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Case Study: *In Re Qimonda*

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On Oct. 28, 2011, the United States Bankruptcy Court for the Eastern District of Virginia issued an opinion with significant ramifications for any holder of a patent license that operates internationally. At issue was an important protection afforded to patent licensees under the United States Bankruptcy Code - § 365(n).

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.

Qimonda AG filed insolvency proceedings 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 June 2009, 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 Virginia Bankruptcy Court entered an order recognizing the German proceedings in July 2009. The recognition order expressly made § 365 of the Bankruptcy Code applicable to the U.S. proceeding. Dr. Jaffé filed a motion to modify the recognition order to clarify § 365 of the Bankruptcy Code would not apply in the event he sought to exercise his rights under the Germany Insolvency Code with respect to contracts.

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As the Germany Insolvency Code does not expressly provide for similar protections as §365(n) of the Bankruptcy Code, the requested modification would likely have eliminated the right of licensees to avoid claims for infringement without paying for new licenses. Several Qimonda licensees opposed this motion, which was ultimately granted by the Virginia Bankruptcy Court, resulting in a revised recognition order in substantially the form requested by the Insolvency Administrator.

The 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 an evidentiary hearing in March 2011. The evidence established the semiconductor industry as a "patent thicket," where any given device may embody multiple patents held by multiple parties, including third parties. Identifying all of these patents up front is not viable. To obtain a degree of quietude from patent infringement claims, semiconductor manufacturers thus enter into license, cross-license, and joint development agreements with each other.

Without these agreements, manufacturers risk paying a "hold-up premium" – a disproportionately expensive license – if found to infringe after they have made a substantial, and nonrecoverable, capital investment in production. The Qimonda licensees provided expert testimony that eliminating the § 365(n) protections and allowing Qimonda to reject their licenses would upset this détente and result in uncertainty, affect investment decisions and increase the "hurdle rate," thereby slowing the pace of innovation and overall economic growth.

Dr. Jaffé, on the other hand, asserted that allowing the provisions of the Germany Insolvency Code to prevail would not significantly impact the market. First, Dr. Jaffé committed to re-licensing the Qimonda patents to the objectors on reasonable and nondiscriminatory (RAND) terms. According to Dr. Jaffé's expert, this would eliminate any hold-up premium and would have a minimal effect on innovation.

Second, Dr. Jaffé pointed out that § 365(n) would preserve only the U.S. patent licenses – the objectors would still need to re-license Qimonda's several thousand foreign patents to fully preserve the "design freedom" they were asking the Bankruptcy Court to protect. As a counterbalance, Dr. Jaffé's expert calculated that Qimonda would lose approximately \$47 million if the licensees could avail themselves of § 365(n) and avoid re-licensing the U.S. patents.

The Bankruptcy Court began its analysis by looking to the origin of § 365(n) as a specific and rapid congressional response to a decision of the United States Court of Appeals for the Fourth Circuit allowing the rejection of a non-exclusive, fully paid up intellectual property license.

The Bankruptcy Court cited the legislative history of § 365(n), which explains that the provision's purpose is to remove a burden imposed on American technological development that was never intended by Congress. In light of this history, the Court addressed whether limiting § 365(n) would appropriately balance the interests of the debtor and the licensees and whether granting comity to Germany law would be manifestly contrary to

the public policy of the United States.

With respect to the balance of interests as between the debtor and the objectors, the Bankruptcy Court noted that each of the licensees would likely have to renegotiate licenses to Qimonda's numerous foreign patents regardless of the court's decision with respect to Qimonda's U.S. patents. Although the licensees were not able to identify any specific Qimonda patents that were required to manufacture their products, the Bankruptcy Court found that cancellation of their rights to use Qimonda's patents created a substantial risk of harm in the form of uncertainty and potential claims for infringement, some of which had already been outlined by Dr. Jaffé while attempting to renegotiate the licenses.

The court acknowledged that Dr. Jaffé's agreement to re-license on RAND terms reduced the risk of a hold-up premium. Nonetheless, the court recognized the licensees risked economic harm insofar as they had effectively lost the opportunity to design around Qimonda's patents by making their initial investments in reliance on their licenses to, and thus without detailed analysis of, Qimonda's intellectual property.

Ultimately, the court determined that the balance of interests favored preserving rights under § 365(n). Dr. Jaffé would still be able to monetize Qimonda's patent portfolio by licensing the U.S. patents to other entities and by re-licensing the non-U.S. patents to the objectors. Although the application of § 365(n) would reduce the value of the German estate, it would not impose an affirmative burden thereon. On the other hand, allowing Dr. Jaffé to reject the licenses would have a substantial negative impact on the sizeable investments the licensees' made in the United States in reliance on the Qimonda licenses.

In addressing the public policy aspect of the district court's mandate, the Bankruptcy Court focused on the legislative history of §365(n) and inquired whether the policy promoted by that section is "fundamental." Initially, the Bankruptcy Court noted that, unlike certain other Bankruptcy Code provisions, § 365 does not automatically apply in cross-border cases, and is instead discretionary. The Bankruptcy Court was nonetheless persuaded by the licensees' expert testimony that the threat of uncertainty could result in many innovative products coming to market later to the detriment of the U.S. economy.

Therefore, the Bankruptcy Court found that under the circumstances of the Qimonda case and the semi-conductor industry, failure to apply § 365(n) would severely impinge an important statutory protection and undermine a fundamental U.S. public policy. Indeed, because patents are territorial, and because the protections of § 365(n) do not apply to foreign patents, the court's decision might actually promote additional high-technology investment in the United States.

While the Bankruptcy Court's ruling that § 365(n) would apply in the Qimonda case could be limited to the semi-conductor industry, the rationale for application of § 365(n) may exist in other industries, particularly those that feature rapid innovation and possible "patent thickets." In addition, it is important to recognize the procedural history of this case and the need for licensees to affirmatively assert that § 365(n) should apply in cross-border cases. Because the application of § 365 of the Bankruptcy Code is discretionary, licensees should promptly move to protect their rights in any cross-border bankruptcy case.