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Attorneys Blake Reese and Bradley S. Friedman of Milbank, Tweed, Hadley & McCloy, New York, in Part II of their article on the Qimonda bankruptcy case, discuss how the ultimate adjudication of this case might have a significant impact on cross-border commerce in general, as well as on Qimonda's patent licensees.

Back to the Future (*Lubrizol*) Part II: An Update on the Qimonda Bankruptcy

By Blake Reese and Bradley S. Friedman

Qimonda AG, once the world's second largest DRAM manufacturer, filed for bankruptcy in a German court in January 2009. In February, the authors described how Qimonda, by way of Chapter 15 of the U.S. Bankruptcy Code, was able to convince a bankruptcy court that it could avoid certain safeguards typically afforded to non-debtor licensees under Chapter 11 in the name of harmonizing the treatment of a foreign debtor's intellectual property throughout the world.[1] In particular, that German law governed the fate of its licenses and, thus, Qimonda could effectively breach its license agreements and, unlike under U.S. law, its licensees would not have rights to continue exploiting the underlying patents. The ultimate adjudication of this case will have a huge impact on cross-border commerce in general, as well as Qimonda's licensees that rely on rights to at least 4,000 U.S. patents and 1,000 U.S. patent applications. The licensees appealed the bankruptcy court's ruling in favor of Qimonda to the district court, which, on July 2, 2010, issued an opinion regarding this issue of first impression.[2]

I. Section 365(n)—Protections for Non-debtor Licensees

Intellectual property licenses are usually executory contracts, and debtors have the right to assume or re-

[1] *See Back to the Future (Lubrizol): Qimonda Bankruptcy Provides Debtors With a Windfall at the Expense of Their IP Licensees* (22 BBLR 316, 3/4/10) (79 PTCJ 488, 2/26/10).

[2] *Micron Technology Inc. v. Qimonda AG (In re Qimonda AG Bankruptcy Litigation)*, E.D. Va., Nos. 1:10cv26, 1:10cv27, 1:10cv28, 7/2/10 (22 BBLR 975, 7/22/10).

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ject executory contracts in a bankruptcy case. Before Section 365(n), if a debtor-licensor rejected a license, then the licensee would merely have a claim for money damages. Unless this claim was secured against an asset, it usually was unsecured debt and got pennies on the dollar.

Meanwhile, the licensee had no further rights to exploit the debtor-licensor's intellectual property, while the debtor was free to sell or license the underlying intellectual property assets to the highest bidder. Companies that spent millions of dollars on intellectual property licenses and invested in infrastructure and a long-term business model based on these licenses were not content with having their rights abruptly cut off. This result occurred in the Fourth Circuit's landmark *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.)* case and led to Congress passing Section 365(n), which gave certain protections to non-debtor licensees and licensors if the debtor counter-party rejects their license.[3]

Those protections include the option for the non-debtor copyright or patent licensee to continue satisfying its obligations (*e.g.*, paying royalties) in exchange for having the ability to keep exploiting the debtor-licensor's copyrights or patents.[4] Although the licensee is not entitled to any prospective rights under the license, such as maintenance or upgrades, it may continue using licensed technology. While the use continues under the duration of the license, often these rights allow the licensee to plan a prudent transition to a new technology platform or provider.

II. Chapter 15

Congress codified Chapter 15 of the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[5] in order to provide ''cooperation between'' U.S. courts, trustees, examiners, debtors, and foreign courts ''involved in cross-border insolvency cases''; ''greater legal certainty for trade and investment''; ''fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor''; ''protection and maximization of the value of the debtor's assets''; and ''facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.''[6]

Chapter 15 opens the door for a foreign debtor to administer its U.S. assets, enforce contracts, and effectuate claims. Chapter 15 provides, among other things, an ancillary proceeding in the United States to a bankruptcy case taking place in a foreign court. Often, U.S. law will afford the foreign debtor some of the more prevalent protections under the U.S. Bankruptcy Code. For instance, the U.S. bankruptcy court typically will give the foreign debtor relief under the automatic stay, which, for the most part, keeps creditors away from the U.S. assets during the bankruptcy. Chapter 15 provides the court with a wide range of discretion in granting various forms of relief at the request of the ''foreign representative.'' This discretion formed the crux of the dispute between the licensees and licensor in the Qimonda bankruptcy.

