Pause Before You Say "Good Riddance To That Rejected Contract"

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The Supreme Court's Decision in *Mission Product Holdings, Inc. v. Tempnology*

Many Chapter 11 debtors have reorganization plans that reject contracts in droves and they never look back. Why? Rejection is part of the debtor's "fresh start". A debtor "monetizes" its old contracts into prepetition claims, often paying only cents on the dollar in damages. But where does that leave counterparties? If that contract was a trademark license, the licensee might be in the catbird seat.

This week, the United States Supreme Court issued an opinion with potentially far-reaching implications in the field of bankruptcy and trademark licenses. The Supreme Court's decision in *Mission Product Holdings, Inc. v. Tempnology,* LLC, 587 U.S. ____ (2019) (Kagan, J.) resolves a circuit split between the First and Seventh Circuits. In *Mission Product*, the Supreme Court found that a debtor's rejection breaches a contract but does not rescind it. All rights that would survive a breach of contract outside of bankruptcy remain in place.

The Debtor, Tempnology, LLC, manufactured apparel designed to stay cool when used in exercise and marketed those products under the trademarked brand name "Coolcore". Tempnology entered into a license agreement with Mission Product Holdings, Inc., wherein Tempnology gave Mission a license to use Coolcore trademarks worldwide. Thereafter, Tempnology filed for Chapter 11 bankruptcy and sought to reject the Mission licensing agreement pursuant to Section 365 of the Bankruptcy Code.

Section 365 of the Bankruptcy Code is a powerful tool for debtors, which allows a debtor, subject to court approval, to "cherry pick" which executory contracts it will seek to assume and which it will seek to reject. A contract is "executory" if there is material performance due and owing by parties on each side of the contract. Essentially, Section 365 allows the debtor to make a value determination with respect to each of its contracts, and decide which to assume (and accept all the rights and burdens of the contract) and which to reject (and monetize the damages into a general unsecured claim that is unlikely to be paid in full in most Chapter 11 bankruptcies).

The bankruptcy court approved Tempnology's rejection of the Mission agreement. The parties agreed that the rejection of the contract allowed Tempnology to stop performing and for Mission to file a claim. However, Tempnology also sought to terminate Mission's right to use the Coolcore trademark. Tempnology argued that that are several provisions in Section 365 that allow a counterparty to specific kinds of agreements to continue exercising contractual rights after rejection. *See, e.g.*, §365(h) (real property leases) and §365(n) (intellectual property licenses). Given there is no specific provision in the Bankruptcy Code covering trademarks, Tempnology argued that the debtor's rejection must extinguish the rights that the agreement had conferred on the trademark licensee. The Bankruptcy Court agreed with Tempnology.

The Bankruptcy Appellate Panel (BAP) reversed, relying heavily on a decision from the Seventh Circuit about the effects of rejection on trademark licensing agreements. *See Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC,* 686 F.3d 372 (7th Cir. 2012). Rather than focus on what Section 365 did not say, the BAP focused on Section 365(g) of the Bankruptcy Code, which plainly states that rejection of a contract constitutes a "breach". Given that a breach does not equate to a termination of a contract outside of bankruptcy, the BAP found that Mission could continue to use the Coolcore trademark.

However, the First Circuit reversed the BAP and reinstated the Bankruptcy Court decision terminating Mission's license. *See In re Tempnology, LLC,* 879 F. 3d 389 (2018). While adopting the Bankruptcy Court's inference that there was no specific provision in Section 365 maintaining the counterparty's rights, the First Circuit also looked more closely at trademark law. The First Circuit recognized that a trademark owner's failure to monitor and exercise quality control over goods associated with its trademark could jeopardize the continued validity of its trademark rights. Thus, if a licensee can keep using a trademark after an agreement is rejected, the debtor-licensor will need to carry on its monitoring activities, which would frustrate Congress's principal aim in providing for rejection: to release the debtor's estate from burdensome obligations.

This decision left the First and Seventh Circuit in direct conflict. The Supreme Court sided with the Seventh Circuit. The Court held that both Section 365's text and fundamental principles of bankruptcy law command that "a rejection has the same consequence as a contract breach outside bankruptcy: It gives the counterparty a claim for damages, while leaving intact the rights the counterparty has received under the contract." The Court relied not only on Section 365(g)'s plain language that rejection constitutes a breach, but on the over-arching general bankruptcy rule that the bankruptcy estate cannot possess any more rights than the debtor did outside of bankruptcy.

The Court also rejected Tempnology's argument based on "negative inference" that there was no specific section of the Bankruptcy Code saving a trademark licensee's rights upon rejection as there are with respect to real property leases, timeshare interests, and intellectual property agreements, for example. In fact, the Court pointed out that these specific provisions in the Code resulted from discrete problems, but all reflected Congress' view that contractual rights survive rejection.

The Court also rejected Tempnology's trademark-specific argument that allowing Mission's rights to survive rejection would impede a debtor's ability to reorganize. While recognizing that trademark-specific concerns exist, the Court pointed out that nothing in the Bankruptcy Code protected these contracts from the general rules of rejection and that to treat them differently "would allow the tail to wag the Doberman". Rejection gives the debtor an ability to escape its future contract obligations, without having to pay much of anything in return. However, it does relieve a debtor of the need to make "economic decisions" concerning its preservation of estate value.

In sum, *Mission Products* underscored the previously settled rule of bankruptcy law that rejection does not equal termination. However, it also puts bankruptcy debtors on relatively uneven footing as to what can and should be done with "rejected" contracts post-rejection, which only serves to heighten the importance of a debtor's initial "valuation" decision as to whether to reject the agreement.

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