

ALERTS

US Supreme Court: Licensors Can't Revoke a Trademark License in Bankruptcy

May 23, 2019

On May 20, 2019, the U.S. Supreme Court issued a ruling of key significance for trademark licensing and for acquisitions, investments, financings and other transactions in which trademark licenses are a key value driver. In *Mission Product Holdings, Inc. v. Tempnology, LLC*,^[1] the Court held, 8-1, that where the licensor of a trademark rejects a trademark license in bankruptcy, the rejection does not deprive the licensee of its rights to use the licensed trademark(s). By setting aside the so-called “rejection-as-rescission” approach in favor of the “rejection-as-breach” approach, the Court’s holding resolves a legal issue that had been outstanding for decades in favor of protecting a trademark licensee’s rights.

Background

The origin of the conflict resolved by the May 2019 decision goes back to 1985, when the Fourth Circuit adopted the “rejection-as-rescission” approach in *Lubrizol Enterprises v. Richmond Metal Finishers*, holding that a debtor’s rejection of an executory contract (i.e., a contract under which neither party has completed performance) worked to revoke its grant of a patent license.^[2] In response to this decision, which was widely criticized by commentators, in 1988, Congress added Section 365(n) to Chapter 11 of the Bankruptcy Code. Section 365(n) provides that a licensee “of a right to intellectual property” may elect to retain its rights under a license, notwithstanding the debtor’s rejection of the license.^[3]

The definition of “intellectual property” in Chapter 11 does not, however, expressly mention “trademarks.”[4] Due to this omission, Section 365(n) was often construed by commentators to mean that, when a licensor rejects a trademark license in bankruptcy, the licensee loses the right to use the licensed trademark(s). Yet, for 30 years, whether or not this interpretation was correct was left unresolved. In fact, in its amicus brief, the International Trademark Association characterized the question at hand for the Court as “the most significant unresolved legal issue in trademark licensing.”

Circuit Split

In 2012, in *Sunbeam*, the Seventh Circuit declined to adopt the “rejection-as-rescission” approach, finding that Section 365(g) provides only that the rejection of a contract “constitutes a breach,” and that nowhere under the Bankruptcy Code or applicable contract law does it follow that the licensor has the right to “vaporize” the counterparty’s rights.[5] In 2018, the First Circuit rejected the Seventh Circuit’s view and instead endorsed the view that Section 365(n), and certain special features of trademark law, weigh against permitting a licensee to retain its rights after a trademark license has been rejected.[6] The Supreme Court granted certiorari to resolve the circuit split.

Supreme Court Decision

In an opinion authored by Justice Elena Kagan, the Supreme Court reversed the First Circuit, finding that “Section 365’s text and fundamental principles of bankruptcy law command” that the rejection of a contract in bankruptcy operates only as a breach, and not as a rescission, of the contract. The Court flatly rejected the First Circuit’s reading of Section 365, based on a negative inference flowing from the omission of “trademarks” from the definition of “intellectual property,” that “by specifically enabling the counterparties in some contracts to retain rights after rejection, Congress showed that it wanted the counterparties in all other contracts to lose their rights.” The Court found that, based on the plain text of Section 365, general principles of contract law, and the Bankruptcy Code’s stringent limits on avoidance actions (i.e., cases in which debtors may unwind pre-bankruptcy transactions), the general rule set out in Section 365(g), rejection-as-breach, applies to trademark licenses. The Court rejected the view that special features of trademark law (in particular, a licensor’s duty to exercise quality control over the

goods and services sold under a license) mandate ignoring what 365(a) and 365(g) direct.

Having found that rejection of a contract “breaches a contract but does not rescind it,” the Court observed that, as a practical matter, the licensee (not the licensor) is faced with a choice: it “can continue to do whatever the license authorizes” or consider the license to be terminated and walk away.

Implications for Corporate Transactions

Prior to the May 2019 decision, for a trademark licensee, there was a looming possibility that its rights could be revoked if the licensor went bankrupt. The loss of such license rights could, of course, have serious consequences, such as requiring a licensee to re-brand an entire line of goods or services for which the licensee had invested significant resources to develop the brand or preventing the marketing and sale of a large inventory of branded products.

While deal structures have been developed to protect licensees against this seemingly harsh result (e.g., by putting the brand in a bankruptcy remote entity or having the licensee take a security interest in the trademarks to secure the obligations under the license), the uncertainty in the law imposed an added layer of complexity — and with it greater time and expense — to deals involving material trademark license rights.

By creating greater certainty as to what happens to a trademark license in the event of the licensor’s bankruptcy, the Court’s holding should, in many respects, lessen the challenges in getting to the finish line on a deal involving material trademark licenses. However, dealmakers should bear in mind that with greater certainty for the licensee comes less optionality for the licensor and factor that into their assessment of what rights a trademark licensor will or should insist on when negotiating the terms of trademark license agreements after this decision.

Questions Remain

Because it only addresses whether a debtor-licensor’s rejection of a license deprives the licensee of its rights under a trademark license, the Court’s holding leaves many questions unanswered. For instance, what remedies does a licensee have against a debtor who rejects a license and

subsequently refuses to perform? While Section 365(g) provides that the licensee has a breach claim, the breach is viewed as arising immediately before the bankruptcy filing. This means that a licensee seeking to recover damages must get in line with the other unsecured parties, and is likely to see only pennies on the dollar. Likewise, if the license requires the licensor to maintain registrations for a trademark, and the licensor fails to do so, might an exclusive or nonexclusive licensee be able to step in to preserve the trademarks itself? Or is the licensee left with only a breach claim? Similarly, what happens if a licensor fails to enforce its rights against infringers who are selling products in competition with the licensee?

From a licensor's perspective, the decision suggests that if a rejecting debtor-licensor also ceases to perform, it does so at its peril. In particular, failure to exercise quality control over the goods and services sold under the licensed trademark(s) could result in the loss of its rights in the trademark to the extent the trademark ceases to serve its function of representing the quality of the goods or services sold under the trademark.

In negotiating trademark licenses, it will be important to consider whether language addressing these issues should be added to accomplish your objectives.

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

[1] 587 U.S. ___, No. 17-1657, Slip op. (May 20, 2019).

[2] 756 F.2d 1043, 1045-1048 (4th Cir. 1985).

[3] 11 U.S.C. § 365(n).

[4] 11 U.S.C. § 101. According to relevant legislative history, the omission of trademarks from the definition of “intellectual property” in Chapter 11 did not reflect an intent by Congress to endorse *Lubrizol* in the context of a trademark license, but rather to allow “more time for study,” because trademarks involve certain considerations (such as the licensor’s duty to exercise quality control over the goods and services in connection with which the licensee uses its trademarks) that do not apply to other forms of

intellectual property, such as patents and copyrights. See *Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012).

[5] 686 F.3d at 377.

[6] 879 F.3d 389 (1st Cir. 2018).

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