III. Qimonda's Chapter 15 Bankruptcy

After Qimonda commenced an insolvency proceeding in Germany, the German court appointed a foreign representative to petition a U.S. bankruptcy court for recognition of the German proceeding. The foreign representative filed a petition under Chapter 15, and the U.S. court recognized the case as a ''foreign main proceeding,'' meaning that it is pending in the country where the debtor has ''the center of its main interest''—here, Germany. As a result of this recognition, the U.S. bankruptcy court enjoyed jurisdiction over Qimonda's U.S. assets.[7]

Shortly after recognizing the proceeding, the bankruptcy court issued an order stating that, pursuant to Chapter 15, ''the following sections [of the Bankruptcy Code] are also applicable in this proceeding: §§ 305-307, 342, 345, 349, 350, **364-366**, 503, 504, 546, 551, 558.''[8] About two and a half months later, Qimonda moved to amend the order to strike the reference to Section 365 or limit the application of Section 365 so the debtor's rejection of licenses would be governed by German bankruptcy law.

Predictably, many of the significant licensees objected to Qimonda's motion to amend, as German bankruptcy law lacks the safeguards that Section 365 affords non-debtor licensees. Specifically, § 103 of the German Insolvency Code allows the debtor to elect non-performance of executory contracts. So, like in *Lubrizol*, Qimonda could elect non-performance of all its licenses and then liquidate the underlying intellectual assets to the highest bidder.

Despite the fact that Qimonda availed itself of the automatic stay provisions of the U.S. Bankruptcy Code; despite Congress's clear intent in enacting Section 365(n) to safeguard licensees in good standing against harsh ''*Lubrizol*-esque'' outcomes; despite a court order dictating the applicability of Section 365 in the Chapter 15 case;[9] and despite express provisions in the licenses that called for the application of Section 365(n) and New York law,[10] the bankruptcy court granted Qimonda's motion and amended its order.

The amended order states that ''section 365(n) applies only if the Foreign Representative rejects an executory contract pursuant to section 365 (rather than simply exercising the rights granted to the Foreign Representative pursuant to the German Insolvency Code).''

[3] 756 F.2d 1043 (4th Cir. 1985).

[4] Trademark licensees are not afforded protection under Section 365(n). For a brief discussion of what is and what is not governed by Section 365, *see, e.g.*, J. Klaiber & B. Reese, *Chapter IP: Protecting Your IP When Your Licensee (or Licensor) Is Bankrupt*, The Deal (April 17, 2009).

[5] Chapter 15 stemmed from the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency.

[6] 11 U.S.C. § 1501.

[7] It is instructive to note that the licenses at issue involved U.S. patents and, at least one formed under U.S. law, for example, New York state law.

[8] (Emphasis added).

[9] On the other hand, the bankruptcy court arguably included Section 365 in the original order to give the debtor the right to assume or reject executory contracts, not necessarily to protect the creditor-licensee's interests.

[10] U.S. bankruptcy law generally prohibits *ipso facto* clauses, which are terms of a contract that are triggered by a company's insolvency or bankruptcy filing. However, some contractual provisions that deal with the parties' obligations in bankruptcy under Section 365 remain enforceable. *See* 11 U.S.C. § 365(e)(2)(A).

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The bankruptcy court reasoned that ''[i]f the patents and patent licenses are dealt with in accordance with the bankruptcy laws of the various nations in which the licensees or licensors may be located or operating, there will be many inconsistent results. In fact, the same idea, process or invention may be dealt with differently depending on which country the particular ancillary proceeding is brought.''

The licensees appealed the bankruptcy court's decision.

IV. The District Court's Decision

On appeal, the district court reviewed whether the bankruptcy court (1) properly ensured that the appellants were sufficiently protected in modifying the discretionary relief granted; (2) erred in concluding that Section 365(n) does not automatically apply in a Chapter 15 proceeding; and (3) erred in granting comity to the German Insolvency Code, which treats executory intellectual properly license contracts differently from licensees protected under Section 365(n).

A. Balancing the Parties' Interests Under Chapter 15

The district court explained that Chapter 15 allows a bankruptcy court discretion in ''grant[ing] any appropriate relief'' necessary to ''effectuate the purpose of this chapter and to protect the assets of the debtors or the interests of the creditors.'' Furthermore, the bankruptcy court, on its own or at the request of the foreign representative or an affected party, ''may'' modify or terminate such discretionary relief. In modifying or terminating such relief, the bankruptcy court must ensure that ''the interests of the creditors and other interested entities, including the debtor, are sufficiently protected.''

