Foster Garvey

Direct Circuit Split Of Protection For Trademark Licensee In A Chapter 11 Bankruptcy Case

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A case recently decided by the U.S. Court of Appeals for the 1st Circuit, *In re Tempnology, LLC*[1], directly rejects the remedy fashioned by the Seventh Circuit in 2012, which provided some rights to a trademark licensee upon rejection of a license agreement.[2] The Bankruptcy Code empowers a Chapter 11 bankruptcy debtor to "reject" contracts and license agreements during the course of a bankruptcy case. The rejection powers are an important tool to allow a debtor to either reorganize or maximize the return on the sale of its assets for the benefit of creditors. The rejection allows the debtor to shed unfavorable agreements or licenses as part of a reorganization proceeding. The economic implications of rejection to a counterparty, and the seeming unfairness, are obvious. However, the Bankruptcy Code provides some protection to licensees of patents and other intellectual property while seemingly leaving a licensee under a trademark unprotected. Or does it?

In *Tempnology*, the First Circuit affirmed what is widely understood to be the majority rule in bankruptcy courts that a trademark licensee, upon rejection of its license agreement, is left only with a claim for damages against the bankruptcy estate. The Seventh Circuit in *Sunbeam Products*, on the other hand, held that the trademark licensee's rights were not "vaporized" upon rejection and would allow the licensee continued use of the trademark if the license agreement and non-bankruptcy law would do so. Of interest in the *Tempnology* opinion was not its affirmance of the majority rule, but the Concurring Opinion by Circuit Court Judge Juan R. Torruella in *Tempnology* that would have adopted the earlier holding of the Seventh Circuit in *Sunbeam*.

The Bankruptcy Code provides a debtor the power to reject any "executory" contract. This power was interpreted by the court in *In re Lubrizol Enterprises, Inc.**[3]*** to permit the rejection of all intellectual property license agreements. The financial and operational impact on patent, copyright, and trademark licensees was tremendous. In October 1988, in reaction to the harsh result reached by the *Lubrizol* court, Congress passed the Intellectual Property Licenses and Bankruptcy Act[4] to protect a licensee's rights in intellectual property in the event of rejection in bankruptcy.[5] Generally, Bankruptcy Code Section 365(n) now permits the intellectual property licensee to either: (i) treat the rejection of the agreement as a breach of contract and file a claim for damages; or, (ii) retain its rights to the intellectual property, although debtor is not obligated to provide any further performance on the agreement. However, the definition of "intellectual property" used by Congress *did not include trademarks*.[6] Congress's omission of trademarks from the definition of intellectual property is what has given rise to the Circuit split. On the one hand, courts hold that the statute is clear that trademarks are not included in the definition of intellectual property, and therefore Congress meant for trademark licenses to be specifically excluded from protection.[7] On the other hand, the Concurring Opinion in *Tempnology* points out that the omission of trademarks from the definition of intellectual property was designed to allow Congress more time to: study the impact of inclusion of trademark licenses in the intellectual property protections; to not postpone the enactment of the curative legislation; and, to allow courts to develop equitable treatment of situations arising from rejection of trademark licenses.

Courts uniformly agree that the curative provisions provided by Bankruptcy Code Section 365 (n) do not provide the protections to a trademark licensee that are provided to licensees of other intellectual property. However, *Sunbeam* and the Concurring Opinion in *Tempnology* argue that the licensee's rights are not "vaporized" upon rejection of the license, and explain that protection may be afforded to trademark licensees under another provision of the Bankruptcy Code, Section 365(g). *Sunbeam* points out that rejection of an executory contract results in a prepetition *breach of the contract which would no longer subject the debtor to specific performance of the contract* and held that the trademark licensee's rights upon rejection of the license are those afforded the non-breaching party under the license agreement or non-bankruptcy law.

The majority in *Tempnology* counters *Sunbeam* by arguing that the trademark licensee's rights are not "vaporized," but instead all of the contract rights are converted into a claim for damages. They argue that allowing the trademark licensee to continue to monitor the use of its marks after rejection would place the debtor in a difficult position; it could either not monitor use of the marks resorting in the loss of the trademark as in a "naked license," or require the debtor to continue post-rejection monitoring of the trademarks, an obligation that would defeat the purpose of debtor's rejection of trademarks in furtherance of its reorganization.

The majority rule followed by the lower courts is that a trademark licensee has no rights to use of the trademark after rejection, but only a claim for damages.[8] The clear split of authority between the First Circuit and the Seventh Circuit could likely prompt the U.S. Supreme Court to weigh in on the issue. In the event that the Supreme Court follows the *Sunbeam* approach, also approved by the Concurring Opinion in the *Tempnology* case, the trademark licensee's rights under license after rejection by the licensor-debtor could be found to be those; (i) provided by the terms of the license agreement in the event of breach; or, (ii) rights provided by non-bankruptcy law.

If you have any questions on how this decision might affect you or your business, please contact Charles Robinson at crobinson@gsblaw.com or 206.816.1451.

[1] *In re Tempnology, LLC*, 2018 WL 387621 (1st Cir. 1/12/2018)

[2] *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012).

[3] *In re Lubrizol Enterprises, Inc.*,756 F.2d 1043 (4th Cir. 1985)

[4] Pub.L. No. 100-506, 102 Stat. 2538 (1988)

[5] *See, In re Centura Software Corporation*, 281 B.R. 660, 668 (Bankr. N.D. Cal. 2002)

[6] *See* 11 U.S.C. §101(35A)

[7] *See, Centura Software*, 281 B.R. at 670.

[8] The Ninth Circuit has not addressed the issue. However, the Bankruptcy Court for the Northern District of California has followed the "majority rule." *See, Centura Software* 281 B.R. 660.