Update: First Circuit Holds That Rejection of a Trademark License by a Bankrupt Licensor Extinguishes the Licensee's Right to Further Use of the Licensed Marks

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In an article in the May 2017 issue of *The Licensing Journal*, we reported on the decision of the Bankruptcy Appellate Panel for the First Circuit (the BAP) in *In re Tempnology LLC*.[1] A key issue in that case was whether the rejection under Section 365 of the Bankruptcy Code[2] in a licensor's bankruptcy case of an executory contract that includes a trademark license extinguishes the non-debtor licensee's right to continue to use the licensed marks for the period prescribed in the contract. The BAP, adopting the rationale articulated a few years earlier by Judge Easterbrook in *Sunbeam Products, Inc. v. Chicago American Mfg., LLC,*[3] concluded that: (1) Under Section 365(g) of the Bankruptcy Code, the debtor-licensor's rejection of the executory contract at issue simply constituted a breach by the licensor of that contract, which, under applicable non-bankruptcy law, did not terminate the license or otherwise eliminate the licensee's right to continue to use the licensed marks in accordance with the terms of the license, and (2) reversed the bankruptcy court's decision to the contrary.

In a two to one decision issued on January 12, 2018, the US Court of Appeals for the First Circuit reversed the BAP.[4] In our previous article, we identified the *Sunbeam* rationale (followed by the BAP in *Tempnology*) as the apparent emerging trend in the case law, at least at the court of appeals level. That observation must now be tempered, as the First Circuit rejected the premise underlying the Seventh Circuit's *Sunbeam* rationale and held that the BAP had erred in concluding that rejection of a trademark license in a bankruptcy case of a debtor-licensor does not extinguish the licensee's right to continued use of the licensed marks.

The First Circuit panel considered the effect of rejection against the backdrop of the Fourth Circuit's 1985 decision in the *Lubrizol* case[5] and the legislative response to that case. In *Lubrizol*, the Court held that the rejection in a debtor-licensor's bankruptcy case of a license of intellectual property deprived the licensee of the right of continued use of the licensed property, relegating the licensee to a pre-petition unsecured claim in the bankruptcy case for damages for breach of contract. The *Lubrizol* case, which involved intellectual property other than trademarks, attracted formidable scholarly criticism.[6]

The Congressional response to *Lubrizol* was the enactment three years later of Section 365(n) of the Bankruptcy Code.[7] That provision affords licensees of most types of intellectual property the right to elect to continue to use intellectual property that has been licensed to them for the term specified in the license, when the license is rejected in the licensor's bankruptcy case. As explained in our previous article, however, trademarks are not included in the Bankruptcy Code's definition of "intellectual property," and Section 365(n), accordingly, does not

expressly apply to trademark licenses. Congress opted not to include trademark licenses under the umbrella of Section 365(n) rather than resolve concerns about the possible effect on quality control maintenance of extending Section 365(n)'s protections to trademark licensees and left it to the bankruptcy courts to develop "equitable treatment" in situations involving trademark licenses.[8]

Against this backdrop, the majority in the *Tempnology* case concluded that rejection is intended to free a debtor from its performance obligations under an executory contract in exchange for the imposition of an unsecured damages claim for breach of contract and that goal cannot be accomplished if a trademark licensee is permitted to use the licensed marks after rejection. The majority reasoned that, if post-rejection use of the licensed marks by the licensee were permitted, the debtor-licensor or its assignee would continue to have a duty imposed by trademark law—a "residual enforcement burden"—to monitor and control the licensee's use of the marks for purposes of quality maintenance or risk the permanent loss of the trademarks.[9] Thus, recognizing a right of continued use of licensed marks by the licensee after rejection of the license by a debtor-licensor would, in the majority's view, deny the debtor-licensor the benefit rejection was intended to bestow.

The dissenting panel member found this reasoning unconvincing, endorsed the *Sunbeam* rationale, and would have affirmed the BAP's ruling.

The *Tempnology* case illustrates that bankruptcies of trademark licensors continue to pose significant legal risks for licensees whose businesses are heavily reliant on the continued ability to use licensed marks for the stated duration of the licenses. In our May 2017 article, we suggested some structuring techniques for licensees when entering into trademark license agreements that may mitigate the risk of rejection if the licensor becomes bankrupt. The reader is referred to that article if he or she has an interest in that subject.

1. In re Tempnology LLC, 559 B.R. 809 (1st Cir. B.A.P. 2016).
2. 11 U.S.C. § 365.
3. Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012).
4. Mission Product Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC), 879 F.3d 389 (1st Cir. 2018).
5. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).
6. *See* commentary referenced in *Sunbeam*, 686 F.3d at 377.
7. 11 U.S.C. § 365(n).
8. *See Tempnology*, 879 F.3d at 401, 406.
9. *Id*. at 402-404.