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Supreme Court Reiterates That Rejection of Executory Contract Constitutes Breach, Does Not Terminate Non-Debtor Counterparty's Rights Under Contract

The U.S. Supreme Court held today in *Mission Product Holdings, Inc. v. Tempnology, LLC* that a trademark licensee may retain certain rights under a trademark licensing agreement even if the licensor enters bankruptcy and rejects the licensing agreement at issue. Relying on the language of section 365(g) of the Bankruptcy Code, the Supreme Court emphasized that a debtor's rejection of an executory contract has the "same effect as a breach of that contract outside bankruptcy" and that rejection "cannot rescind rights that the contract previously granted."

In so ruling, the Supreme Court resolved a circuit split by reversing the First Circuit's January 2018 decision in the same case¹ and siding with the Seventh Circuit's opinion in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012).²

Background

In 2012, Tempnology, LLC ("Tempnology") and Mission Product Holdings, Inc. ("Mission") entered into an agreement (the "Agreement") that, among other things, granted Mission (1) the exclusive right to distribute certain cooling fabric products manufactured by Tempnology, (2) a non-exclusive, perpetual license to Tempnology's patent and other non-trademark intellectual property, and (3) a limited, non-exclusive license to use Tempnology's trademark and logo for the purpose of performing its obligations and exercising its rights under the Agreement. The Agreement was terminated in 2014, triggering a two-year wind-down period. Under the Agreement, Mission was entitled to retain its distribution and trademark rights until 2016 and its other intellectual property rights in perpetuity.

In September 2015, Tempnology voluntarily filed for bankruptcy under chapter 11 and moved to reject certain of its contracts, including the Agreement, pursuant to section 365(a) of the Bankruptcy Code. Mission objected, and the litigation that followed largely focused on section 365(n) of the Code. Section 365(n) provides that when a debtor-licensor rejects an intellectual property license, the non-debtor licensee has the option to retain its rights to intellectual property under the license as they existed before the

¹ For a full summary of the First Circuit's ruling, which held that a trademark licensee loses the right to use a trademark when the debtor-licensor rejects the license at issue, see our [January 2018 Client Alert](#).

² For a full summary of *Sunbeam*, see our [August 2012 Client Alert](#).

bankruptcy filing, subject to certain limitations. Mission asserted that the Agreement was not executory, and thus not subject to rejection under section 365(a), while expressly reserving its rights under section 365(n). The bankruptcy court entered an order permitting Tempnology to reject the Agreement, “subject to [Mission’s] election to preserve its rights under 11 U.S.C. § 365(n).”

Tempnology subsequently sought a declaratory judgment from the bankruptcy court that section 365(n) does not cover trademark licenses and that Mission therefore could not retain its trademark licenses under the rejected Agreement.³ Litigation regarding the scope of Mission’s section 365(n) rights—and the legal consequence of rejection for Mission—ensued.

The bankruptcy court ultimately held that section 365(n) did not apply to Mission’s distribution and trademark rights and that rejection of the Agreement extinguished Mission’s distribution and licensing rights. The Bankruptcy Appellate Panel for the First Circuit reversed, holding that a licensee’s right to use trademarks does not necessarily terminate upon rejection. However, the First Circuit, in its January 2018 opinion, rejected the Bankruptcy Appellate Panel’s decision and reinstated the bankruptcy court’s decision.

The Supreme Court’s Ruling

In overturning the First Circuit’s decision, the Supreme Court focused not on section 365(n) of the Bankruptcy Code but instead on section 365(g). The Court reasoned that under section 365(g), a debtor’s rejection of an executory contract has the same effect as a breach of that contract outside bankruptcy. Because of such rejection, the Supreme Court explained, debtor Tempnology could stop performing under the contract, and non-debtor Mission could assert a prepetition claim for damages resulting from such nonperformance. However, outside bankruptcy, the Supreme Court said, a licensor’s breach would not revoke continuing rights given to a counterparty under a contract, and all the rights that would ordinarily survive a contract breach would remain in place. The “same result must follow from rejection in bankruptcy,” stated the opinion.

Based on several provisions of section 365 which provide that a non-debtor counterparty to specific kinds of agreements may continue to exercise contractual rights after a debtor’s rejection, Tempnology argued that the ordinary consequence of rejection must lead to the termination of contractual rights. The Supreme Court rejected this “negative inference,” opining that Congress enacted the provisions on which Tempnology relied at different times to “respond[] to a discrete problem” rather than to set up a “reticulated scheme” of narrowly tailored exceptions. According to the Supreme Court, this “mash-up of legislative interventions” could be read to reinforce or clarify the general rule that contractual rights survive rejection, as part of a pattern in which “Congress whacked Tempnology’s view of rejection wherever it raised its head.”

³ For a full discussion of section 365(n), see our [January 2018 Client Alert](#).

The opinion noted that Tempnology’s argument would treat rejection as having “more the effect of a contract rescission.” However, rejection as rescission would circumvent the Bankruptcy Code’s “stringent limits” on avoidance actions (in which, under “exceptional” and “narrow circumstances,” debtors may unwind pre-bankruptcy transfers), because it would permit debtors to rescind previously granted interests for “any plausible economic reason.” That result would “subvert everything the Code does to keep avoidances cabined—so they do not threaten the rule that the [bankruptcy] estate can take only what the debtor possessed before filing,” explained the Supreme Court.

The Supreme Court also rejected Tempnology’s policy argument that unless rejection terminates a licensee’s right to use a trademark, the debtor must choose between monitoring the goods sold under a license and risking the loss of its trademark. The Supreme Court was not convinced that the distinctive features of trademark licenses should dictate a construction of section 365 that would govern “much more than trademark licenses.” According to the Supreme Court, section 365’s edict that rejection is a breach “expresses a more complex set of aims than Tempnology acknowledges;” in allowing rejection of contractual duties, said the Supreme Court, section 365 does not grant the debtor an exemption from all the burdens that generally applicable law imposes on property owners, nor does it relieve the debtor of the need to make economic decisions about preserving the estate’s value. Rather, the opinion remarked, Congress sought to balance multiple competing interests and to weigh the legitimate interests and expectations of the debtor’s counterparties.

Conclusion

The Supreme Court’s decision has far-ranging implications, as the opinion’s reasoning can be expanded to apply to the vast majority of contracts that may be rejected in bankruptcy. The Supreme Court acknowledged the broad reach of its decision, noting that section 365(g) speaks to “any executory contract.” As a result, the Supreme Court clarifies that a debtor’s rejection of an executory contract permits the debtor only to stop performing under the contract, and not to revoke the contractual rights granted to the non-debtor counterparty.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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