In pointing out a ''somewhat anemic record,'' the district court explained that the bankruptcy court did not give proper reasoning to support its conclusory statements of the apparent interests of the parties. With respect to protecting the debtor's interests, the bankruptcy court did not articulate why application of Section 365(n) would unavoidably ''splinter'' or ''shatter'' the Qimonda patent portfolio ''into many pieces that can never be reconstructed'' which would render the portfolio effectively unsalable. In fact, as the district noted, ''were 365(n) to apply in this case, [the licensees] would retain valid cross-licenses to certain Qimonda patents, and accordingly any 'splintering' of Qimonda's patent portfolio would have no effect on [the licensees] intellectual property interests.'' On the other hand, the bankruptcy court did not provide sufficient reasons why the debtor's demanding that the licensees pay new licensing or royalty fees was an ''unfortunate but an inevitable result'' of Qimonda's insolvency. Furthermore, the bankruptcy court failed to consider any information about the nature of the licensed U.S. patents and whether cancellation of the licenses for those patents would put at risk the licensees' investment in manufacturing or sales facilities in this country for products embodied by those patents.

B. Discretionary (Non-Automatic) Application of Section 365(n)

Through its statutory interpretation, the district court determined that Section 365 applies within the discretion of the bankruptcy court and not automatically in Chapter 15 proceedings. This determination was based on Chapter 15's explicitly referencing Sections 361-363 and not Section 365 as provisions that automatically apply in a Chapter 15 proceeding. The court explained that while Section 363(l) references Section 365, ''it does so only in the context of rendering *ipso facto* clauses unenforceable.'' The district court reasoned that not every sale under Section 363 implicates agreements with *ipso facto* clauses and, therefore, Section 365 is only applied within the discretion of the bankruptcy court and not automatically in every sale. In other words, bankruptcy courts can subject asset sales in Chapter 15 proceedings to Section 365, but, if the bankruptcy court does not exercise its discretion, Section 365 will not apply.

C. Public Policy and the Comity of German Law

The district court addressed whether granting comity to German law (*i.e.* not applying Section 365(n) and applying the German Insolvency Code) was properly decided or an abuse of the bankruptcy court's discretion. The court noted the two components of Chapter 15: (1) that the bankruptcy court ''*shall* grant comity or cooperation to the foreign representative''; and (2) that nothing in Chapter 15 ''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*.''

Reading these two complementary sections *in pari materia*, the district court held that any analysis must focus on whether Section 365(n) embodies ''the fundamental public policy of the United States, such that subordinating section 365(n) to German Insolvency Code § 103 is an action 'manifestly contrary to the public policy of the United States.' '' Citing to the legislative history of Section 365(n) and paying particular attention to Congress's affirmative steps to change the outcome of the *Lubrizol* decision, the district court noted the need to address two main factors: (1) whether the foreign proceeding is procedurally unfair; and (2) whether the application of the foreign law would ''severely impinge the value and import of a U.S. statutory or constitutional right.'' Referencing the sparse bankruptcy court record, the district court noted that the bankruptcy court must first determine whether the relief granted violates fundamental U.S. policies under Chapter 15 because the application of the German Insolvency Code and the conditioning of Section 365(n), seemingly without qualification, appear to be at odds with Congress's intent to reject *Lubrizol*.

As a result, the district court remanded this case to the bankruptcy court in order for it to more fully explain its basis for modifying the discretionary relief previously granted and determine whether the relief granted violated fundamental U.S. public policies.

V. Conclusion

The district court has laid the framework for the bankruptcy court's analysis. Under this framework, while the bankruptcy court will be forced to justify its decision to modify its initial order to apply Section 365 to the Chapter 15 proceeding, the district court has made clear that a bankruptcy court can avoid such justification by altogether avoiding the application of Section 365 in a Chapter 15 proceeding. In other words, if a bankruptcy court does not modify or terminate an order requiring the application of 365, and, instead, never speaks of Section 365, it will be operating within its discretion. Accordingly, licensees will be anxiously awaiting the bankruptcy court's finding of whether an application of foreign law that conflicts with Section 365(n) is improper under Chapter 15 for violating fundamental U.S. public policies.

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