

## Fourth Circuit Addresses Protections for US IP Licenses in Case Under Chapter 15 of the Bankruptcy Code

In a case of significant importance to licensees of US intellectual property, the US Court of Appeals for the Fourth Circuit held in *Jaffé v. Samsung Electronics Co. (In re Qimonda)*, Case No. 12-1802, 2003 WL 26478864 (4th Cir. Dec. 3, 2013) (“*Jaffé*”), that a bankruptcy court did not err by requiring that the protections of section 365(n) of the Bankruptcy Code apply with respect to a foreign debtor’s US intellectual property (“IP”) as a condition of granting the debtor’s foreign representative relief under chapter 15 of the Bankruptcy Code. This decision affirms that the significant protections for IP licensees pursuant to section 365(n) of the Bankruptcy Code can apply in an ancillary chapter 15 case to US IP even where licensees would receive no similar protections in the debtor’s home country insolvency proceeding.

Section 365(n) of the Bankruptcy Code provides licensees of “intellectual property” the opportunity to preserve their rights under their IP licenses, notwithstanding the debtor’s general ability to reject executory contracts in bankruptcy (which may include IP licenses). Not all foreign jurisdictions, however, have constructed a statutory framework to protect the rights of an IP licensee in a licensor’s insolvency, and such jurisdictions may even enable the licensor to terminate a license of IP in insolvency.

The *Jaffé* court directly confronted the question of the extent to which the laws of the United States protect the interests of IP licensees in

cross-border insolvency proceedings, such as those under chapter 15 of the US Bankruptcy Code, when the laws of the home country insolvency proceeding allow for termination of US licenses upon insolvency. Notwithstanding chapter 15’s strong policies in favor of cooperation and coordination with foreign insolvency proceedings, the *Jaffé* court ruled that US policy of protecting IP licensees pursuant to section 365(n) was important enough to require application of section 365(n) with respect to US IP in an ancillary proceeding under chapter 15 even though the home country’s insolvency laws would not provide licensees similar protections. While the *Jaffé* court’s decision is no doubt significant, it remains to be seen whether other courts will afford IP licensees similar protections in other chapter 15 proceedings.

### Section 365(n)

The ability to reject burdensome executory contracts under section 365 of the Bankruptcy Code is one of the strongest tools afforded to a debtor in a US bankruptcy proceeding. In general, a contract is executory when, as of the petition date, each of the counterparties has unperformed obligations, the nonperformance of which would be a material breach. Under the Bankruptcy Code, rejection generally constitutes a breach of the debtor’s obligations as of the petition date, giving rise to a prepetition damage claim.

When the debtor is a licensor of IP, there is a tension between the rejection power and the licensee's right to continued use of the IP. Prior to the enactment of section 365(n), the US Court of Appeals for the Fourth Circuit resolved such tension soundly in favor of the debtor-licensor in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*,<sup>1</sup> where the court permitted the rejection of an IP license by a debtor-licensor, thereby depriving the licensee of continued use of the IP.

To correct the perceived inequity of the *Lubrizol* decision, Congress promptly enacted section 365(n) of the Bankruptcy Code. Pursuant to section 365(n), if a debtor-licensor rejects a license for "intellectual property" (as such term is defined in section 101(35)(A) of the Bankruptcy Code), the licensee may elect either (i) to treat the license as terminated if the breach caused by the rejection would allow the licensee to do so by the terms of the license, by applicable non-bankruptcy law, or by an agreement made by the licensee with another entity or (ii) to retain, as a general matter, its rights under the license and any agreement supplementary to the license (including any exclusivity provision) and to continue to use the licensed IP (as such rights existed immediately before the filing of the bankruptcy case) as provided by the license for the term of the license and any term for which the license may be extended.

## Chapter 15

Chapter 15 largely incorporates the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law. It was enacted to facilitate cooperation and coordination with foreign proceedings, to facilitate fair and efficient administration of cross-border insolvencies and to protect and maximize a foreign debtor's US-based assets.

