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The Supreme Court Decision Mission Product Holdings, Inc. v. Tempnology, LLC Has Broad Implications for Licenses and Other Agreements in Bankruptcy: Analysis

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On May 20, 2019, the United States Supreme Court decided the case *Mission Product Holdings, Inc. v. Tempnology, LLC*. The facts of the case and its potential implications were discussed previously on this blog here. In the 8-1 decision authored by Justice Kagan, the court ruled that agreements rejected by a debtor in bankruptcy will not be deemed terminated or rescinded. Rather, the non-debtor party will retain whatever rights it would have under applicable non-bankruptcy law following a breach of the agreement. While the decision dealt with a rejected trademark license, the court made clear that the ruling applied broadly to every type of agreement rejected by a debtor under section 365 of the Bankruptcy Code. Rejection of agreements very often serves as a critical tool in Chapter 11 by allowing a debtor to walk away from burdensome obligations. The fact that non-debtor parties will retain certain post-rejection rights will require debtors – and potential debtors – to consider how rejection will address their reorganization goals. Non-debtor parties, on the other hand, should consider how best to use the negotiating leverage granted to them by the Supreme Court.

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The *Mission Products* case involved Tempnology, LLC, a company that manufactured athletic sportswear and licensed the right to use its COOLCORE trademark and related rights to a licensee called Mission Product Holdings, Inc. In summary, Tempnology attempted to use its Chapter 11 bankruptcy filing as a means to reject a trademark license with Mission, and thus terminate Mission's rights under the license. Many courts have held that, following the rejection of an agreement such as a license in a bankruptcy case, non-debtor parties are limited to filing a general unsecured claim. Depending on the case, general unsecured claimants may receive much less than the face value of their claims. However, some courts – including the Seventh Circuit Court of Appeals in a 2012 case called *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC* – have held that rejection does not terminate a licensee's rights and that the non-debtor licensee retains certain post-rejection enforcement rights. To that point, outside of the bankruptcy context, a licensor's breach of a trademark license agreement does not mean that the licensee no longer has any rights in the license. In fact, state law provides a number of licensee remedies short of termination.

In the *Mission Products* case, the bankruptcy court held that termination of the license agreement revoked Mission's right to use the COOLCORE marks. The Bankruptcy Appellate Panel reversed, relying upon the *Sunbeam* court's rationale. On appeal to the First Circuit, the court reinstated the bankruptcy court decision that rejection effectively terminated the license agreement. The Supreme Court granted certiorari to address the split between the Seventh and First Circuits.

Justice Kagan began the court's analysis by disposing of any argument that the matter was moot. Tempnology argued that there was no live controversy because the license agreement terminated by its terms and all assets had been distributed in the bankruptcy case. The court found that the matter was not moot for several reasons, including that Mission may be able to "seek the unwinding of prior distributions to get its fair share of the estate." However, while eight justices found that the matter was not moot, Justice Gorsuch wrote a short dissent, asserting that the inability of Mission's lawyers to articulate a theory that would actually result in a claim for damages mooted the matter.

As to the substance of the case, the court directly addressed the meaning and effect of rejection under bankruptcy law. The court noted that two competing views had arisen. On one side – articulated in the *Sunbeam* decision – rejection acts merely as a breach and the non-debtor party has not only a claim for damages against the debtor, but also retains the post-breach rights the non-debtor party would have outside of bankruptcy. On the other side – articulated by the First Circuit – rejection acts as a rescission of the agreement, leaving the non-debtor party with the sole remedy of filing a claim in the bankruptcy case. The court came down firmly on the *Sunbeam* side of the dispute, largely based on a finding that Bankruptcy Code section 365(g) unambiguously states that rejection of a license or other "executory contract" constitutes a breach of such agreement, which is deemed to have occurred immediately before the filing of the bankruptcy case.

