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ALERT MEMORANDUM

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Fourth Circuit Protects Patent Licensees from Termination of Licenses in a Foreign Bankruptcy

The U.S. Court of Appeals for the Fourth Circuit in *Jaffé v. Samsung Electronics Co. (In re: Qimonda AG)*, No. 12-1802, 2013 WL 6388591 (4th Cir. Dec. 3, 2013) (the "Opinion") held that a German debtor could not use a chapter 15 proceeding to enforce the termination of the debtor's licenses of U.S. patents under German insolvency law without providing the protections afforded to licensees under section 365(n) of the Bankruptcy Code. The Fourth Circuit affirmed a decision of the bankruptcy court that concluded that Bankruptcy Code section 1522—which requires interests of creditors be sufficiently protected to the extent a foreign representative is permitted to administer assets within the United States—would prevent the recognition of the termination of the licenses unless the licensees' rights were preserved consistent with the Bankruptcy Code protections. While the decision turned on specific fact findings by the Bankruptcy Court that were affirmed as reasonable findings by the Fourth Circuit, this decision provides potential safeguards for the protection of intellectual property licenses in the Bankruptcy Code against the effect of foreign insolvency regimes.

Facts and Lower Court Decision

Qimonda AG ("Qimonda"), a German manufacturer of semiconductor memory devices, filed for insolvency in Germany in January 2009. Dr. Michael Jaffé was appointed as its insolvency administrator, the estate fiduciary, and filed an application in the Bankruptcy Court for the Eastern District of Virginia (the "Bankruptcy Court") for recognition of the German proceedings under Chapter 15. Dr. Jaffé also requested authority to administer the debtors' assets within the territorial jurisdiction of the United States.

Qimonda's principal assets consisted of its patent portfolio, including a significant number of U.S. patents. Its patents were subject to broad cross-licensing agreements with its competitors, whereby each party provided non-exclusive licenses of their patents to the other party in exchange for a reciprocal license. Such patent cross-licensing agreements were commonly used in the industry in order to reduce the risk of "hold-up" claims, i.e. the ability of the owner of a patent infringed by the manufactured product to extract a significantly higher *ex-post* royalty than what would have been agreed to upfront. Such risks particularly exist in the semiconductor industry given the dense network of overlapping intellectual property rights incorporated in each semiconductor product and the concomitant risk of infringement of patents owned by other entities. The cross-licenses enabled the parties to commit to the large upfront costs of constructing fabrication plants for the semiconductors, with a much reduced risk of hold-up claims.

In the course of Qimonda's liquidation, the German administrator, Dr. Jaffé, sought to monetize the patents by re-licensing them. To do so, he declared, pursuant to German

insolvency law, the cross-license agreements to be unenforceable.[1] On initial application, the Bankruptcy Court held that the enforceability of the patent cross-license agreements should be determined by German insolvency law and the chapter 15 proceeding should "supplement, but not supplant, the German proceeding". *See In re Qimonda AG*, No. 09–14766-RGM, 2009 WL 4060083 at *2 (Bankr. E.D. Va. Nov. 19, 2009). Several of the patent licensees (the "Licensees") appealed to the district court on the basis that, with respect to the licenses of U.S. patents, such termination would deny them the protections of section 365(n) of the Bankruptcy Code, which provides that counterparties of a rejected contract may continue to exercise any rights to intellectual property provided under the rejected contract.[2] The district court remanded the issue to the Bankruptcy Court with instructions to consider (1) whether the interests of the creditors were sufficiently protected as required by section 1522(a) of the Bankruptcy Code; and (2) whether circumventing the protections of section 365(n) is manifestly contrary to the public policy of the United States pursuant to section 1506 of the Bankruptcy Code. *See In re Qimonda AG Bankr. Litig.*, 433 B.R. 547, 557-58, 567-71 (E.D. Va. 2010).

On remand, the Bankruptcy Court determined that the intellectual property protections in section 365(n) applied to any termination of licenses of U.S. patents by the Qimonda estate. *In re Qimonda AG*, 462 B.R. 165 (Bankr. E.D. Va. 2011). First, the Bankruptcy Court held that the termination of the patent cross-license agreements, without further protection of the licensee, would not appropriately balance the interests of the estate's creditors and the debtor, as required by section 1522(a) of the Bankruptcy Code.[3] Section 1522(a) provides that before a bankruptcy court may grant certain relief to a foreign representative under Chapter 15—such as the administration of the estate's U.S. assets—the court must establish that the interests of creditors are sufficiently protected. Before the hearing, Dr. Jaffé committed to re-license the patents to the Licensees at a reasonable and non-discriminatory (RAND) rate. Nonetheless, the Bankruptcy Court determined that the loss in value to the Qimonda estate from an inability to re-license the patents was outweighed by the risk created to the Licensees' investments in their products and fabrication facilities. *Id.* 180-83.

