TRADEMARK TALK

Fate of licences in bankruptcy

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SCOTUS is set to decide on a case that will determine what happens to licence agreements when the licensor files for bankruptcy

In the case of *Mission Product Holdings Inc v Tempnology, LLC*,[1] the Supreme Court of the US (SCOTUS) is set to settle a hotly disputed issue of intellectual property law: whether a licensor may terminate a licence (along with the counterparty's rights thereunder) by rejecting the licence agreement in bankruptcy.

If so, the impact on – and risks borne by – licensees would be enormous. Intellectual property rights once thought to be secure for the duration of the licence agreement could be lost in the licensor's bankruptcy. Businesses built around these intellectual property rights could then be forced to pay again (and at a higher price) for those very same licence rights. Businesses unable to regain those lost intellectual property rights (due to insufficient funds or higher bids) could be forced to shutter all licence-related operations, potentially destroying the entire business.

But, not to fear: Although Yogi Berra once wisely said "never make predictions, especially about the future," smart money says that SCOTUS will not let that happen. And, even if it does, there will be ways to protect licence rights in that new environment.

Some bankruptcy basics

One of a debtor's most valuable tools in bankruptcy is the ability to keep good contracts (ie, assumption) or shed burdensome ones (ie,rejection).[2] Rejection constitutes a breach of the contract,[3] whereupon the contract counterparty may no longer compel the debtor's performance. The counterparty's remedy for any unfulfilled obligations is a pre-bankruptcy damages claim that is afforded the lowest priority for distribution purposes.

In the case of an ordinary supply contract, rejection is straightforward: if the supplier files for bankruptcy and rejects the supply contract, then the counterparty cannot compel any future supply and may assert a prepetition claim for damages.

Lubrizol, Sunbeam, and special rules for rejecting intellectual property

However, in the case of intellectual property contracts, rejection historically has been less straightforward, primarily due to courts' differing views of the very nature of intellectual property rights. When viewed essentially as a contract for the future supply of intellectual property, rejection of a licence agreement would (as in the example above) eliminate the debtor's obligation to provide any further intellectual property. This was the Fourth Circuit's view of intellectual property in the 1985 *Lubrizol* decision.[4]

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In response to *Lubrizol*, Congress adopted section 365(n) of the Bankruptcy Code[5] to establish special rules for rejecting "intellectual property". Under section 365(n), licensees of "intellectual property" have two options when faced with rejection: (i) treat the agreement as terminated and assert a prepetition claim for damages; or (ii) retain the right to use the licensed IP for the duration of the licence, but forfeit any future damage claims. Thus, Congress made clear that licensees may retain "intellectual property" rights when faced with rejection.

However, Congress only partially fixed the Lubrizol problem because section 365(n) applies only to "intellectual property", which includes patents and trade secrets but excludes things such as trademarks.[6] Due to this omission, courts have varied in their treatment of trademark licences in bankruptcy.

For example, in its 2012 *Sunbeam* decision,[7] the Seventh Circuit rejected *Lubrizol* and held that rejection in bankruptcy does not terminate a licensee's right to use a trademark. In so doing, the Seventh Circuit implicitly rejected the view of a trademark licence as the type of supply contract described above. Instead, the court viewed a trademark licence as a property interest already conveyed to the licensee that the debtor could not take back by virtue of its own unilateral breach (ie, rejection) of the licence agreement. The court noted that rejection is a breach that "merely frees the estate from the obligation to perform and has absolutely no effect upon the contract's continued existence" and that nothing about the rejection process "implies that any rights of the other contracting party have been vaporised".[8]

Tempnology's licence agreement gets vaporised in bankruptcy

The post-*Sunbeam* bankruptcy case of *Tempnology LLC* ("*Tempnology*") follows a familiar pattern and shows the further inconsistent treatment of rejected trademark licences in bankruptcy. Tempnology had entered into a licence agreement that granted

Mission Product Holdings, Inc ("Mission") exclusive distribution rights for certain products and a related trademark licence. After filing for chapter 11 protection, Tempnology sought to reject the licence agreement. Mission objected and argued that, notwithstanding any rejection, it should retain its exclusive distribution rights and its trademark licence.

