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Split First Circuit Prevents Non-Debtor Licensee From Using Rejected Trademark License

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A Chapter 11 debtor-licensor's rejection of a trademark license "left [the non-debtor licensee ("M")] with only a pre-petition damages claim in lieu of any obligation by Debtor to further perform under . . . the trademark license . . .," held the U.S. Court of Appeals for the First Circuit on Jan. 12, 2018. *In re Tempnology, LLC*, 2018 W.L. 387621, *1 (1st Cir. Jan. 12, 2018) (2-1). Reversing the Bankruptcy Appellate Panel ("BAP") and affirming the bankruptcy court, the First Circuit explained that "we favor the categorical approach of leaving trademark licenses unprotected from [bankruptcy] court approved rejection." *Id.* at *11. Thus, M's "right to use Debtor's trademarks did not otherwise survive rejection of the" license. *Id.*, at *4. "[P]ractically speaking," said the court, the issue for the parties was "whether to classify as prepetition or post-petition liability any damages caused by Debtor's failure to honor its executory obligations" under the rejected trademark license. *Id.*, at *5. But the dissent urged an equitable approach "guided by the terms of the [parties' agreement] and non-bankruptcy law," consistent with a major decision by the Seventh Circuit that the BAP had followed.

Relevance

The key trademark issue, conceded the First Circuit, "poses for this circuit an issue of first impression concerning which other circuits are split." *Id.*, at *1. It expressly noted the Seventh Circuit's contrary view in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372, 377 (7th Cir. 2012) (Easterbrook, Ch. J.) (right to use debtor's trademark continues post-rejection), a view shared by an important judge on the Third Circuit. *In re Exide Techs*, 607 F.3d 957, 964-68 (3d Cir. 2010) (Ambro, J., concurring) (". . . a trademark licensor's rejection of a trademark agreement . . . does not necessarily deprive the trademark licensee of its rights in the licensed mark."). The First Circuit, however, followed the approach taken by the Fourth Circuit in *Lubrizol Enters, Inc. v. Richmond Metal Finishers, Inc*. 756 F.2d 1043 (4th Cir. 1985) (effect of rejection was to terminate intellectual property license). The U.S. Supreme Court may soon get a chance to resolve this circuit split.

Facts

The Chapter 11 debtor ("Debtor") and its licensee, M, had signed a marketing and distribution agreement in 2012 giving M, among other things, a "non-exclusive, non-transferrable, limited license . . . to use [Debtor's] trademark and logo . . . for the limited purpose of performing its obligations," subject to certain limitations.

The parties later litigated various issues under the agreement until 2015. After sustaining operating losses, Debtor filed a Chapter 11 petition and moved to reject its agreement with M under Bankruptcy Code ("Code") § 365(a). According to the Debtor, "it sought to reject the Agreement because it hindered Debtor's ability to derive revenue from other marketing and distribution opportunities." *Id.* Although M objected, the bankruptcy court granted the motion, holding, among other things, that the trademark license was not included within the protections of Code § 365(n) for certain intellectual property, and was thus "unprotected from rejection." *Id.*, at *3.

M appealed to the BAP for the First Circuit. The BAP affirmed other parts of the bankruptcy court's decision, but "disagreed as to the effect of" its trademark holding. "Rather than finding that rejection extinguished [M's] rights, the BAP followed the Seventh Circuit's ruling in *Sunbeam* . . . ." *Id.* According to the BAP, "because [Code] § 365(g) deems the effect of rejection to be a breach of contract, and a licensor's breach of a trademark agreement outside the bankruptcy context does not necessarily terminate a licensee's rights, rejection under § 365(g) likewise does not necessarily eliminate those rights. Thus, the BAP reversed the bankruptcy court's determination that [M] no longer had protectable rights in the Debtor's trademarks and trade names." *Id.*

The First Circuit

The First Circuit affirmed the bankruptcy court. "Unlike the BAP and the Seventh Circuit [in *Sunbeam*]" it held "that [M's] right to use Debtor's trademarks did not otherwise survive rejection of" the parties' agreement. *Id.* at *4.