Critical to the court's decision was a finding that a party – including a debtor in bankruptcy – should not be permitted to use its breach to deny the other party its rights under a contract. The court set forth a hypothetical involving a copy machine lease to make the point. Assume, the court stated, that a law firm leased a copy machine from a dealer and the lease required the dealer to provide monthly service in exchange for a fee. Assume further that the dealer later breaches the agreement by refusing to provide service. The law firm is thereby presented with a choice. The firm could retain the copier, continue to make the service payments, and sue the dealer for damages. Alternatively, the firm could cease making payments, return the copier to the dealer, and sue for damages. The key issue, the court pointed out, is that the decision of whether to terminate the agreement and return the copier is for the law firm to make. The dealer cannot, based on its own breach, terminate the agreement and reclaim the copy machine. Likewise, the court reasoned, if the dealer had filed Chapter 11 bankruptcy, the dealer would not be able to use rejection – which is deemed a breach under section 365(g) – to terminate the lease and to reclaim the copier. The court reasoned that to determine otherwise would be to grant the debtor with avoidance powers not set forth in the Bankruptcy Code. The court noted that powers such as avoiding a fraudulent transfer can be invoked only in narrow circumstances and that interpreting section 365 to provide for a new – very broad – avoidance power "would subvert everything the Code does to keep avoidances cabined."

The court also rejected Tempnology's arguments that there was a "negative implication" created by other provisions in Bankruptcy Code section 365, such as sections 365(h) and 365(n). Those sections provide specified post-rejection protections to certain parties, including non-residential real property tenants in the case of 365(h) and intellectually property licensees in the case of section 365(n). Tempnology argued that because Congress provided post-rejection protections to such specifically identified parties, it followed that all other parties had no post-rejection rights. The court reviewed the legislative history of the subsections of section 365 and found no grand plan by Congress to protect certain parties, while leaving others behind. Rather, the enactments occurred "over a span of half a century" as a result of a "mash-up of legislative intervention." The court also made clear that, while section 365(n) applies to certain intellectual property licenses, it does not apply to trademark licenses. Thus, in a somewhat ironic twist, the fact that Congress left trademark licensees out of the "protection" of section 365(n) means that trademark licensees may be better off post-rejection because they are not required to fit within the confines of the 365(n) terms.

Finally, the court addressed Tempnology's concern that allowing trademark licensees to retain post-rejection rights is contrary to the reorganization policies of Chapter 11 because it will require the debtor/licensor "to choose between expending scarce resources on quality control and risking the loss of a valuable asset," i.e., the mark. The court rejected this argument for a number of reasons, including that section 365 involves all types of leases and executory contracts and thus to allow a particular concern relating to trademark licenses to define the meaning of rejection "would allow the tail to wag the Doberman." More broadly, the court noted that while the Bankruptcy Code favors reorganizations, "it does not permit anything and everything that might advance that goal."

As such, the court reversed the First Circuit decision and remanded the case to the bankruptcy court. In addition, Justice Sotomayor wrote a concurring opinion "to highlight two potentially significant features" of the holding. First, Justice Sotomayor noted that the decision should not be read to grant every trademark licensee the unfettered right to continue using the mark post-rejection. Rather, a case-by-case inquiry must be made to determine whether, in fact, the licensee's rights would survive a breach under applicable non-bankruptcy law. Second, the court's decision sets forth separate post-rejection effects for trademark licensees versus licensees of other types of intellectual property. Justice Sotomayor suggested that, given that outcome, Congress may wish to tailor post-rejection remedies that specifically apply to trademark licensees.

While the *Mission Products* case answers the question of whether a rejection should be treated as a termination or a rescission, the case is certain to raise other questions in future cases. As Justice Sotomayor stated in her concurrence, it will be necessary to conduct an analysis of non-bankruptcy law to determine the scope of the non-debtor party's post-rejection rights. That likely will inject a degree of uncertainty into the planning and strategy of many potential Chapter 11 bankruptcy cases. In addition, disputes over such post-rejection rights may lead to higher Chapter 11 costs. This may exacerbate the existing concerns among many that Chapter 11 is too expensive. That said, while *Mission Products* may limit the options of some debtors, certain powerful tools (the automatic stay, lien avoidance, non-consensual "cram down" contract modifications) exist only in bankruptcy. Without a doubt, creative debtors' counsel will determine how to continue making use of such powerful bankruptcy tools, even though the concept of rejection is not quite as powerful as some lower courts interpreted it to be.