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Mission Accomplished: Supreme Court Ratifies Seventh Circuit's 'Rejection-as-Breach Rule' for Trademarks in Bankruptcy

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In a closely watched and heavily anticipated decision, the U.S. Supreme Court recently came down solidly behind our own Seventh Circuit Court of Appeals in addressing a split among the appellate courts as to the consequences when a trademark licensor files for bankruptcy. That decision[1] warrants a close read by both intellectual property attorneys and bankruptcy attorneys, not only because it resolves an inter-circuit split, but because it provides clarity where such clarity was lacking. It is noteworthy that a Supreme Court often chided as overtly partisan was in this case nearly unanimous [8-1] in its reasoning.[2]

The fog of confusion that overlay the split among the circuits was understandable. Each side rested its arguments on well-accepted rules of construction, all uncomfortably perched atop an evolving case law and a resulting patchwork of statutory responses fashioned by efforts in Congress to keep up. If nothing else, the Supreme Court may be credited with finally ending, in this arena at least, an unproductive and ultimately unnecessary game of legislative/judicial "whack-a-mole."

In this case, the petitioner, Mission Product Holdings, Inc. [hereafter, "Mission"] was a company that marketed and distributed clothing and accessories. Mission had entered into a licensing contract in 2012 with the Respondent, Tempnology, LLC [hereafter, "Tempnology"], in which Tempnology granted Mission a non-exclusive license to use Tempnology's trademarks in connection with Tempnology's "Coolcore™" line of goods, described by Justice Kagan as "clothing and accessories designed to stay cool when used in exercise."[3] Of some interest [especially to Justice Gorsuch] was the fact that this case was argued and decided in 2019, well after the licensing agreement had expired in July of 2016; matters were brought to a head less than a year before that license expired, when Tempnology filed a petition for Chapter 11 bankruptcy protection in September of 2015.

Section 365(a) of the Bankruptcy Code[4] confers an extraordinary power upon the debtor or the assigned trustee in a Chapter 11 ["reorganization"] bankruptcy: subject to the [bankruptcy] court's approval, it can assume <u>or</u> reject any executory contract, presumably to obtain whichever outcome best works to its advantage. It is entirely the debtor's [trustee's] call. However, once it makes that call, Section 365(g) of the Bankruptcy Code[5] expressly states that "the rejection of an executory contract . . . constitutes a breach of such contract." And not just any breach, mind you, but one deemed to have dated from "immediately before the date of the filing of the petition" for bankruptcy.[6] Since pre-petition claimants, unlike post-petition claimants, are lumped together with all the unsecured creditors, the claimant creditor is typically left hanging out to dry, fortunate indeed to get more than pennies on the dollar.[7]

Interestingly, both parties agreed that the debtor's rejection of the licensing agreement constituted a breach. They also agreed that meant that Tempnology could immediately stop performing under the contract, and that Mission could assert its pre-petition claim in bankruptcy court [along with the usual horde of other unsecured creditors].[8] As the justices saw it, however, Tempnology wanted more. Specifically, Tempnology argued not only that its rejection of the contract left Mission holding the bag under most

unfavorable terms, BUT also terminated the rights Mission had under that contract to use the Coolcore trademarks. The upshot of that position, if true, would be that Tempnology could not only abrogate its duties, but rescind the rights of Mission as well.

Tempnology's position was predicated on a negative inference drawn from a customary canon of statutory construction, but flew in the face of a prior decision of the seventh circuit.[9] Specifically, Tempnology noted that, *inter alia*, there are numerous subparagraphs of section 365 of the Bankruptcy Code which address specific kinds of agreements, in which the licensee is expressly permitted to keep exercising its contractual rights after a debtor's rejection. The conceptually nearest example is section 365(n), which relates to intellectual property licenses[10]. According to section 365(n), if the debtor-licensor rejects the license agreement, the licensee can continue to use the property, so long as the licensee otherwise complies with the contract [*e.g.*, continues to make payments required by the contract]. Applying negative inferences[11] from the lack of specific inclusion of trademarks in Section 365(n) or any other subparagraph of Section 365, Tempnology argued that the debtor's rejection of a trademark license must compel a different result than pertains to patents or copyrights and thus it must also extinguish the rights conferred on the trademark licensee. Then began a bit of judicial yo-yo: the bankruptcy court agreed with Tempnology's position,[12] but the bankruptcy appellate panel reversed.[13] Finally, a divided first circuit ultimately reversed the appellate panel and reinstated the decision of the bankruptcy court,[14] the lone dissenter [Judge Torruella][15] citing to the seventh circuit's reasoning in the *Sunbeam* case.

