

Rejecting Trademark Licenses in Bankruptcy: *In re Tempnology*

The decision provides some additional, though limited protection for licensees of trademarks in bankruptcy proceedings

Introduction

In *In re Tempnology LLC*,¹ the Bankruptcy Appellate Panel (the BAP) for the First Circuit provided additional clarity regarding the rights of intellectual property licensees under section 365(n) of the United States Bankruptcy Code,² particularly with respect to trademark licenses. In *Tempnology*, the First Circuit BAP concluded that:

- Section 365(n) extends only to licenses of “intellectual property” as defined in the Bankruptcy Code,³ and excludes trademarks and other contractual rights, such as exclusive product distribution rights, even if such rights are included in the same agreement.
- Rejection of a trademark license pursuant to section 365(g) constitutes a breach by the debtor-licensor that does not necessarily terminate the non-debtor-licensee’s rights or deprive the licensee of its right to continue to use the trademarks post-rejection; instead, the licensee has the rights he or she would have for breach under the terms of the agreement and non-bankruptcy law.⁴

The decision is significant because it marks one of the first bankruptcy appellate decisions expressly adopting the reasoning and interpretation of the Seventh Circuit Court of Appeals in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,⁵ which held that rejection of a trademark license constitutes a breach by the debtor-licensor that does not necessarily terminate the licensee’s rights (or otherwise void the underlying contract), but instead gives the licensee the rights of a non-breaching license counterparty under non-bankruptcy law.⁶ Thus, *Tempnology* marks the continuation of a trend of cases where courts have found various ways to provide some protection to trademark licensees from the perceived inequity that would result from complete termination of the licensee’s rights.⁷ *Tempnology* is also significant as one of the few bankruptcy appellate decisions specifically addressing the scope of section 365(n) applied to an agreement containing separate licenses of non-trademark intellectual property (*i.e.*, “intellectual property” as defined in the Bankruptcy Code) and of trademarks, together with other contractual rights, holding that section 365(n) applies only to the licensed “intellectual property,” and not to the trademark license or contractual rights (in this case, exclusive product distribution rights).⁸

Overview of the Rights of Trademark Licensees and Section 365(n)

Section 365(n) was adopted in response to the perceived inequity of the Fourth Circuit Court of Appeals’ decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*⁹ In *Lubrizol*, the debtor rejected an

intellectual property license, and the court concluded that the licensee was only able to seek monetary damages (which would be a prepetition unsecured claim), and could not continue to use the licensed property or seek specific performance on the contract.¹⁰ In effect, the Fourth Circuit treated rejection of the license as a termination, even though the express language of section 365(g) treats rejection as a “breach” of contract by the debtor, and nothing in the Bankruptcy Code provides that such a breach by the debtor terminates the non-breaching party’s rights.

In response to *Lubrizol*, Congress adopted section 365(n) of the Bankruptcy Code to protect licensees of “intellectual property;” however, as defined in the Bankruptcy Code, “intellectual property” does not include trademarks.¹¹ Section 365(n) is an exception to the general rule that a debtor may reject an executory contract, and operates as an important shield to non-debtor-licensees of intellectual property. Under section 365(n), a licensee whose intellectual property license is rejected by a debtor-licensor can either: (1) treat the debtor’s rejection as a termination of the license and assert a claim for rejection damages; or (2) retain its rights to use the intellectual property as the rights existed as of the filing of the bankruptcy petition (including the ability to enforce exclusivity and extension provisions in the agreement as the provisions relate to the licensed intellectual property against the debtor and any successor). If the licensee chooses to retain its rights, the licensee must continue making royalty payments, and waive administrative claims arising from performance of the contract and any setoff rights.¹²

While section 365(n) established protections for licensees of non-trademark “intellectual property,” Congress intentionally excluded trademarks from the Bankruptcy Code’s definition of “intellectual property.”¹³ As a result of the exclusion of trademarks from section 365(n) and the Fourth Circuit’s interpretation of the effect of license rejection in *Lubrizol*, many bankruptcy courts following the adoption of section 365(n) have searched for ways to provide a degree of protection to trademark licensees when their licenses are rejected. For instance, the court in *In re Matusalem*¹⁴ found that section 365(n) applied to a franchise agreement in its entirety because the agreement included both licenses of trademarks and other intellectual property rights (trade secrets). The court also refused to authorize the rejection of a license agreement based on the debtor’s failure to meet the business judgment standard for rejecting the contract.¹⁵ Other courts have found that trademark licenses were no longer executory,¹⁶ or have imposed “transition periods” to alleviate the licensees’ damages from rejection.¹⁷ However, some courts have continued to deny any protection to trademark licensees and rely on *Lubrizol*’s interpretation of the effect of rejection.¹⁸

