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NEWSLETTER

Fourth Circuit Protects Rights of Patent Licensees in Cross-Border Bankruptcy Case

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On December 3, 2013, the United States Court of Appeals for the Fourth Circuit affirmed the decision of the United States Bankruptcy Court for the Eastern District of Virginia with respect to the protections afforded to patent licensees under § 365(n) of the Bankruptcy Code in cross-border cases administered under chapter 15 of the Bankruptcy Code. Section 365(n) is a limitation on a debtor's right to reject intellectual property licenses in bankruptcy, and generally provides that in the event of a rejection, the licensee may elect either to treat the license as terminated or retain its rights (including any right of exclusivity) for the duration of the license.

The case arose out of the insolvency proceedings of Qimonda AG (Qimonda), which were commenced in Munich, Germany, in January 2009. Qimonda's assets include approximately 10,000 patents, including 4,000 U.S. patents, the most valuable of which relate to Dynamic Random Access Memory (DRAM), flash memory, and semiconductor process technology. In order to protect Qimonda's interest in the U.S. patent portfolio, Qimonda's Insolvency Administrator, Dr. Michael Jaffé, filed a petition in the Eastern District of Virginia under chapter 15 of the United States Bankruptcy Code for recognition of the insolvency proceedings in Germany. The Bankruptcy Court granted recognition, but the recognition order expressly made § 365 of the Bankruptcy Code applicable to the U.S. proceeding. Dr. Jaffé then filed a motion to modify that order to clarify that § 365 of the Bankruptcy Code would not apply in the event he sought to exercise his rights under the Germany Insolvency Code (which does not provide for protections similar to § 365(n)) with respect to the licenses.

Authors

Scott A. Felder
Partner
202.719.7029
sfelder@wiley.law

While the administrator initially succeeded in obtaining the requested relief, several licensees appealed the ruling, and the District Court remanded the matter with instructions for the Bankruptcy Court to determine whether restricting rights under § 365(n) "was manifestly contrary to the public policy of the United States" and whether the licensees would be "sufficiently protected" in the absence of § 365(n).

The Bankruptcy Court held a four-day evidentiary hearing in March 2011. As the Fourth Circuit recounted, the evidence at that hearing established the semiconductor industry as a "patent thicket," where any given device may embody multiple patents held by multiple parties, including third parties and it would be "all but impossible" to identify "and design around each and every one." As at least one expert testified, the large costs associated with bringing a new semiconductor product to market exacerbate "the patent thicket" and create a classic "holdup" problem that could allow a patent holder to extract an unreasonably high royalty if infringement was found following a substantial investment. Thus, to avoid this potential holdup premium and otherwise protect themselves from patent claims, semiconductor manufacturers "have routinely entered into broad, non-exclusive cross-license agreements with each other." Indeed, Qimonda had cross-license agreements with virtually every other major semiconductor manufacturer.

Before the Bankruptcy Court, Dr. Jaffé committed to relicensing the Qimonda patents to the objectors on reasonable and non-discriminatory (RAND) terms and presented an expert witness who testified that allowing Dr. Jaffé to relicense the patents under those terms "would not unduly impair the function of the semiconductor industry." The licensees presented their own expert who testified that Dr. Jaffé's plan would, among other things, (1) destabilize the system of licensing, (2) reduce investment, innovation, and competition, and (3) harm U.S. productivity growth and U.S. consumers. The licensees also noted that Dr. Jaffé might sell the patents to an entity that itself files for insolvency and sets the cycle in motion again.

In light of this record and after analyzing the legislative history of § 365(n) and applying a balancing test with respect to the interests of the insolvency estate and the licensees, the Bankruptcy Court concluded that the licensees should be afforded rights under § 365(n).

Dr. Jaffé appealed the decision of the Bankruptcy Court and requested a direct appeal to the Fourth Circuit, which was certified. On appeal, Dr. Jaffé argued that the Bankruptcy Court erred both in its construction of the specific provisions of chapter 15 to establish a balancing test and abused its discretion in applying this test.

The Fourth Circuit began its analysis with a discussion of the history and objectives of chapter 15 as well as the various statutory provisions. Particularly relevant to the issues presented on appeal were § 1521 of the Bankruptcy Code, which provides for certain discretionary relief upon the request of the foreign representative, and § 1522, which provides that the court may grant relief under § 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected." Dr. Jaffé first argued that the protections set forth in § 1522 could not apply to the licensees because he did not request any discretionary relief related to § 365(n). The Fourth Circuit quickly disposed of this argument, noting that Dr. Jaffé requested other discretionary relief under § 1521 and ruled that where a representative requests any discretionary relief, the bankruptcy court must then consider and apply the provisions of § 1522.

Dr. Jaffé then argued that the Bankruptcy Court's application of a balancing test vis-a-vis the interests of creditors and interested parties under § 1522 was flawed. Specifically, he argued that "§ 1522(a) is merely a procedural protection 'designed to ensure that all creditors [could] participate in the bankruptcy distribution on an equal footing' and thus should not be used to protect parties from the substantive bankruptcy law that would otherwise apply in the foreign main proceeding." In addressing this argument, the Fourth Circuit noted that the text of § 1522 requires protection for both creditors and the debtor and therefore implies that "each entity must receive at least some protection" and that "providing protection to one side might well come at some expense to the other." According to the court, this type of analysis is "logically best done by balancing the respective interests based on the relative harms and benefits in light of the circumstances presented, thus inherently calling for application of a balancing test." The court also found support for this interpretation in the Model Law on Cross-Border Insolvency, upon which chapter 15 is based, and upon the *Guide to Enactment of the Model Law*. In particular, the *Guide to Enactment* includes several passages that indicate the need to balance relief that may be granted to a foreign representative with the rights and concerns of other interests.

Finally, the Fourth Circuit was not willing to conclude that the Bankruptcy Court abused its discretion in applying the balancing test to conclude that the application of § 365(n) was appropriate. Specifically, the court found the "bankruptcy court's thorough examination of the parties' competing interests to have been both comprehensive and eminently reasonable."

One might conclude that the Fourth Circuit's decision in this case could be limited to the semiconductor industry. However, the balancing test and framework for the application of § 1522 is likely applicable to all cases in the Circuit. Moreover, the reasoning set forth by the Bankruptcy Court (and generally adopted by the Fourth Circuit) for application of § 365(n) may exist in other industries, particularly those that feature rapid innovation and possible "patent thickets." Licensees should be aware of the *Qimonda* decision and actively assert their rights under § 365(n) in cross-border cases.