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Nine Point Ruling Limits High Court Bankruptcy Contract Rule

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A debtor rejects a burdensome contract in its bankruptcy case. Is it game over for the nondebtor? Answer: It depends.

In its 2019 decision in Mission Product Holdings Inc. v. Tempnology LLC, the U.S. Supreme Court resolved a circuit split concerning the effect of contract rejection under Section 365 of the Bankruptcy Code.[1] More specifically, the Supreme Court was required to decide whether a nondebtor trademark licensee retained its right to use a licensed trademark following rejection of the license by a debtor licensor.

Despite several Bankruptcy Code amendments enacted to protect nondebtors from the impact of rejection for certain types of agreements, including real property leases, time share agreements, and intellectual property licenses — other than trademark licenses, the court did not view the matter as a close call. In an 8 to 1 decision, the Supreme Court held that

> a debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside of bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor's rejection cannot revoke the trademark license.[2]

Following Mission Product, bankruptcy courts have struggled with the real-world implications of the Supreme Court's ruling. The U.S. District Court for the District of Delaware's July 30 decision in Caliber North Dakota LLC v. Nine Point Energy Holdings, however, establishes a clear boundary on the rights of nondebtor counterparties following rejection of their contracts in bankruptcy.[3]

In a fast-moving battle between oil and gas exploration and production company Nine Point Energy LLC and its midstream services provider, Caliber North Dakota LLC, both the bankruptcy court and district court held that while nondebtor counterparties retain existing contract rights following rejection in bankruptcy, those rights terminate when they depend upon the debtor's future performance.

As discussed below, Nine Point illustrates the practical limits to the rejection-as-breach rule adopted by the Supreme Court in Mission Product.

Mission Product

In 2012, Tempnology, the licensor, granted Mission Product Holdings, the licensee, the nonexclusive trademark license to distribute its proprietary "Coolcore" line of exercise clothing and accessories.

In 2015, Tempnology commenced a Chapter 11 case and sought bankruptcy court approval of its decision to reject its trademark license with Mission Product. The U.S. Bankruptcy Court for the District of New Hampshire approved the request and subsequently held that rejection had the effect of rescinding the licensee's rights to use the Coolcore trademark.[4]

On appeal, the Bankruptcy Appellate Panel for the First Circuit reversed the bankruptcy court, relying on the U.S. Court of Appeals for the Seventh Circuit's 2012 decision in Sunbeam Products Inc. v. Chicago American Manufacturing LLC,[5] in which the Seventh Circuit held that a trademark licensee's rights were not rescinded following rejection of the license in bankruptcy.[6] Adopting the Seventh Circuit's rejection-as-breach approach, the panel held that rejection represents a mere breach of the underlying agreement and does not eliminate rights already granted to the nondebtor counterparty, namely the licensee's right to continue using the Coolcore trademark.[7]

The U.S. Court of Appeals for the First Circuit disagreed with the panel and the Seventh Circuit. Among other reasons, the First Circuit was persuaded that a negative inference should be drawn from the several amendments to the Bankruptcy Code that protect contract counterparties in certain instances from the impact of rejection. The First Circuit reasoned that if Congress enacted changes to the Bankruptcy Code to protect counterparties from the loss of rights following rejection of certain types of contracts — in particular licensees of intellectual property other than trademarks — then rejection must have the effect of depriving counterparties of those rights, the so-called rejection-as-rescission approach.[8]

The Supreme Court granted certiorari to resolve the split among the courts of appeals.

The Supreme Court first observed that under Section 365(a) of the Bankruptcy Code, a debtor may assume a contract that it deems to be a good deal for its estate.[9] Alternatively, if the contract is burdensome or not beneficial, the debtor may choose to reject the contract, thereby repudiating any further performance of its duties.[10]

Section 365(g) of the Bankruptcy Code very plainly states that rejection "constitutes a breach of contract" immediately prior to the debtor's bankruptcy filing.[11] The Bankruptcy Code offers no further guidance concerning the effect of rejection on the nondebtor's rights.

In particular, could Mission Product, the licensee, continue to use the "Coolcore" trademarks following Tempnology's rejection? The First and Seventh Circuits offered the Supreme Court two starkly different schools of thought on the issue.