In 2012, the Seventh Circuit Court of Appeals, recognizing the challenges posed to trademark licensees by the *Lubrizol* decision and the exclusion of trademarks from section 365(n) protections, took a different approach. In *Sunbeam*, the Seventh Circuit rejected *Lubrizol*’s interpretation of the effect of rejection and, based on the language of section 365(g), concluded that rejection of a trademark license constitutes a breach by the debtor that does not inherently terminate the non-debtor’s rights in the trademark.¹⁹ Instead, the non-debtor has the rights of a non-breaching party under applicable non-bankruptcy law.²⁰ According to the court, “[o]utside of Bankruptcy, a licensor’s breach does not terminate a licensee’s right to use intellectual property” and, therefore, rejection does not give rise to termination.²¹ Thus, “rejection 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 It merely frees the estate from the obligation to perform and has absolutely no effect upon the contract’s continued existence.”²²

However, despite the Seventh Circuit’s decision in *Sunbeam*, courts have continued to struggle with the scope of section 365(n). For example, in *In re Crumbs Bake Shop, Inc.*,²³ the bankruptcy court determined that it would be “inequitable to strip the licensees of their rights in the event of rejection,” and ruled that section 365(n) could be applied to protect the trademark licensee in the case.²⁴ The *Crumbs* court discussed the Seventh Circuit’s decision in *Sunbeam*, but relied on section 365(n) instead of section

365(g), reasoning that Congress intended bankruptcy courts to “exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under [section] 365(n).”²⁵ *Tempnology* is significant in part because it marks one of the few bankruptcy appellate decisions expressly adopting *Sunbeam*’s reasoning and the resulting scope and impact of sections 365(n) and 365(g) on rejection of a contract that provided licenses of trademark and non-trademark intellectual property rights, as well as other contract rights. As such, *Tempnology* diverges from certain cases, such as *Crumbs*, in which courts have attempted to expand the scope of section 365(n) to protect trademark licensees. The *Tempnology* court instead provided limited protection to trademark licenses based on its interpretation of the effect of rejection under section 365(g).

***In re Tempnology* – The Scope of Section 365(n) and the Impact of Rejection on a Trademark Licensee**

In *Tempnology*, Mission Product Holdings, Inc. (Mission) entered into a co-marketing and distribution agreement with Tempnology LLC, n/k/a Old Cold, LLC.²⁶ Under the agreement Mission was granted:

- The exclusive right to distribute certain branded products within the United States, and first rights of notice and of refusal in certain other countries
- The non-exclusive right to sell certain branded products anywhere else in the world
- A non-exclusive perpetual license to use Tempnology’s intellectual property other than its trademarks, domain names and logos
- A non-exclusive license to use Tempnology’s “Coolcore” trademark and logo²⁷

The trademark license was limited and set to expire upon the termination of the agreement, except as necessary to allow either party to exercise its rights during a two-year wind-down period.²⁸

After filing for bankruptcy, Tempnology filed a motion to reject the agreement.²⁹ Mission objected and made an election under section 365(n) of the Bankruptcy Code, arguing that it retained its rights under the agreement, including the intellectual property license, as well as its exclusive product distribution rights and its rights under the limited trademark license.³⁰

The bankruptcy court ruled that: (1) section 365(n) protected Mission’s rights as a non-exclusive licensee as to “patents, trade secrets, and copyrights” granted under the non-trademark intellectual property license; (ii) section 365(n) provided no protectable interest in Tempnology’s trademarks or trade names; and (iii) section 365(n) provided no protectable interest in the exclusive rights to distribute Tempnology’s branded products provided in the agreement.³¹ The bankruptcy court concluded that section 365(n) did not extend to exclusive distribution rights, even though the products were patented, because the distribution rights did not constitute a license of intellectual property and thus did not fall within section 365(n).³² Additionally, in determining that Mission retained no rights in the trademarks and logos, the bankruptcy court reasoned that section 365(n) did not apply, because trademarks are not included within the Bankruptcy Code’s definition of “intellectual property.”³³

Mission appealed, raising (i) whether section 365(n) applied to protect the exclusive product distribution rights granted in the agreement, and (ii) whether Mission retained any rights to use the trademark and logo even though trademarks are not included in the Bankruptcy Code’s definition of “intellectual property.”

