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You Can Reject Me, But You Can't Vaporize Me: The Supreme Court Clarifies the Effect of Rejection of Trademark Licenses in Bankruptcy

May 28, 2019

On May 20, 2019, the U.S. Supreme Court issued its decision in the closely watched case at the intersection of trademark and bankruptcy law, *Mission Product Holdings Inc. v. Tempnology*.[1] The decision addresses whether, under section 365 of the Bankruptcy Code, a debtor-licensor's rejection of a trademark license agreement terminates a licensee's right to continue using the trademark. Writing for an 8 to 1 majority, Justice Kagan held that a debtor-licensor's rejection of a trademark license agreement *does not* deprive the non-debtor licensee of its right to continue using the licensed trademark during the full term of the license agreement.

The Court's decision—that rejection does not terminate the trademark licensee's right to use the trademark—resolves a long-standing circuit split. It also provides an important statement of the Supreme Court's general view of the impact of the "rejection" of a contract by a debtor in a bankruptcy case.[2] The Court focused on the plain meaning of the Bankruptcy Code in reaching its holding that rejection cannot rescind rights that the contract previously granted. Put more colorfully, rejection does not "vaporize" the contract counterparty's rights.[3]

BACKGROUND

In bankruptcy, the treatment of intellectual property-related agreements – often valuable property of the estate – has led to many disputes between debtors and other parties in interest. The debtor in possession has a strong interest in strategically managing the estate's assets to maximize value. However, these interests must be weighed against society's interest in respecting intellectual property rights, including ensuring that the debtor respects commitments made to third parties when licensing out IP rights.

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1 *Mission Product Holdings, Inc. v. Tempnology, LLC*, 587 U.S. ___ (2019).

2 Rejection is a bankruptcy-specific concept: in order to release the debtor's estate from burdensome obligations, the Bankruptcy Code gives a debtor the right, with court approval, to "reject" any contract with respect to which performance remains due to some extent on both sides.

3 Rejection of a contract by a debtor in bankruptcy "does not 'terminate the contract' or 'vaporize[]' the counterparty's rights." *Mission Product* (2019).

With these competing policies in mind and in response to the Fourth Circuit's 1985 decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,[4] Congress enacted section 365(n) of the Bankruptcy Code in 1988.[5] In section 365(n), licensees of certain types of IP (basically everything other than trademarks) receive special protections in the event the debtor rejects the licensees' contract. For intellectual property covered by this section, a licensee can choose to retain its IP rights even after a debtor rejects the contract, so long as the licensee continues to make the agreed-upon royalty payments. In defining intellectual property, section 365(n) specifically includes patents, trade secrets and copyrights, but omits trademarks.[6]

Congress's decision to exclude trademarks from the definition of IP set the stage for an eventual circuit split on the treatment of rejected trademark licenses. The Seventh Circuit, in *Sunbeam Products Inc. v. Chicago American Manufacturing*,[7] held that a trademark licensee may continue to use the licensed trademark post-rejection because this right would not be terminated under applicable non-bankruptcy law (i.e., state contract law). Courts following the Seventh Circuit effectively treat rejected trademarks the same as other IP agreements under section 365(n). By contrast, the First Circuit in *Mission Product Holdings Inc. v. Tempnology (In re Tempnology)*[8] held that section 365(n) exempts trademark licensees from the special protection afforded other types of IP and, therefore, licensees' rights in trademarks do not survive rejection by a debtor-licensor.

Thus, *Tempnology* became a suitable vehicle for the Supreme Court to address the impact of rejection of a trademark license by a debtor-licensor. In so doing, the Court answered the question that Congress left open in enacting section 365(n): namely, that trademarks should be treated the same as other IP rights for purposes of section 365 of the Bankruptcy Code.[9]

The Supreme Court's *Mission Product* decision is an important commercial decision, as the unexpected loss of the ability to utilize trademark rights due to the bankruptcy of a licensor can have severe adverse economic consequences for licensees that have invested capital and designed a business plan around in-licensed trademark rights.

BACKGROUND OF THE CASE

Tempnology, LLC (Tempnology) manufactured clothing and accessories designed to stay cool when used in exercise. In 2012, Tempnology entered into an exclusive license with Mission Product Holdings Inc. (Mission Holding) to distribute certain of Tempnology's "Coolcore" products in the United States and a non-exclusive license to use the "Coolcore" trademarks, both in the United States and around the world. In 2015, Tempnology filed a voluntary Chapter 11 bankruptcy petition. Soon after its bankruptcy filing, Tempnology sought approval of the bankruptcy court to reject its licensing agreement with Mission Holding. Although the parties agreed the rejection did not apply to nonexclusive patent licenses, they disagreed as to whether the rejection applied to (1) grants of trademark licenses and (2) Mission Product's exclusive rights to sell certain of Tempnology's goods.

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[4] 756 F.2d 1043 (4th Cir. 1985) (holding a debtor-licensor's rejection of a license terminates the non-debtor licensee's right to use the licensed intellectual property).

[5] 11 U.S.C. §365(n).

[6] 11 U.S.C. §101(35)(B): "The term '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". Congress explicitly excluded trademarks from the definition of intellectual property when it enacted section 365(n), deciding instead to postpone congressional action "to allow the development of equitable treatment of this situation by bankruptcy courts". S. Rep. No. 100-505, 100th Cong., 2nd Sess. 1988, 1988 U.S.C.C.A.N. 3200.

[7] 686 F.3d 382 (7th Cir. 2012).

[8] 879 F.3d 389 (1st Cir. 2018).

[9] While the enactment of section 365(n) was necessary to overturn *Lubrizol* and an important body of case law had developed in the 30 years since section 365(n) was enacted, one reading of the Court's decision in *Mission Product* is that section 365(n) was not necessary in the first place given the plain language of section 365(g) as discussed below.