One view, espoused by the Seventh Circuit in Sunbeam, is that rejection represents only a breach of the underlying contract and does not disturb the preexisting rights of the nondebtor counterparty. By contrast, the First Circuit embraced the rejection-as-rescission model when it concluded that the licensee lost the right to use the trademark upon the licensor's rejection of the license.

The Supreme Court found that the rejection-as-rescission rule, if adopted, would ignore the plain text of Section 365(g), which states that rejection is a breach, and impermissibly expand a debtor's bankruptcy estate by according the debtor greater property rights in bankruptcy than it had outside of bankruptcy.[12]

The court observed that if debtors could use contract rejection to effect a rescission of previously granted property rights, then rejection would become "functionally equivalent" to "avoidance," that is, the ability to unwind a prior transfer.[13] In this regard, the court observed that this "result would subvert everything the Code does to keep avoidances cabined — so they do not threaten the rule that the estate can take only what the debtor possessed before filing."[14]

As for the argument that a negative inference should be drawn from the several amendments to Section 365 that expressly protect nondebtor counterparties from the impact of rejection, the Supreme Court sardonically dismissed this position, noting that "this mash up of legislative interventions says nothing much of anything about the content of Section 365(g)'s general rule."[15]

The Supreme Court concluded by holding that a "debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside of bankruptcy. Such an act cannot rescind rights that the contract previously granted."[16] The licensee, therefore, retained its right to use the Tempnology trademark notwithstanding the rejection of the trademark.[17]

Nine Point Energy

Nine Point was an oil and gas exploration and production company. Nine Point had service agreements with Caliber, a third party, to provide midstream services, including the transportation of oil, gas and water.

The contracts contained "Dedications" pursuant to which Nine Point (1) "exclusively dedicate[d], grant[ed], and commit[ted] to the performance of" the contracts all of its interests in oil and gas leases, wells and produced minerals, and (2) agreed not to deliver oil and gas to any gatherer, purchaser, marketer or other entity other than Caliber.[18]

On March 15, Nine Point filed for Chapter 11 in the U.S. Bankruptcy Court for the District of Delaware and sought to reject the contracts. Caliber responded, claiming that for a variety of reasons, the dedications would survive rejection. Citing Mission Product, Caliber argued that "rejection is merely a breach, not a termination, of a contract."[19]

According to Caliber, the dedications "granted Caliber the exclusive right to provide essential midstream services — specifically, to gather oil, gas and produced water — to [Nine Point] on the leaseholds covered by the Caliber Contracts."[20]

Caliber further argued that the effect of the dedications was that "so long as [Nine Point] continued to produce oil or gas from these leaseholds, Caliber — rather than a competing provider — would continue to provide these key services."[21]

Citing Mission Product, Caliber argued that "a debtor cannot rescind contractual rights and property interests it has given to other parties — such as Caliber's exclusive right to be Nine Point's midstream services provider — simply by rejecting its contracts with those parties."[22] Further, Caliber claimed that "[l]ike the license at issue in Mission Product, the Caliber Contracts transferred a right to Caliber—specifically, the exclusive right to transport any and all oil or gas produced from the dedicated properties."[23]

In response, Nine Point argued the dedications were meaningless absent its own ongoing contractual performance, and because Nine Point could not be required to perform under a rejected contract, the dedications did not survive rejection. That is, in order for Caliber to make use of the dedications, easements and other rights arising under the contracts, Nine Point must continue extracting oil and gas and delivering it to Caliber.[24]

Nine Point argued that Caliber's position, if correct, would bar any debtor from obtaining replacement goods or services after rejecting any contract containing an exclusivity provision, and would allow nondebtor counterparties to insulate themselves from rejection by simply adding an exclusivity provision to any contract.[25] Such a tactic would make it impossible for any debtor to reject any contract.