The First Circuit BAP first agreed with the bankruptcy court that the exclusive product distribution rights were not preserved under section 365(n). The BAP reasoned that the agreement had two goals: “first, to grant Mission the right to distribute certain of [Tempnology]’s products on an exclusive basis in a defined territory during a limited period; and second, to grant Mission a non-exclusive license to use some of [Tempnology]’s intellectual property in perpetuity.”³⁴ As such, the agreement dealt with “far more than licensing of intellectual property.”³⁵ While the exclusive product distribution rights gave Mission the right to sell certain of Tempnology’s products in certain territories, they did not give Mission any exclusive license rights with respect to Tempnology’s intellectual property.

According to the BAP, upon rejection of an executory contract, “the licensee’s [section] 365(n) election applies only to its rights to intellectual property and not to any other rights that it may have received under the executory contract.”³⁶ The BAP reasoned that to hold otherwise could render any contract “rejection proof” by inserting an intellectual property license “no matter how remote or untethered the license provision [is] from the other terms of the agreement.”³⁷ Accordingly the distribution rights were not protected by section 365(n).

Second, the BAP held that section 365(n) does not extend to protect any trademark rights because the definition of “intellectual property” under the Bankruptcy Code does not encompass trademarks, tradenames and logos.³⁸ In coming to this conclusion, the First Circuit BAP declined to follow the rationale (such as that held by the court in *Crumbs* and discussed in the concurring opinion in *Exide*) to extend section 365(n) to trademarks on “equitable grounds.”³⁹ Instead, the BAP explicitly adopted the approach taken in *Sunbeam*, rejecting the bankruptcy court’s endorsement of “*Lubrizol*’s approach to the rejection of executory contracts, namely that rejection terminates the contract,” noting that “*Lubrizol*, ... is not binding precedent in this circuit and like the many others who have criticized its reasoning, we do not believe it articulates correctly the consequences of rejection of an executory contract under [section] 365(g).”⁴⁰ Applying the rationale from *Sunbeam*, the BAP concluded that while the trademark and logo were not entitled to special protections under section 365(n), Tempnology’s rejection constituted a breach under section 365(g) that did not necessarily terminate Mission’s trademark rights under the agreement. Instead, the licensee’s post-rejection rights were governed by the terms of the agreement and applicable non-bankruptcy law.⁴¹

Conclusion

Tempnology is significant because it marks one of the first post-*Sunbeam* bankruptcy appellate decisions that addresses the scope of section 365(n) as applied to an agreement that included “intellectual property,” trademark, and other contractual rights. Therein, the BAP explicitly adopted the Seventh Circuit’s *Sunbeam* analysis and reasoning that rejection of trademark licenses is governed by section 365(g) of the Bankruptcy Code, which gives the trademark licensee the rights it would have as the non-breaching party to a contract under applicable non-bankruptcy law, and explicitly rejected *Lubrizol*’s conclusion that rejection amounts to termination or rescission of the license. Furthermore, *Tempnology* clarified that trademark rights are distinct from intellectual property rights, even when they are coupled together in the same contract, and broke from certain post-*Lubrizol* cases that attempted to expand the scope of 365(n) to apply to trademark licenses.

While the BAP’s holding that “the Debtor’s rejection of the Agreement did not vaporize Mission’s trademark rights under the Agreement,” marks a partial victory for trademark licensees, it fell short of the more fulsome protections of section 365(n), particularly as to exclusivity rights, and the court did not clarify what rights the licensee would retain after rejection.⁴² The practical impact of the concept that “after rejecting a contract, a debtor is not subject to an order of specific performance” (which the *Sunbeam* court outlined and the BAP in *Tempnology* upheld), is to make it relatively clear that rejection of an exclusive

trademark license will likely render the license non-exclusive as a practical matter following rejection. Further the concept would also not allow the licensee to mandate that the licensor comply with provisions of the license requiring ongoing registration, maintenance, enforcement or defense of the licensed trademark(s).⁴³

