized this approach, arguing that it gave too much weight to a few lines in the Senate Committee Report accompanying section 365(n)'s enactment. The Court acknowledged that the Senate Committee Report references equitable considerations but noted that (1) the Report should not be given the force of a statute and (2) when Congress intended to grant courts the ability to create equitable exceptions to the Bankruptcy Code, it did so expressly in the statute. The Court also observed that a case-specific, equitable approach would "impos[e] increased uncertainty and costs on the parties in bankruptcy proceedings."

Code may protect from rejection certain negative covenants – such as confidentiality – that do not materially restrict the debtor's reorganization, are tied closely to the intellectual property license, and are necessary to implement its terms."

6 The Agreement expressly provides that Tempnology may exercise such control.

7 The Court also noted that the logic behind the *Sunbeam* approach seems to apply with equal force outside of the trademark context and, thus, "invite[s] further leakage."

Conclusion

Tempnology establishes a clear split between the First and Seventh Circuits regarding the consequences of trademark license rejection for licensees. If Mission files a petition for *certiorari*, additional guidance may be forthcoming. Whether other courts will adopt *Tempnology* or *Sunbeam* or craft an entirely different rule remains to be seen.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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