Implicitly rejecting *Sunbeam*, the Tempnology bankruptcy court followed *Lubrizol*, overruled Mission's objection, and allowed Tempnology to "vaporise" Mission's exclusive distribution rights and trademark licence rights through rejection of the agreement.[9]

The First Circuit ultimately affirmed the bankruptcy court decision, leading to the SCOTUS case currently on appeal. The parties have fully briefed the issues, and the court heard oral argument on 20 February. A decision is expected in May.

Appeal to SCOTUS

The SCOTUS essentially faces a choice between the two competing views of licence agreements found in *Lubrizol* and *Sunbeam*.

As expected, Tempnology has advocated for *Lubrizol's* "supply contract" view of licence agreements, stressing that a debtor is relieved of all obligations under a rejected contract and that a counterparty's sole remedy is a claim for prepetition breach. Yet, without termination, Tempnology argued that it would be forced to monitor the trademark post-rejection. But with termination, Tempnology argued that it could more easily fulfill the bankruptcy goal of business rehabilitation.

For its part, Mission has advocated for the *Sunbeam* position. It noted that rejection is a breach – not a termination – and that, both inside and outside of bankruptcy, a licensor's breach does not permit the licensor to terminate or rescind the contract. Mission also argued that the bankruptcy estate takes the debtor's property as it is, subject to the rights and interests of others. Because Mission held a property interest in the intellectual property – including the exclusive right to sell it in a specified geographic area for a specific period of time – rejection could not disturb those rights. Accordingly, Mission argued for reversal.

Better bet: Sunbeam view

It is never easy to predict how a court will rule, but the *Sunbeam* approach advocated by Mission appears to be the better bet for several reasons:

- Weight of scholarly authority. Justice Ginsburg noted that the overwhelming weight of authority – including the six *amicus* briefs filed in the case[10] – supports the *Sunbeam* approach and rejects the *Lubrizol* approach;
- Larger ramifications. Justice Breyer and others voiced concern about the larger ramifications of the *Lubrizol* approach, specifically in the franchise context. Could a large franchisor (eg, McDonald's) hold thousands of franchisees and their businesses hostage by filing for bankruptcy and rejecting their franchise agreements?;
- Real estate analogy. Justice Alito and Justice Kagan repeatedly referenced an analogy to real estate leases: a bankrupt landlord that rejects a lease agreement cannot evict a non-breaching tenant. Rejection in that context merely means that the landlord cannot be forced to fix windows or perform any other future obligations set forth in the lease agreement. This type of analogy clearly supports Mission and the *Sunbeam* view.

Best practices in a vaporising world

But what happens if the *Lubrizol* view prevails? What can licensees do to protect their licensed property?

All is not lost. Although a SCOTUS decision in favour of Tempnology would be severely disruptive for licensees, they (and their creative counsel) could adjust by employing one or more licence-protecting strategies, for example:

- Ensure that a bankruptcy-proof third party, and not the original licensor, holds the licence;
- Get a first-position security interest in the licensed property, which would permit foreclosure upon default and prevent rejection in bankruptcy;
- Negotiate an option to purchase the property under appropriate circumstances;
- Structure the licence so that it would not be executory (and, therefore, not subject to rejection) in the event of the licensor's bankruptcy; or
- Employ any other creative strategies in response to whatever decision the SCOTUS ultimately hands down.

Footnotes

1. *Mission Product Holdings Inc vTempnology, LLC*, 879 F.3d 389 (1st Cir. 2018), cert. granted 26 Oct 2018 (No. 17-1657).
2. 11 USC § 365(a).
3. 11 USC § 365(g).
4. *Lubrizol Enters, Inc v Richmond Metal Finishers, Inc* (*In re Richmond Metal Finishers Inc*), 756 F.2d 1043 (4th Cir 1985).
5. 11 USC § 365(n).
6. 11 USC § 101(35A).
7. *Sunbeam Products, Inc v Chicago American Mfg*. (*In re Lakewood Engineering & Mfg. Co.*), 686 F. 3d 372 (7th Cir 2012).
8. Id. at 377 (quoting *Thompkins v Lil' Joe Records, Inc*, 476 F.3d 1294, 1306 (11th Cir 2007).
9. *In re Tempnology, LLC*, 2015 BL 372538 (Bankr DNH 2015).
10. Six *amicus* curie briefs were filed in the case, including those by the United States Department of Justice, certain law professors, the Intellectual Property Owners Association, the New York Intellectual Property Law Association, the American Intellectual Property Law Association, and the International Trademark Association.

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