So, what <u>was</u> the position staked out by the seventh circuit in *Sunbeam*? In a nutshell, it was a wholesale rejection of a fourth circuit decision, *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc*., 756 F.2d 1043 (4th Cir.1985). That decision held that, when an executory intellectual-property license is rejected by the debtor licensor/trustee in bankruptcy, the licensee loses its right to continued use of the licensed intellectual property. Judge Phillips, speaking for a unanimous fourth circuit panel, opined that:

> …we can only conclude that the district court was under a misapprehension of controlling law in thinking that by rejecting the agreement the debtor could not deprive Lubrizol of all rights to the process. Under 11 U.S.C. § 365(g), Lubrizol would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract. [*Citation omitted*]. Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party.[16]

The fourth circuit's reasoning in *Lubrizol* is noteworthy for its broad rejection by most of the other circuits as well as for the swiftness in which its holding was effectively negated by Congress, when it adopted the aforesaid subsection 365(n) in 1988, creating the above-described "exception" for intellectual property licenses. The seventh circuit summarized the checkered history of the *Lubrizol* caselaw, including its legislative rejection by Congress, and openly criticized it as "mistaken."[17] As Chief Judge Easterbrook noted in the panel's unanimous decision, *Lubrizol* had earned the uniform criticism of a long list of legal scholars.[18] He expressly noted that since Section 365(g) provides that a bankrupt's rejection of a contract constitutes a "breach" it follows that "What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place." [19] In short, the power in bankruptcy to extinguish one's obligations does not *ipso facto* confer the right to rescind the other party's rights as well.

Thus, by the time the first circuit rendered its judgment in *Tempnology* embracing the reasoning in *Lubrizol*, that reasoning had already been, for decades, rejected by Congress, the seventh circuit, legal scholars of every stripe and every other appellate circuit. Nevertheless, there was now a clear conflict among the circuits, and the Supreme Court accepted the task of resolving that conflict.

In doing so, the Supreme Court wasted little time in rejecting the first circuit's reasoning in *Tempnology* [and, by extension, the fourth circuit's reasoning in *Lubrizol*] in favor of the seventh circuit's reasoning in *Sunbeam*. The heart of Justice Kagan's ruling is supplied by a lengthy paragraph affirming a simple principle:

> The parties and courts of appeals have offered us two starkly different answers. According to one view, a rejection has the same consequence as a contract breach outside bankruptcy: It gives the counterparty a claim for damages, while leaving intact the rights the counterparty has received under the contract. According to the other view, a rejection (except in a few spheres) has more the effect of a contract rescission in the non-bankruptcy world: Though also allowing a damages claim, the rejection terminates the whole agreement along with all rights it conferred. Today, we <u>hold</u> *[sic]* that both Section 365's text and fundamental principles of bankruptcy law command the first, rejection-as-breach approach. We reject the competing claim 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. And we reject an argument for the rescission approach turning on the distinctive features of trademark licenses. Rejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach.[20]

One might have argued that since Section 365(g) had already and obviously stated that "the rejection of an executory contract . . . constitutes a breach of such contract", it should not have been necessary for the Supreme Court to gild the lily. One

would have been wrong.

For trademark attorneys, it is worth bearing in mind that the Supreme Court in this case is reminding us that contracts relating to the use of trademarks are, first and foremost, contracts relating to the use of property. It is thus not necessary to explore the various aspects of the Bankruptcy Code relative to arcane situations. We also might celebrate the fact that Congress was not obliged to create yet another exception to the Bankruptcy Code for trademark licenses, which "exception" would not have been necessary in the first place.■

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1. *Mission Prod. Holdings v. Tempnology, LLC*, 139 S. Ct. 1652 [May 20, 2019].
2. And to be fair, the lone dissenter, Justice Gorsuch, considered the case mooted by time and the right to appeal "improvidently granted" insofar as the licensing agreement at issue had by then expired by its own terms. He did not attempt to reach the merits. See *139 S. Ct. 1667-68*.
3. *Mission*, 139 S. Ct. at 1658.
4. 11 USC § 365(a).
5. 11 USC § 365(g).
6. 11 USC § 365(g)(1).
7. Justice Kagan, *Mission*, 139 S. Ct. at 1658, citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, at 531-32.
8. *Mission*, 139 S. Ct. at 1659.
9.*Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC*, 686 F. 3d 372, 376-377 (CA7 2012), discussed below
10. Note that "intellectual property" is a defined term in the Bankruptcy Code: 11 U.S.C. § 101(35A) provides that "intellectual property" includes patents, copyrights, and trade secrets. <u>It does not mention trademarks</u>.
11. Old-timers might prefer the Latin equivalent, "*expressio unius est exclusio alterius*" [the express mention of a specific thing or things is an implied exclusion of other things not mentioned]: *Maxwell on Interpretation of Statutes*, [10th ed., Sharp and Galpin, 1953], 331.
12. *In re Tempnology, LLC*, 541 B. R. 1, at 7 (Bkrtcy. Ct. NH 2015).
13. *In re Tempnology, LLC*, 559 B. R. 809, at 820-823 (Bkrtcy. App. Panel CA1 2016).
14. *In re Tempnology, LLC*, 879 F. 3d 389 (2018).
15. *Ibid*, at 405-07.
16. 756 F.2d 1043, at 1048.
17. 686 F. 3d 372, at 376.
18. 686 F. 3d 372, at 377.
19. 686 F. 3d 372, at 378.
20. *Mission*, 139 S. Ct. at 1661.

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