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Memorandum

First Circuit Rules That Licensor's Rejection of Trademark License in Bankruptcy Terminates Licensee's Right to Use Trademark

February 8, 2018

On January 12, 2018, the United States Court of Appeals for the First Circuit ruled that a trademark licensee lost its right to use the licensed mark following rejection of the license by the debtor-licensor. The Court re-affirmed that Section 365(n) of the U.S. Bankruptcy Code does not provide special protections to trademark licensees and held that rejection of a trademark license by the debtor effectively terminated the licensee's right to use the subject marks.[1]

The First Circuit ruling sets up a circuit split on the issue, by disagreeing with the Seventh Circuit's ruling in the *Sunbeam* case.[2] In *Sunbeam*, the Seventh Circuit held that rejection of a trademark license by the licensor is a pre-petition breach, but does not terminate the licensee's right to continued use of the mark.

Why the Case Matters

The circuit split creates uncertainty for trademark licensees because their right to continued use of a mark following the licensor-debtor's rejection of the trademark license will depend on where the licensor files for bankruptcy. Although there are mixed bankruptcy court opinions on the issue of trademark licenses, upholding licensees' rights on various grounds after a rejection, even though Section 365(n) does not include trademarks in its "rejection override" provisions,[3] the *Tempnology* case represents a split at the circuit level.

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[1] *In re Tempnology, LLC*, 879 F.3d 389, 395 (1st Circ. 2018).

[2] *Sunbeam Products, Inc. vs. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012). For ease of reference, the First Circuit includes the Districts of Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island, and the Seventh Circuit includes Illinois, Indiana and Wisconsin.

[3] See, *e.g.*, *In re Crumbs Bake Shop*, 522 B.R. 766, 772 (Bankr. D.N.J. 2014) (holding that courts should consider applying § 365(n) to trademark licenses on case-by-case basis); In re Lakewood Engineering, 459 B.R. 306 (Bankr. N.D. Ill. 2011) (same); *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (refusing to allow rejection by trademark owner that was motivated by bad faith).

Given the above, trademark licensees (and lenders for whom such licenses are pledged as collateral) should consider bankruptcy protections *at the time the licenses are signed*. Such protections include putting the licensed trademarks in a "bankruptcy remote" entity, granting the licensee a lien on the trademark or other assets of the licensor as a disincentive to rejection, placing financial covenants on the licensor, obtaining a guaranty from a credit worthy entity and other measures.[4] Moreover, licensees and their lenders should analyze the financial health of the trademark owner as part of their customary due diligence.

Case History and Analysis

Tempnology, LLC filed for Chapter 11 reorganization and rejected a trademark license granted to Mission Product Holdings, Inc. The bankruptcy court ruled that Mission could not override the rejection, because Section 365(n) does not protect trademark licensees.[5] The Bankruptcy Appellate Panel affirmed this point, but reversed as to the effect of such rejection. The BAP, following *Sunbeam*, held that Tempnology's rejection of the license was a breach of the contract, but did not terminate the agreement – in sum, Mission could continue to use the trademark.[6]

The First Circuit affirmed that 365(n) does not protect trademark licensees, holding that courts should not use generalized equitable discretion to overrule clear language in the Code. The court then disagreed with *Sunbeam*, holding that it was logically untenable to allow a trademark licensee to continue using the trademark after the licensor's rejection. The court noted that a trademark owner is legally obligated to perform quality control activities under its licenses or risk losing its rights in the trademark. Therefore, under *Sunbeam*'s approach, the debtor-licensor would be forced to perform executory obligations under the license – which departs from Section 365(a) of the Code – or risk losing the value of its trademark, if the trademark licensee is allowed to use the trademark after rejection. The court also found that *Sunbeam*'s approach to use fact-specific, equitable discretion in cases of trademark licenses would be too burdensome, and thus favored the categorical approach of excluding trademark licenses from Section 365(n) "until Congress should decide otherwise."[7]

In short, trademark licensees will not be able to use the marks after debtor-licensors' rejections if debtor-licensors file for bankruptcies in the First Circuit, while they will be if debtor-licensors file for bankruptcies in the Seventh Circuit. Given this uncertainty, trademark licensees (and lenders for whom such licenses are

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[4] Please consult the partners listed on this memorandum to discuss these options.

[5] See 11 U.S.C. §365(n) (covering "intellectual property licenses") and 11 U.S.C. §101(35A) (defining "intellectual property" to include patents and copyrights, but not trademarks).

[6] *In re Tempnology LLC*, 559 B.R. 809 (B.R.A.P. 1st Cir. 2016); *In re Tempnology LLC*, 541 B.R. 1 (Bankr. D.N.H. 2015).

[7] *Tempnology*, 879 F.3d at 404.

pledged as collateral) should consider bankruptcy protections *when signing trademark licenses* and evaluate the trademark owners' financial health as part of their customary due diligence.

For further information about this decision, please contact one of the following members of the Firm.

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