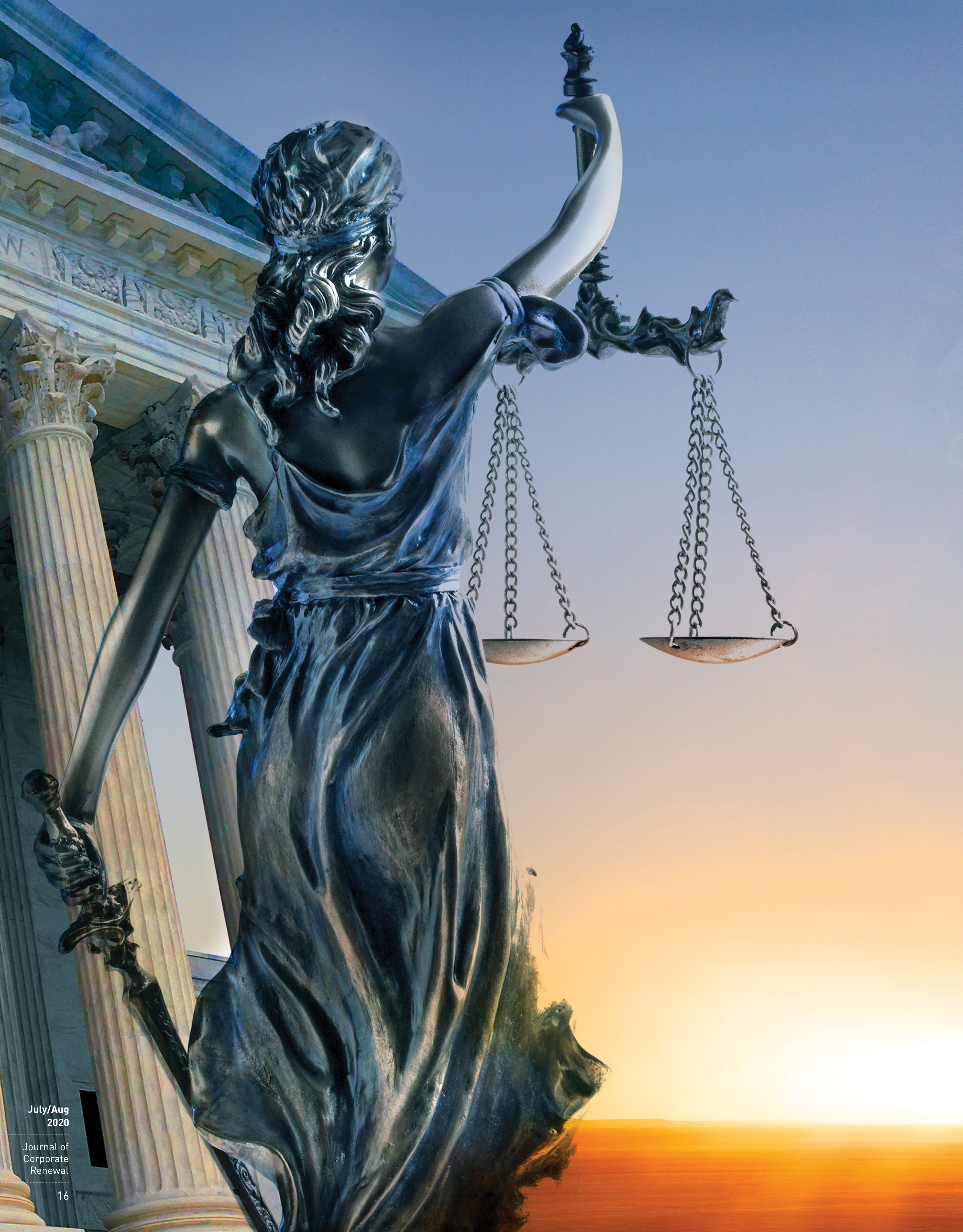

PROTECTING EXCLUSIVE DISTRIBUTION RIGHTS

for Patented Products and Other Licensed IP

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The ability of companies to continue as going concerns has become more challenging than ever. As companies pivot and move forward with product production and sales, they must consider not only their financial viability but the financial viability of their customers, suppliers, and licensors.