The bankruptcy court entered an order granting Tempnology's motion to reject the trademark license agreement with Mission. In so doing, the bankruptcy court concluded that Tempnology's rejection of the contract terminated Mission Product's right to use the licensed marks.

Mission Product appealed to the First Circuit Bankruptcy Appellate Panel (BAP), which reversed the bankruptcy court. The BAP adopted the reasoning of the Seventh Circuit in *Sunbeam*, holding that, post-rejection, Mission Product's rights in the trademark were properly governed by the terms of the agreement and applicable non-bankruptcy law. However, on further appeal to the Court of Appeals for the First Circuit, the court reversed the BAP and affirmed the bankruptcy court's holding, concluding that section 365(n) did not apply to Mission Product's trademark license.[10] In so holding, the First Circuit noted that preserving Mission Product's right to continue using Tempnology's trademark notwithstanding Tempnology's rejection of the license agreement would create a "burdensome obligation" for the debtor and its estate.[11]

SUPREME COURT DECISION

In its decision, the Supreme Court rejected the First Circuit's approach and instead adopted the reasoning of the Seventh Circuit in *Sunbeam*. Justice Kagan employed a plain reading of section 365 and, more specifically, section 365(g),[12] to find that rejection of a contract in bankruptcy operates as a breach, not rescission. Because the Bankruptcy Code does not define breach, the term is given its meaning outside bankruptcy (i.e., under contract law). Under contract law, the non-breaching party may choose whether to continue performance and seek damages from the breaching party or cease performance. Notably, this decision lies with the non-breaching party – in this case, the non-debtor licensee (Mission Holding) – and not with the breaching party – here, the debtor (Tempnology). The Supreme Court noted that the First Circuit's approach would lead to the exact opposite outcome – the debtor, having breached the license agreement, would control whether the non-breaching party may retain its rights under the license agreement. The Court found such a result contrary to both contract and bankruptcy law. Instead, the Court found that upon the debtor-licensor's rejection of a license agreement, the contract counterparty receives a pre-petition claim for damages, and any rights the counterparty otherwise has under the contract per its terms and applicable non-bankruptcy law are left in place.[13]

The Court rejected Tempnology's argument that because section 365(n) does not expressly cover trademark licenses (due to the Bankruptcy Code's definition of "intellectual property", which excludes trademarks) it must mean that rejection results in a different outcome (i.e., termination instead of survival). The Court again turned to the plain meaning of section 365(g), finding that because section 365(n) does not include trademark licenses, these licenses simply fall under the general rule that rejection constitutes breach, not rescission.

In her concurrence, Justice Sotomayor highlighted two issues with the decision. First, she noted that the core question was and remains "whether the licensee's rights would survive a breach under applicable non-bankruptcy law".[14] Thus, the terms of a contract or governing state law may impact the outcome in particular cases and may lead courts to limit the rights of a licensee following rejection. Such holdings would not run contrary to the Court's decision in *Mission Product*. Second, Justice Sotomayor emphasized the distinction between trademark licensees' post-rejection rights and those possessed by licensees of other types of intellectual property, as defined by the Bankruptcy Code, governed by section 365(n). In certain respects, a licensee's rights under these specific types of agreements are more circumscribed

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[10] As described above, trademarks are not included in the definition of "intellectual property" for purposes of section 365(n).

[11] Trademark law imposes on the trademark owner certain obligations to monitor and exercise quality control over goods associated with a trademark.

[12] Section 365(g) provides that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease".

[13] Specifically, the Court stated that "[t]he debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed." *Mission Product* (2019).

[14] *Mission Product* (Sotomayor, J., concurring).

than the rights of licensees under agreements governed by the general rules of rejection under section 365.[15] Ironically, while practitioners have long worried about the implications of trademarks not being included in section 365(n), following the Supreme Court's decision in *Mission Product*, trademark licensees actually may be better off as a result, as they now benefit from the general rule articulated by the Court without being subject to the specific requirements of section 365(n).

CONCLUSION

The Supreme Court's decision in *Mission Product* will alter the calculus for many trademark licensors seeking to use the bankruptcy process to rid themselves of disadvantageous license agreements. Debtor-licensors may have to monitor licensee use of their marks post-rejection to prevent harm to the marks, as well as continue maintaining and policing their trademarks as required by applicable license agreements and trademark law post-rejection, using precious estate resources. This of course will need to be factored into the decision of the debtor-licensor whether to reject or assume (keep in place) the license agreement in the first place. Conversely, non-debtor licensees will be able to retain license rights in trademarks and keep their existing payment structures intact through bankruptcy of a debtor-licensor, absent express contractual language to the contrary. As such, licensees may now have greater leverage over debtor-licensors seeking to unwind trademark license agreements.

Additionally, the *Mission Product* decision could motivate new approaches to licensing trademarks in the first instance. The decision notably does not confer a blanket right for every trademark licensee to continue using licensed trademarks, but rather leaves open the door for review of the individual license terms on a case-by-case basis. Accordingly, because the decision reverts to contract law in analyzing the non-breaching party's rights following a breach, licensors may consider adding additional language to their trademark license agreements to permit rescission should the licensor file for bankruptcy. How these new approaches may be viewed by the courts remains to be seen, but what is clear now is that the Supreme Court has significantly reduced licensor bankruptcy risk for companies that rely on in-licensed trademark rights.

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[15] For example, a licensee making an election to retain its license rights under section 365(n) is deemed to waive any set-off rights or post-petition "administrative expense" claims it may have in respect of the applicable license agreement. 11 U.S.C. § 365(n)(2)(C).