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Problems in the Code

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A Hole in § 365(n)

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Congress enacted § 365(n) of the Bankruptcy Code in response to the Fourth Circuit's 1985 decision in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*[1] *Lubrizol* held that the technology license at issue was executory and approved its rejection, but most importantly, it held that rejection operated to terminate the licensee's right to continue using the licensed intellectual property.

Section 365(n), enacted three years later, ameliorated some of the harshness of this result. Under § 365(n), if the court approves rejection of a license of "intellectual property" (IP), as defined in the Code, the licensee may elect to retain its rights to the licensed IP, including any exclusivity rights, for the remaining life of the license plus any as-of-right renewal or extension period.

Congress did not include trademarks in the IP's definition covered by § 365(n). The reason is not important here; what is important is that the omission led to almost 30 years of litigation. One stark example of the sorts of issues that came up is *In re Centura Software Corp.*,[2] in which a bankruptcy court refused to permit a licensee to use the debtor's trademarks after the debtor rejected the license — even though at the very same time, it held that the licensee could continue marketing and selling the debtor's related software copyrights post-rejection under § 365(n). Consider how odd this result is: If the licensee used the copyrights, what name could possibly go on the box consistent with the Lanham Act? Using any name other than the trademark owner's could be actionable. The ability to keep using the copyright license thus may ultimately have been of little use.

Circuit Split: What Happens to a Trademark License After Rejection?

By 2018, there was a circuit split. In *In re Tempnology LLC*,[3] the First Circuit held that because of the unique nature of trademarks, it was impossible to permit a licensee to continue using a mark after rejection. The First Circuit put it as follows:

> Trademarks, unlike patents, are public-facing messages to consumers about the relationship between the goods and the trademark owner. They signal uniform quality and also protect a business from competitors who attempt to profit from its developed goodwill. The licensor's monitoring and control thus serve to ensure that the public is not deceived as to the nature or quality of the good sold.[4]

This obligation to ensure quality control — which provides information to the public and without which the trademark may be deemed abandoned — is utterly inconsistent with rejection, in the First Circuit's view, because the purpose of rejection is to free the debtor from continued performance. Because of this, although the licensee in *Tempnology* had elected under § 365(n) to retain its rights to other licensed IP, the First Circuit held that it could not retain rights to the associated trademarks.

However, the Seventh Circuit in *Sunbeam Prods. Inc. v. Chicago Am. Mfg. LLC*[5] came out the other way. In that case, the licensee had licenses for the debtor's patents and trademarks. The debtor rejected both, and the licensee elected to retain its rights in both — but the company that bought the debtor's assets sued to prevent the licensee from continuing to use the trademarks. After all, § 365(n) does not cover trademark licenses.

The Seventh Circuit held that under § 365(g), rejection is nothing more than a breach of contract by the debtor. A licensor who breaches a license outside of bankruptcy cannot use its own breach as

1 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).
2 281 B.R. 660 (Bankr. N.D. Cal. 2002).
3 879 F.3d 389 (1st Cir. 2018).
4 *Id.* at 402 (citation omitted).
5 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 568 U.S. 1076 (2012).

a basis for preventing the licensee from using the licensed property, so a breach by a bankrupt licensor should have no different effect. Thus, the sole effect of rejection was that the debtor breached the contract; rejection did not terminate the contract, nor did it affect the nonbreaching party's right to the benefit of the contract. As a matter of normal contract law, when there is a breach, the nonbreaching party elects whether to terminate the contract or to continue it and seek damages for breach. Bankruptcy does not alter that basic rule.

The U.S. Supreme Court granted *cert* in the *Tempnology* case and, in a 2019 decision, came down squarely in favor of licensees retaining their rights. The opinion by Justice Elena Kagan[6] focused on the statutory language. Section 365(g) states that rejection constitutes a breach. Similar to the Seventh Circuit in *Sunbeam*, the Supreme Court observed that a debtor in bankruptcy has no greater property or contract rights than outside of bankruptcy, so if the effect of a nonbankruptcy breach is that the nonbreaching party can keep its rights, then that is also the effect of a breach by a bankrupt debtor. That the breach is due to rejection makes no difference.

The unique nature of trademarks was not a reason to create a special carve-out. Nothing in § 365 indicates that Congress intended to treat rejection of trademark licenses differently from any other executory contract. Yes, debtors who are trademark licensors may need to continue exercising quality control, but that merely presents them with a business decision: Is the future value of the asset (once the licensee's rights terminate) worth spending money to preserve, and does the need to exercise quality control affect whether rejection is "worth the candle"?

Remaining Questions After *Tempnology*

Where does this leave us? With a lot of questions. Presumably, with time, the courts will arrive at a stable set of rules to govern the scope of a licensee's rights and responsibilities following rejection of a trademark license. However, what § 365(n) does not address — and neither does *Tempnology* — is what happens if the relationship of the parties is broader than just an IP license. The IP licenses may be at the heart of a licensor/licensee agreement, but there is often an entire congeries of related agreements and rights that operate together to enable the licensee to run its business using the licensor's IP. Distribution agreements, supply agreements, consultancies, secondment of employees, periodic training and approval rights agreements — depending on the nature of the business and the type of IP, there could be any number of contracts that a business may need besides the license agreements it has with the debtor, and without which it cannot as a practical matter run its business.