For companies that offer or sell products that are protected under third-party intellectual property rights, preserving a company's rights to continue to make, use, sell, offer for sale, and import the products that are subject to third-party patent rights is a key consideration. Additionally, the ability to market and distribute products under third-party protected brand names or trademarks may be important.

What happens to a company's exclusive distribution rights or rights to use licensed trademarks granted under a contract when the licensor becomes a debtor in a case under the U.S. Bankruptcy Code? A company's ability to protect its contractual rights may very well depend on how it structured its contract. Last year, the U.S. Supreme Court resolved a circuit split regarding this question when it decided *Mission Products Holdings, Inc. v. Tempnology, LLC.*[1]

This article revisits the Supreme Court's ruling and suggests strategies distributors and licensees may consider employing at the outset when negotiating exclusive distribution and licensing agreements to protect themselves in the event a grantor or licensor ends up in bankruptcy.

The Parties' Dispute

Less than two years before filing for bankruptcy, Tempnology LLC, a manufacturer of athletic clothing and accessories designed to keep wearers cool during exercise, entered into a co-marketing and distribution agreement with Mission Products Holdings Inc. for an initial term of two years, subject to automatic one-year renewals. More specifically, Tempnology granted to Mission:

1. Exclusive distribution rights to sell certain branded products covered by patents and copyrights held by Tempnology (Coolcore Products) to *sporting goods retailers* in the United States during the term of the agreement and the wind-down period

2. Exclusive distribution rights to sell a particular subset of the Coolcore Products to *anyone* in the United States during the term

3. A nonexclusive, fully paid, irrevocable, perpetual, worldwide, fully transferable license to use Tempnology's intellectual property other than trademarks (IP license)[2]

4. A limited, nonexclusive license to use the trademarks associated with the Coolcore Products during the term

The agreement separated the provisions granting the exclusive distribution rights from the provisions granting the IP license. Further, either party could terminate the agreement at any time without cause by giving written notice to the other party. Upon such a termination, a two-year wind-down period would ensue, during which Mission would continue to have rights to purchase, distribute, and sell the Coolcore Products with the same exclusivity rights that existed pre-termination. (Though not confirmed

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explicitly in the lower court opinions, it is reasonable to assume, for reasons discussed later in this article, that the agreement also provided for termination for cause and elimination of the wind-down period if the agreement was terminated by the grantor for cause in accordance with its terms.)

Less than two years after the parties entered into the agreement, Mission notified Tempnology that it was exercising its termination rights without cause, purportedly triggering the commencement of the two-year wind-down period. Tempnology, in turn, notified Mission that it was terminating the agreement for cause based on the alleged breach of the agreement by Mission. The dueling notices precipitated an arbitration proceeding, in the first phase of which the arbitrator determined that the agreement remained in full force and effect.[3] Before the arbitration could be completed, however, Tempnology filed a petition for relief under Chapter 11 of the Bankruptcy Code. That filing stayed the arbitration proceeding.

Almost immediately after filing for bankruptcy, Tempnology sought to reject the agreement under Section 365 of the Bankruptcy Code and, separately, to sell substantially all of its assets free and clear of all liens, claims, encumbrances, and other interests under Section 363 of the Bankruptcy Code. Mission objected to both of Tempnology's motions, giving notice that it was exercising its rights under Section 365(n) of the Bankruptcy Code with respect to the agreement. Mission further asserted that, by exercising its Section 365(n) rights, it preserved its exclusive distribution rights and its rights under the limited, nonexclusive trademark license for the duration of the wind-down period, notwithstanding Tempnology's rejection of the agreement.

Therefore, according to Mission, Tempnology's assets could not be sold free and clear of Mission's exclusive distribution rights and nonexclusive trademark license, which would continue in effect until the expiration of the wind-down period. Tempnology disputed these assertions, arguing that Mission's only rights with respect to Tempnology's products and intellectual property that would survive rejection of the agreement under Section 365 of the Bankruptcy Code were its rights under the nonexclusive IP license, which covered patents and certain other types of IP but did not apply to trademarks.

Lower Court Decisions

As usually happens in Chapter 11, the Bankruptcy Court sided with the debtor, Tempnology, and authorized it to reject the agreement. As a result, Tempnology "could stop performing under the contract" and Mission could assert a claim for "damages resulting from Tempnology's non-performance."[4] After the Bankruptcy Court allowed the company to reject the agreement, Tempnology went back to the same court and requested a declaration that the rejection "also terminated the rights it had granted Mission to use the Coolcore trademarks."