However, this general concept leaves open many questions. For instance, in order to ensure the trademark in question is not abandoned under the Lanham Act, proper trademark licensing involves an ongoing process of collaboration and cooperation between the trademark licensor and trademark licensee.⁴⁴ These quality control standards are often implemented in a license agreement through requirements that the licensee not commercialize products bearing the licensed trademarks, unless they have been properly inspected and approved by the licensor. The *Sunbeam* and *Tempnology* decisions suggest that a licensee would be able to use the licensed trademark rights for products that had already been inspected and approved, but the licensee's ability after rejection of the license agreement to use the licensed mark on new products is uncertain if the licensor refuses to approve additional or modified products. Thus, the *Sunbeam* and *Tempnology* decisions illustrate the importance of careful attention to the rights the licensee retains following a breach of the contract by the licensor when drafting license agreements. Licensees should seek to clarify the continuing effect of provisions under the license agreement that would restrict the licensee's continued use of the trademark following the licensor's breach.

Finally, *Tempnology* provides an important (and relatively rare) bankruptcy appellate analysis on the limited protection afforded by section 365(n) on non-intellectual property rights included in an agreement with an intellectual property license. In *Tempnology*, the BAP explicitly rejected the notion that section 365(n)'s protections would include the exclusive right to distribute patented products, which was granted alongside the intellectual property license, but was not itself a right to intellectual property. Executory contracts subject to 365(n) may contain provisions unrelated to the licensing of intellectual property, and under *Tempnology*'s reasoning, upon rejection, section 365(n) will not apply to protect many of these bargained for rights from termination.⁴⁵ Thus, when an agreement deals with the licensing of intellectual property and additional, non-intellectual property rights, courts may consider the terms and construction of an agreement to determine the extent to which the latter are distinct from the former.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Peter M. Gilhuly

peter.gilhuly@lw.com
+1.213.891.8720
Los Angeles

Ted A. Dillman

ted.dillman@lw.com
+1.213.891.8603
Los Angeles

Kimberly A. Posin

kim.posin@lw.com
+1.213.891.7322
Los Angeles

Shawn P. Hansen

shawn.hansen@lw.com
+1.213.891.8520
Los Angeles

Ghaith Mahmood

ghaith.mahmood@lw.com
+1.213.891.8375
Los Angeles

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Endnotes

¹ *In re Tempnology LLC*, 559 B.R. 809 (B.A.P. 1st Cir. 2016).

² References herein to the Bankruptcy Code or sections refer to the United States Bankruptcy Code, codified at title 11 of the United States Code § 101 et seq.

³ See 11 U.S.C. § 101(35A) (providing the definition of "intellectual property" in the Bankruptcy Code, which does not include trademarks).

⁴ *In re Tempnology LLC*, 559 B.R. at 821-24.

⁵ *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012).

⁶ *Id.* at 376-78.