The bankruptcy court rejected Caliber's argument and distinguished Mission Product where "the counterparty had the right to continue to use [the licensed trademark] after rejection, notwithstanding the fact that the debtor was relieved of its obligation to perform."[26]

By contrast, in Nine Point, "under the express terms of the [Contracts], Caliber has no right to use the Interests and Dedications except in its performance of the contracts."[27]

Therefore, Caliber was starkly different from the counterparty in Mission Product inasmuch as the licensee in Mission Product had the right to continue using the trademark in its own business and — unlike Caliber — was not limited to using the mark based on continued performance by the debtor.[28]

Caliber appealed to the U.S. District Court for the District of Delaware, which affirmed the bankruptcy court and rejected each of Caliber's arguments. The district court explained that even though

> Mission Product stands for the proposition that rejection cannot restrain a non-debtor's use of its contractual rights that do not depend on the debtor's future performance; it does not allow a non-debtor to force a debtor to perform under a contract after its rejection.[29]

Further, the district court agreed with the bankruptcy court that, unlike in Mission Product, Caliber has no right to use the dedications except in performance of the contracts, "which can only occur if the [Nine Point] perform[s] by extracting fluids and sending them to Caliber for processing and transportation," noting that "necessary performance by [Nine Point] was the foundation of the Bankruptcy Court's ruling."[30]

With respect to Caliber's exclusivity argument, the district court agreed with Nine Point that "Caliber's reading [of Mission Product] would allow any contract counterparty to inoculate itself from the effects of rejection by including an exclusivity provision," and found that this result would "fundamentally impair a debtor's ability to reorganize by forcing it to continue to perform under burdensome contracts, contrary to the purpose of [Section]365 of the Bankruptcy Code."[31]

As a result of the district court's decision, the Caliber contracts were rejected and the dedications did not survive.

The Limits of Mission Product Holdings

Nine Point establishes an important outer boundary on the rights of contract counterparties under the rejection-as-breach rule articulated by the Supreme Court in Mission Product.

Both the district court and the bankruptcy court found in Nine Point that, while rejection may not rescind a contract counterparty's existing rights, the nondebtor counterparty may not enforce those rights when they depend upon the debtor's future performance. The district court recognized, for example, that exclusivity requires faithful performance by both parties to a contract.

Once an exclusive contractual arrangement is rejected in bankruptcy, the nondebtor counterparty may not enforce exclusivity provisions against the debtor. As the district court pointed out in Nine Point, to hold otherwise would impair a debtor's ability to reorganize by forcing it to continue to perform under a rejected agreement, a result contrary to Section 365 of the Bankruptcy Code.

Notably, inasmuch as exclusivity and other restrictive covenants such as noncompetition and nonsolicitation agreements impose virtually identical burdens on a debtor, i.e., the duty to refrain from taking certain actions, Mission Product and Nine Point may prompt bankruptcy courts in the future to more closely examine the vitality of cases holding that restrictive covenants may be enforced against a debtor following rejection of the contract containing such covenants.[32]

Although those cases are decided under Section 101(5) of the Bankruptcy Code and a line of authority dating back to the Supreme Court's 1985 decision in Ohio v. Kovacs,[33] the result reached is plainly at odds with the precedent set by the bankruptcy and district courts in Nine Point.

In any event, Nine Point clearly strengthens the hand of any debtor that seeks to unshackle itself in bankruptcy from the burdens of an uneconomical contract.

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[1] Mission Product Holdings, Inc. v. Tempnology, LLC , 139 S.Ct. 1652 (2019).

[2] Id. at 1666.

[3] In re Nine Point Energy Holdings, Inc. , 2021 WL 3269210 (D. Del. July 30, 2021).

[4] In re Tempnology, LLC , 541 B.R. 1, 8 (Bankr. D. N.H. 2015).

[5] Sunbeam Products, Inc. v. Chicago Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012).

[6] See In re Tempnology, LLC , 559 B.R. 809, 822–23 (1st Cir. BAP 2016). In Sunbeam, the Seventh Circuit explained "What §365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. ... The debtor's unfulfilled obligations are converted to damages ... But nothing about this process implies that any rights of the other contracting party have been vaporized." 686 B.R. at 377 (internal citations omitted).

[7] In re Tempnology, 559 B.R. at 823.

[8] The First Circuit explained: "In defining the intellectual property eligible for the protection of section 365(n), Congress expressly listed six kinds of intellectual property. ... Trademark licenses (hardly something one would forget about) are not listed" and held "we favor the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise." In re Tempnology, LLC, 879 F.3d 389, 401, 404 (1st Cir. 2018) (citations omitted).