The Bankruptcy Court held that that the protections triggered by Tempnology's election to exercise its Section 365(n) rights extended only to the nonexclusive, perpetual IP license. The court also found that Section 365(n) did not protect the trademark license, as trademarks are excluded from that statute.

Notwithstanding that more and more courts—especially at the appellate level—had been holding that rejection by a debtor-licensor of a license of intellectual property, including trademarks, simply relieves the debtor of any obligation to specifically perform its affirmative obligations under the license agreement and does not deprive the licensee of the use of any and all such intellectual property for the time set forth in the agreement, the Bankruptcy Court found in favor of Tempnology.[5] The Bankruptcy Court held that rejection of the agreement deprived Mission of any further use of Tempnology's trademarks, thus permitting the purchaser of Tempnology's assets in a Section 363 sale to take its trademarks free and clear of both Mission's exclusive distribution rights and its nonexclusive right to use of the trademarks.

On appeal, the 1st U.S. Circuit Bankruptcy Appellate Panel (BAP) reversed and, citing *Sunbeam*, focused on the fact that Section 365(g) of the

Bankruptcy Code states that "rejection of a contract 'constitutes a breach.'"[6] Breach of an agreement under non-bankruptcy law does not eliminate contractual rights already conferred upon the non-breaching party.[7] Thus, "rejection 'convert[s]' a 'debtor's unfulfilled obligations' to a pre-petition damages claim[, b]ut it does not 'terminate the contract' or 'vaporize[]' the counterparty's rights."[8] Thus, under the BAP's decision, Mission could retain its nonexclusive right to use the Coolcore trademark as set forth in the agreement.

Another round of appeals ensued, and the 1st U.S. Court of Appeals rejected the BAP's and 7th Circuit's positions and reinstated the lower court's decision to terminate Mission's license to use the Coolcore marks.

The Supreme Court's Decision

After reviewing the Bankruptcy Code's provisions regarding executory contracts and trademark licenses, the Supreme Court ultimately adopted the 7th Circuit's view and held in favor of Mission. Noting that trademark license agreements are executory contracts governed by Section 365 of the Bankruptcy Code, the Supreme Court relied on Section 365(g) to interpret the meaning of rejection—"a breach of [an executory] contract deemed to occur immediately before the date of the filing of the petition."[9]

But as the Bankruptcy Code does not define or give special meaning to "breach," its meaning is the same in bankruptcy as it is in contract law outside bankruptcy.[10] When a party to a contract breaches an agreement, the non-breaching, injured party has two options: to treat the contract as terminated or to continue the contract and sue the breaching party for damages. Likewise, Mission had the right either to treat the trademark license as terminated or to elect to continue to perform under the agreement with respect to the trademark license (including paying licensing fees) and assert a claim against Tempnology for damages for breaching the agreement.

The Supreme Court rejected Tempnology's argument that the effect of rejecting the agreement and, in connection, the trademark license was synonymous with termination due to those subsections of Section 365, including Section 365(n), that allow the counterparty to an executory contract to elect to retain certain rights notwithstanding rejection.[11] While the Bankruptcy Code permits a debtor to stop performing future obligations, it does not allow a debtor to rescind a license already conveyed: a debtor's property does not shrink because of bankruptcy nor does it expand.[12]

How, then, can owners of intellectual property and their licensees prepare for potential insolvency? The following suggestions will help such parties better answer this question.

Structuring Considerations

Licensors of rights to patents, copyrights, or other IP enumerated in Section 365(n) of the Bankruptcy Code—be they distribution, licensing, or other rights to IP—will want to retain control over the use of their IP, even in the case of its own or a licensee's

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bankruptcy case. Conversely, licensees that end up in bankruptcy will want to maximize their rights under the operative licensing agreements for as long as possible, notwithstanding its bankruptcy proceedings.

Thus, parties must consider the impact not only of a bankruptcy proceeding commenced by their counterparties, but their own bankruptcy cases. Licensing parties will need to take a practical approach to structure agreements that allow each party to exercise its rights and terminate its continuing obligations within a reasonable period of time, should one party face financial bankruptcy.