1. *Statutory Framework for Rejection.* The Court of Appeals first explained the statutory framework for contract rejection in reorganization cases. Code § "365(a) permits the debtor-in-possession to assume those contracts that are beneficial and reject those that may hinder its recovery," thus furthering "Chapter 11's 'paramount objective' of rehabilitating debtors." *Id.* at *4, citing *In re FBI Distrib. Corp.*, 330 F.3d 36, 41 (1st Cir. 2003). After rejecting a contract, "a Debtor is left with a liability for what the Code deems to be a pre-petition breach of the contract." *Id.*, citing Code § 365(g). Distinguishing between "statutory breach" and "common law breach," the court relied on the Fourth Circuit's controversial decision in *Lubrizol Enters, Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985) ("[T]he statutory 'breach' contemplated by § 365(g) controls, and provides only a money damages remedy for the non-bankrupt party. . . . Allowing specific performance would obviously undercut the core purpose of rejection under § 365(a).").

2. *Legislative Response to Lubrizol.* Congress responded to the *Lubrizol* decision three years later in 1988 by enacting Code § 365(n), giving "a [nondebtor] licensee of intellectual property rights a choice between treating the license as terminated and asserting a claim for pre-petition damages — a remedy the licensee held already under § 365(g) — or retaining its intellectual property rights under the license." *Id.* at *5. In this Code amendment, Congress also defined intellectual property in § 101(35A), but specifically excluded trademarks from the new statutory protection. According to the First Circuit, "[t]rademark licenses (hardly something one would forget about) are not listed [in the new definition of intellectual property], even though relatively obscure property such as 'mask work . . .' is included . . . . Nor does the [new definition] contain any catchall or residual clause from which one might infer the inclusion of properties beyond those expressly listed." *Id.* at *9. Moreover, reasoned the court, this case did not present "a request by a party following rejection to recover its own property temporarily in the hands of the Debtor. Rather, it presents a demand by a party to continue using the debtor's property." *Id.*

3. *The Fresh Start Rationale.* The court then explained its rejection of the Seventh Circuit's *Sunbeam* decision. Noting that the goal of § 365(a) was to release the Debtor "from burdensome obligations," it declined to accept *Sunbeam's* premise that a debtor should be freed from "any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark."

Id. at *10. In this case, reasoned the court, Debtor should not be forced to choose between performing its obligations under the license agreement or risking the loss of its trademarks under applicable federal law. Any such "restriction on Debtor's ability to free itself from its executory obligations, even if limited to trademark licenses alone, would depart from the manner in which Section 365 (a) operates." *Id.*, at *10. "In sum, . . . *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens. [It] also rests on a logic that invites further degradation of the debtor's fresh start options." *Id.*, at *11.

4. *Majority Response to Dissent.* The dissent essentially argued for "equitable treatment" of the non-debtor licensee, M, when a debtor-licensor breaches the trademark license. *Id.*, at *12-13. In response, the majority reasoned that "a case-specific, equitable approach" would entail "added cost and delay" in distinguishing "between greater and lesser burdens" among the debtor and the non-debtor licensee. *Id.*, at *11. In short, the majority wanted to preserve the debtor's "fresh start options." *Id.*

Comment

The majority in *Tempnology* relied on the notion that federal bankruptcy law preempts federal trademark law, taking a "categorical approach" that values reorganization over other concerns. Unless the First Circuit rehears, vacates and reverses the panel opinion, the case is ripe for U.S. Supreme Court review.

The Seventh Circuit's *Sunbeam* decision is more persuasive. First, merely because trademarks are not covered by the protection of Code § 365(n), means nothing: "an omission is just an omission." 686 F.3d at 375. "According to the Senate committee report on the bill that included § 365(n), the omission was designed to allow more time for study, not to approve *Lubrizol*." *Id.* Second, "[o]utside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property . . . . [N]othing about [the rejection] process implies that any rights of the other contracting party have been vaporized . . . . [R]ejection 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." *Id.*, at 376-377, quoting *Thompkins v. Lil' Joe Records Inc.*, 476 F.3d 1294, 1306 (11th Cir. 2007). Finally, "*Lubrizol* devoted scant attention to the question whether rejection cancels a contract, worrying instead about the right way to identify executory contracts to which the rejection power applies [and] [s]cholars uniformly criticize *Lubrizol* . . . ." *Id.*, at 377.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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