[9] Mission Product, 139 S.Ct. at 1658.

[10] Id.

[11] 11 U.S.C. §365(g). See also Mission Product, 139 S.Ct. at 1658 ("Section 365(g) places [a counterparty whose contract is subject to rejection] in the same boat as the debtor's unsecured creditors.").

[12] See Mission Product, 139 S.Ct. at 1663.

[13] The concept of "avoiding power rejection" was extensively analyzed by Professor Michael T. Andrew in his highly influential law review article. Michael T. Andrew, Executory Contracts, Understanding Rejection, U. of Colo. L. Rev. 845, 901–22 (1988).

[14] Id.

[15] Id. at 1664.

[16] Id. at 1666.

[17] Curiously, as Justice Sotomayor points out in her concurring opinion, the Court's holding in Mission Product puts trademark licensees in a better position than licensees of other forms of intellectual property even though the latter group were the express beneficiaries of Congressional intervention. See 11 U.S.C. §365(n); see also Mission Product, 139 S.Ct. 1666 (Sotomayor, J. concurring) ("[T]he Court's holding confirms that trademark licensees' postrejection rights and remedies are more expansive in some respects than those possessed by licensees of other types of intellectual property."). When the licensee of intellectual property (other than trademarks) confronts rejection of its license in bankruptcy, section 365(n) of the Bankruptcy Code offers the licensee a choice: either (a) treat the license as terminated or (b) retain the licensed intellectual property. Significantly, if the licensee chooses the latter option and retains its intellectual property rights, it must pay a price. Specifically the licensee must continue to pay contractual royalties and waive its right of set off for any damages it suffered. 11 U.S.C. §365(n)(2). By contrast, under Mission Product, trademark licensees may both retain the use of the trademark following rejection and set off its damages against future royalty payments. See Mission Product, 139 S.Ct. 1666–67 (Sotomayor, J. concurring) (explaining licensees of intellectual property covered by section 365(n) "are governed by different rules" than trademark licensees). Depending on the circumstances of the arrangement, the trademark licensee could enjoy free use of the licensed mark. As a result, trademark licensees fare better under Mission Product than patent licensees fare under legislation that was enacted for the express purpose of assisting patent licensees.

[18] See In re Nine Point Energy Holdings, Inc., 2021 WL 3269210 at *6 and n.5 (D. Del. July 30, 2021).

[19] In re Nine Point Energy Holdings, Inc., 2021 WL 2212007 at *6 (Bankr. D. Del. June 1, 2021).

[20] Appellant's Opening Brief, Case No. 21-cv-973 (RGA), Docket No. 15 at 8–9 (Dist. Del. July 12, 2021).

[21] Id. at 9.

[22] Id. at 2.

[23] Id. at 21.

[24] See Brief of the Debtors, Case No. 21-cv-973 (RGA), Docket No. 28 at 21–23 (Dist. Del. July 19, 2021).

[25] See id. at 23.

[26] Nine Point Energy, 2021 WL 2212007 at *6.

[27] Id.

[28] Id.

[29] Nine Point Energy, 2021 WL 3269210 at *8.

[30] Id.

[31] Id. The District Court further explained that "an 'exclusivity' provision requires future performance by both parties. Thus, while it is possible to view an exclusivity provision as something that belongs to Caliber, it only has meaning if it is an obligation of [Nine Point]. In other words, the exclusivity provision is an obligation that binds [Nine Point] to perform in a certain way." Id. at *8 n.7.

[32] See, e.g., Sir Speedy, Inc. v. Morse, 256 B.R. 657, 660 (Bankr. D. Mass. 2000) (holding nondebtor counterparty could enforce non-competition provision of rejected franchise agreement); In re Klein, 218 B.R. 787, 791 (Bankr. W.D. Pa. 1998) (holding covenant not to compete remained effective despite rejection of the contract containing the covenant); In re Printronics, Inc., 189 B.R. 995, 1004 (Bankr. D.N. Fla. 1995) (holding a covenant not to compete contained in the rejected contract survived rejection).

[33] Ohio v. Kovacs, 469 U.S. 274 (1985).

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