Insofar as trademark rights are concerned, a licensor of these rights should exercise caution when determining whether to reject trademark licenses as a debtor in bankruptcy. As *Mission Products* shows, rejection may not terminate the licensee's right to use the licensed marks, despite the trademark licensor's continuing duty to monitor and exercise quality control over the goods and services sold by a licensee.

The *Mission Products* holding applies not only to trademark licenses but to any other executory contract that is not subject to special treatment under Section 365 of the Bankruptcy Code.

To protect exclusive distribution rights in the event a grantor of distribution or licensing rights to IP files for bankruptcy protection, neither the grantor, nor a purchaser of substantially all of the grantor's assets in a bankruptcy sale, could be compelled to continue to sell products to the distributor. To mitigate that fact, an agreement could be structured to grant to the distributor a nonexclusive license with respect to the grantor's intellectual property to manufacture, or have manufactured elsewhere, the subject products in the event the grantor declines or is unable to continue to supply the products.

The agreement also should include an exclusive license to use the grantor's intellectual property (which ideally includes more than just trademarks) in connection with the distribution and sale of licensed products in a defined exclusive territory and/or field for the term of the agreement. Such a structure should improve the prospects for preserving distributor exclusivity for the term in the event of rejection of the agreement. J

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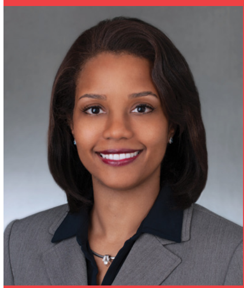

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[1] 139 S. Ct. 1652 (2019).

[2] The IP license appears to have been quite expansive, entitling the distributor to the non-exclusive, royalty-free use of the grantor's intellectual property (other than trademarks) in perpetuity and not just in connection with Cooling Accessories or other products sourced from the grantor. See *In re Tempnology LLC,* 559 B.R. 809, 812 (1st Cir. B.A.P. 2016).

[3] Under Section 365(n)(1) of the Bankruptcy Code, if a debtor rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee has the option to (A) treat the rejection as a termination or (B) retain its rights to the IP under the operative agreement (including any supplements to the agreement) as those IP rights existed immediately before bankruptcy, for (i) the duration of the contract; and (ii) any period for which the licensee may extend the contract under applicable non-bankruptcy law.

[4] *Mission Product,* 139 S.Ct. at 1659.

[5] See *Sunbeam Prods., Inc. v. Chicago American Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012) (Easterbrook, J.) (concluding that *Lubrizol* was wrongly decided and holding that rejection of a trademark license by debtor-licensor's bankruptcy trustee did not deprive the licensee of continued use of the licensed trademarks); see also *In re Exide Technologies,* 607 F.3d 957, 967-968 (3d Cir. 2010) (Ambro, J., concurring) (expressing the view, in a case involving a trademark license, that rejection is not tantamount to rescission and does not have same result as termination of a contract); *Thompkins v. Lil' Joe Records, Inc.,* 476 F.3d 1294, 1306 (11th Cir. 2007) (holding that purpose of Section 365 is not to be the functional equivalent of rescission and that rejection merely frees the bankruptcy estate from the obligation to perform and has no effect upon rejected contract's continued existence); *Crumbs Bake Shop,* 522 B.R. at 771-772 (holding courts may use Section 365 to free bankrupt licensor from burdensome duties that hinder its reorganization but should not use it to take back trademark rights it bargained away); *contra In re HQ Global Holdings, Inc.,* 290 B.R. 507 (Bankr. D. Del. 2003); *In re Old Carco, LLC,* 406 B.R. 180 (Bankr. S.D.N.Y. 2009); *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.),* 281 B.R. 660 (Bankr. N.D. Cal. 2002); *In re Chipwich,* 54 B.R. 427 (Bankr. S.D.N.Y. 1985) (following *Lubrizol*).

[6] *Mission Products,* 139 S.Ct. at 1659 (citing 11 U.S.C. Section 365(g)).

[7] *Id.* (citing *Tempnology*, 559 B.R. at 820).

[8] *Id.* (citing *Tempnology*, 559 B.R. at 822 (quoting *Sunbeam*, 686 F.3d at 377)).

[9] *Id.* at 1658 (internal citations omitted).

[10] *Id.* at 1661 (citing *Field v. Mans,* 516 U.S. 59, 69 (1995)).

[11] *Id.* at 1663.

[12] *Id.*