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- ⁷ For further discussion of this trend and court decisions addressing the consequences of trademark license rejection, see Peter M. Gilhuly, Kimberly A. Posin & Ted A. Dillman, *Intellectually Bankrupt?: The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 AM. BANKR. INST. L. REV. 1, 45-47 (2013), available at <https://www.lw.com/thoughtLeadership/intellectually-bankrupt-guide>.
- ⁸ *In re Tempnology LLC*, 559 B.R. at 817-18, 821-23.
- ⁹ *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).
- ¹⁰ *Id.* at 1048.
- ¹¹ See 11 U.S.C. § 101(35). According to the legislative history of section 365, Congress explained that it specifically did not address trademarks when it enacted section 365(n) because “such contracts raise issues beyond the scope of [the] legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.” S. Rep. No. 100-505, at 5 (1988).
- ¹² See 11 U.S.C. § 365(n)(1)(B). A licensee protected by section 365(n) whose debtor-licensor rejects the license is in a position analogous to a tenant under a rejected real estate lease pursuant to section 365(h), which allows the tenant to remain in possession of a lease with modified rights when the debtor-lessor rejects the lease. See 11 U.S.C. § 365(h).
- ¹³ See *supra* note 11.
- ¹⁴ *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993).
- ¹⁵ See *id.* at 515, 519-22 (noting section 365(n) applies to intellectual property of secret formula and trademark, and finding that it was not within the debtor’s business judgment to reject an agreement where rejection would “utterly destroy” franchisee’s business); cf. *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)*, 281 B.R. 660, 671-73 (Bankr. N.D. Cal. 2002) (arguing that “*Matusalem’s* dicta does not suggest an extension of [section] 365(n) protection to trademarks upon a balancing of equities”).
- ¹⁶ *In re Exide Techs.*, 607 F.3d 957, 963-68 (3d Cir. 2010) (finding the license to be no longer executory and therefore not subject to rejection, and in a concurring opinion, reasoning that Congress intended to allow for the development of “equitable treatment” of trademark licenses, pursuant to which courts should use their equitable powers to deny rejection of trademark licenses); see also S. Rep. No. 100-505, at 5 (“Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.”).
- ¹⁷ See *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513-14 (Bankr. D. Del. 2003) (finding that debtor-franchisor could reject the license agreement because trademarks are excluded from “intellectual property” however granting the franchisee’s request for a “transition period” during which to continue to use debtor-licensor’s trademark); *In re Exide Techs.*, 340 B.R. 222, 227, 250 (Bankr. D. Del. 2006) (allowing the debtor to reject a trademark license, but approving a two-year “transition period” for the benefit of the licensee in order to “mitigate any potential damage and business disruption that [the licensee] may suffer as a result of losing the [trade]mark”).
- ¹⁸ *In re Old Carco L.L.C.*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) (refusing to provide protections to trademark licensees because trademarks were excluded from the Bankruptcy Code’s definition of “intellectual property” and as a result were excluded from the scope of section 365(n)’s protections); *In re HQ Global Holdings, Inc.*, 290 B.R. at 513 (“[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisee’s right to use the trademark stops on rejection.”); *In re Centura Software Corp.*, 281 B.R. at 674 (noting that “both pre and post-amendment cases as well as scholarly writings suggest that, upon the rejection of a trademark license, *Lubrizol’s* harsh holding controls, and the licensee is left with only a claim for breach”); *Blackstone Potato Chip Co, Inc. v. Mr. Popper, Inc. (In re Blackstone Potato Chip Co., Inc.)*, 109 B.R. 557, 560-61 (Bankr. D.R.I. 1990) (post-365(n) case where the court, without discussing section 365(n), rejected a trademark license and found that under *Lubrizol* the licensee did not have a continuing right to use the trademark). But see *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380, 394 n.1 (2d Cir. 1997) (“The effects of a rejection of a trademark licensing agreement are a matter that remains to be litigated. To date, this Court has not addressed whether a [section] 365 rejection operates as a kind of avoiding power to bring back into the estate a license of the debtor’s trade name or trademark that was conferred by the debtor prior to its bankruptcy filing.”) For a more complete discussion of these issues, see Gilhuly et al., *supra* note 7, at 45-49.
- ¹⁹ *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372, 376-78 (7th Cir. 2012).
- ²⁰ *Id.* 376-77.
- ²¹ *Id.*; Gilhuly et al., *supra* note 7, at 47.
- ²² *Sunbeam*, 686 F.3d at 377 (citations omitted).
- ²³ *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014).
- ²⁴ *Id.* at 772.
- ²⁵ *Id.* at 772-73.
- ²⁶ *In re Tempnology LLC*, 559 B.R. 809, 811 (B.A.P. 1st Cir. 2016).

²⁷ *Id.* at 812-13.

²⁸ *Id.* at 813.

²⁹ *Id.*

³⁰ *Id.* at 814.

³¹ *Id.*

³² *Id.*

³³ *Id.* at 814-15.

³⁴ *Id.* at 818.

³⁵ *Id.* at 817.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 821-22.

³⁹ *Id.*

⁴⁰ *Id.* at 822.

⁴¹ *Id.* at 822-23.

⁴² *Id.* at 817-18, 821-23.

⁴³ *Id.* at 822.

⁴⁴ In order to avoid what has been called “naked trademark licensing,” a trademark licensor must maintain adequate control over how its licensed trademark is actually used by its licensees. See 15 U.S.C. § 1127 ; see also *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*, 549 F.2d 368, 387 (5th Cir. 1977) (“If a trademark owner allows licensees to depart from its quality standards, the public will be misled, and the trademark will cease to have utility as an informational device.”); *Robinson Co. v Plastics Research & Development Corp.*, 264 F. Supp. 852, 862-64 (W.D. Ark. 1967) (While controlled licensing does not constitute abandonment, mark is abandoned where license from owner allows licensee to use mark without owner retaining control over use). If the licensor does not control the quality of branded products adequately, the licensor risks losing its trademark rights through abandonment. See *id.*

⁴⁵ *In re Tempnology LLC*, 559 B.R. 809, 817-18, 822-23 (B.A.P. 1st Cir. 2016).