Many of those other agreements the debtor/licensor can simply reject and stop performing. It is one thing if the debtor/licensor stops performing under an IP license, because the core of an IP licensee is a grant of permission to use the IP, any additional obligations of the licensor can fairly be regarded as ancillary. However, that is not true of many of the other agreements that often accompany IP licenses. Many such agreements require the debtor/licensor to provide affirmative performance to the licensee. For example, think of a restaurant franchisee who can use the licensed mark only in a manner approved by the licensor but cannot compel the debtor/licensor to provide the requisite ingredients or paper goods. Similar scenarios can be imagined for certain kinds of software licenses or patents: They only can be exploited with the active support of the licensor pursuant to some other contract — and that other contract can be rejected, with the consequence that the support stops. In such cases, both § 365(n) and *Tempnology* may have given the licensee a hollow victory: Yes, the licensee can retain its rights but cannot fully use them.

It is not just the licensee who can be left to deal with these adverse effects. The debtor/licensor can also be left holding the bag.

Especially if the IP licenses are exclusive, the web of related agreements can create a recipe for gridlock. If all the relevant contracts were rejected, the licensee would be the only one able to use the IP if it elected under § 365(n) or *Tempnology* to retain its rights, but the licensor could withhold ancillary services or goods that the licensee would need to carry on its business. This would leave the debtor/licensor unable to realize any value on its IP for the remaining term of the license, but it would also leave the licensee with rights to IP that it is unable to exploit.

Clearly, the purpose of rejection is to relieve the debtor of the obligation to continue performing. Just as clearly, the purpose of § 365(n), and of the contract rules protecting the nonbreaching party, is to enable the nonbreaching party to choose to retain its rights if that seems advantageous. However, if the debtor cannot be compelled to perform and the nondebtor cannot be compelled to surrender its rights, a nonproductive standoff can be inevitable.

So far, this issue has not come up since the Supreme Court ruled. Before *Tempnology*, when trademark licenses used to terminate upon rejection, there were more opportunities for this issue to arise. After all, trademarks were often just one piece in a network of agreements that included other IP licenses. This setup should be familiar to anyone who has worked on a corporate spinoff or divestiture of a line of business. But *Tempnology* did not solve this problem as much as move the arena in which it can arise: A trademark license by itself probably will not be treated differently from other IP licenses, but other kinds of related contracts might be.

As previously mentioned, the difficulty not only affects the licensee; the debtor is also affected. This situation seems to drive the parties to a position where the debtor must assume the contract because it may be left with little or no advantage from rejection. Of course, that creates real problems for a debtor without the resources to assume the license. Moreover, if the related agreements are viewed as parts of a single transaction, if the debtor does want to assume one of the agreements it might be required to assume all of them, which, due to the cure requirements, could be quite burdensome.[7]

6 *Mission Prod. Holdings Inc. v. Tempnology LLC*, __ U.S. __, 139 S. Ct. 1652 (2019).

7 *See, e.g., In re FPSDAI LLC*, 450 B.R. 392, 398 (Bankr. E.D.N.Y. 2011) (debtor could not assume lease without also assuming and curing defaults in related franchise agreement).

Reorganization might also be made more difficult. Even a § 363 sale could become more difficult. The debtor cannot have the sole right to use the licensed IP until the license expires, which can depress its value to a potential buyer. If the license is exclusive, that also means that the debtor cannot count on having the licensed IP available to use in its business until the license term runs out. Either way, this issue can make a reorganization or sale more difficult.

What (if anything) can be done about this? The answer depends on your policy preference. On the one hand, if you think it is undesirable to have a situation where IP cannot be exploited effectively because different entities control different parts of the package of rights that are needed, then there are two choices: Amend the Code to (1) restore the *Lubrizol* rule so that the debtor can regain all the needed rights upon rejection; or (2) provide that if an exclusive licensee of IP elects under § 365(n) to keep its rights, it can also keep all the associated contractual rights necessary to enable it to use the IP.

Neither of these solutions is perfect. Reinstating *Lubrizol* would bring back the very problem that led to § 365(n) in the first place — namely, if the licensor filed a petition and rejected the license, an exclusive licensee who invested large sums in bringing new products to market could find itself deprived of the rights that it needs to realize a return on its investment. However, if the § 365(n) election carried along other, non-IP-related contractual rights, then the debtor would be deprived of the main benefit of rejecting contracts, because it would be compelled to continue performing. To some extent, the Supreme Court's observation in *Tempnology* — that the need to continue some degree of performance after rejection (due to quality control) is just one more factor the debtor has to account for in deciding whether to reject — could apply here, too, but the scale of the continued need to perform would be different in kind from the relatively narrow performance needed for quality control.

The other alternative is just to leave things where they are. Without a clear statutory rule, the parties would be driven in the normal course to seek a negotiated solution. After all, the current state of affairs could leave both the debtor/licensor and the licensee unable to profit from the IP-based business. Unless there is a noneconomic motive for continuing this state of affairs (*i.e.*, a family feud[8]), most rational businesses should be able to reach a consensual resolution so that both could have at least some prospect of benefit. **abi**

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8 *See, e.g., In re Ron Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993).