Second, the Bankruptcy Court held that allowing the cancellation of the licenses of the U.S. patents violated the Bankruptcy Code because it would be manifestly contrary to the public policy of the United States and therefore such a termination should not be enforced by the court

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1 Section 103 of the German Insolvency Code allows a debtor to decide whether to continue performing the debtor's executory contracts. However, unlike section 365 of the Bankruptcy Code, it includes no carve-out for intellectual property rights. *See* 11 U.S.C. § 365(n).

2 Section 365(n)(1) of the Bankruptcy Court provides: "If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect— […] (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—(i) the duration of such contract; and (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law."

3 Section 1522(a) of the Bankruptcy Code provides: "The court may grant relief under section 1519 or 1521 …only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

pursuant to section 1506 of the Bankruptcy Code.[4] The intellectual property protections in section 365(n) were held to be of great public importance and the Bankruptcy Court found that such cancellation would slow the pace of innovation of the U.S. semiconductor industry. *Id.* at 184-85.

Dr. Jaffé appealed the Bankruptcy Court decision directly to the U.S. Court of Appeals for the Fourth Circuit.

The Fourth Circuit Decision

The Fourth Circuit affirmed the Bankruptcy Court's ruling that the termination of the licenses of U.S. patents under German law could not be enforced in the chapter 15 proceeding unless the Licensees' rights were preserved consistent with section 365(n).

First, the Fourth Circuit held that section 1522(a) requires a bankruptcy court to undertake a balancing analysis that considers the interests of the estate's creditors and the debtor. Opinion at *11. The Fourth Circuit rejected Dr. Jaffé's argument that section 1522(a) provides a mere procedural protection rather than protecting creditors from the effects of the substantive bankruptcy law of the foreign bankruptcy forum. Dr. Jaffé argued that, other than the limited public policy protections of section 1506, the court should defer to foreign substantive law. Rather, the Fourth Circuit held that when granting discretionary relief in a Chapter 15 proceeding a court cannot blind itself to the costs to creditors of imposing foreign law and must consider whether creditors are sufficiently protected from such effects. *Id.* at *12.

Second, the Fourth Circuit found reasonable the Bankruptcy Court's section 1522(a) analysis that any gains to the estate from re-licensing the U.S. patents were outweighed by the costs to the Licensees. Although the Licensees had been unable to identify specific infringements of Qimonda patents, the risk of infringing a Qimonda patent and the threat of infringement litigation was viewed by the court as significant. In a classic example of the power of hold-up value, the Licensees who already invested in their technology and manufacturing processes would have to pay the royalties demanded by Qimonda and they would be unable to design their products or facilities around the patents with the same freedom as they would have had *ex ante*. In the face of such costs to the Licensees, Dr. Jaffé's commitment to re-license the patents—even at reasonable and non-discriminatory (RAND) rates—did not sufficiently protect the Licensees' interests. *Id.* at *13-14. In addition, the Bankruptcy Court had questioned the protection provided by a re-licensing agreement if Qimonda could sell the patents to a German entity who, in a subsequent bankruptcy, could once again terminate the licenses and sue the Licensees for infringement. *Id*. at *14.

On the basis that it had resolved the appeal on other issues, the Fourth Circuit did not find it necessary to address the Bankruptcy Court's determination of whether the termination of licenses would be manifestly contrary to public policy, and therefore whether such relief would be barred by section 1506. The Fourth Circuit did however note that in ensuring that the

[4] Section 1506 of the Bankruptcy Code provides that "Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

Licensees' interests were sufficiently protected through section 1522(a), the Opinion furthered the public policy interests underlying the intellectual property protections inherent in section 365(n). *Id*. at *15-16. In reserving on this question, the court left for another day the question of whether, if a court found that the section 1522 balancing of interests analysis tipped in the other direction, the cancellation of licenses of U.S. patents still would not be enforced as being manifestly contrary to the public policy of the United States.

Conclusion

For over two decades, section 365(n) of the Bankruptcy Code has extended special protections to intellectual property rights for licensees of patents owned by a debtor in a U.S. proceeding. Similar protections are not uniformly contained in foreign insolvency regimes where debtors have the right to repudiate IP licenses. The *Qimonda* decision preserves such licensee rights where foreign debtors seek the protection and relief of U.S. courts in the guise of a chapter 15 ancillary proceeding, and thereby promotes the ability of licensees to rely on their continued interest in intellectual property even in the face of insolvent licensors.

A current proposal before the U.S. Senate, H.R. 3309, would codify, and expand upon, the Opinion. *See* Innovation Act, H.R. 3309, 113th Cong. § 6(d)(1) (2013). The bill would apply section 365(n) automatically in each Chapter 15 proceeding.

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