Under chapter 15, a foreign representative of the foreign debtor files a petition for recognition by the US bankruptcy court of a foreign insolvency

proceeding as either a "foreign main proceeding" or a "foreign nonmain proceeding." Recognition of a foreign insolvency proceeding as a "foreign main proceeding" affords a foreign representative certain automatic relief, including application of the "automatic stay" of section 362 of the Bankruptcy Code to the debtor and property of the debtor within the territorial jurisdiction of the United States and the ability to operate the debtor's business within the United States under section 363. Application of section 365 of the Bankruptcy Code, including the provisions of section 365(n), is not mandatory upon recognition of a foreign proceeding as a foreign main proceeding.

In addition to the automatic relief that comes with the entry of an order granting recognition of a foreign proceeding as a foreign main proceeding, section 1521 of the Bankruptcy Code authorizes the bankruptcy court to grant discretionary relief. Section 1521 provides that "where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditors, the court may, at the request of the foreign representative, grant any appropriate relief." 11 U.S.C. § 1521(a). This discretionary relief may include entrusting the administration, realization and distribution of all or part of the debtor's assets within the territorial jurisdiction of the United States to the foreign representative. *Id.* § 1521(a)(5), (b).

The framework reflects the full commitment of the United States to cooperate with foreign insolvency proceedings in support of, among other things, greater legal certainty for trade and investment.

But the ability of a foreign representative to administer a foreign debtor's US assets in furtherance of a harmonized cross-border insolvency is not unbridled. The US bankruptcy court may grant discretionary relief under section 1521 only if it determines that "the interests of the creditors and other interested entities, including the debtor, are sufficiently protected." *Id.* § 1522(a). The bankruptcy court

may also subject the discretionary relief it grants under section 1521 “to conditions it considers appropriate.” *Id.* § 1522(b). Further, pursuant to section 1506 of the Bankruptcy Code, the bankruptcy court may deny a foreign representative relief to which it is otherwise entitled under chapter 15 if such relief is “manifestly contrary to the public policy of the United States” (i.e., the “public policy exception”).

## Qimonda

The licensor-licensee tension arose again in *Jaffé*, where a US bankruptcy court decided whether application of the protections of section 365(n) in respect of US IP being administered by a foreign representative was necessary to sufficiently protect the interests of licensees whose licenses would otherwise be terminated under the applicable laws of the foreign main proceeding.

In *Jaffé*, the debtor (“Qimonda”) was a German corporation that manufactured semiconductor devices. When Qimonda filed for insolvency in Germany in January 2009, the principal assets of its estate consisted of some 10,000 patents, about 4,000 of which were US patents. The patents were subject to cross-license agreements with Qimonda’s competitors, as was consistent with industry practice to avoid infringement risks caused by the “patent thicket”—i.e., the overlapping patent rights of some 420,000 patents in the semiconductor industry.

Qimonda’s foreign representative, Dr. Michael Jaffé, filed a petition under chapter 15 of the US Bankruptcy Code for recognition of the German insolvency proceeding as a “foreign main proceeding.” The foreign representative also requested certain discretionary relief—specifically, that the bankruptcy court entrust to him the administration of all of Qimonda’s assets within the territorial jurisdiction of the United States, largely consisting of the 4,000 US patents.

The bankruptcy court granted the petition and recognized the German proceeding as Qimonda’s foreign main proceeding. The bankruptcy court also granted discretionary relief under section 1521. The bankruptcy court, however, conditioned such relief on making section 365 of the Bankruptcy Code applicable to Qimonda’s US patents.

Because Qimonda was in the process of liquidation, the foreign representative’s objective was to replace the existing cross-licenses paid in-kind (i.e., paid with other cross-licenses) for new licenses paid in cash through royalties. Applicable German law, it was assumed, authorized termination of the licensees’ rights to use Qimonda’s IP and provided no protection to such licensees akin to section 365(n) of the Bankruptcy Code. The foreign representative sought to declare Qimonda’s existing licenses unenforceable and to re-license Qimonda’s IP for the benefit of Qimonda’s creditors.

The licensees objected to the foreign representative’s efforts and sought to invoke their rights under section 365(n) of the Bankruptcy Code. They argued that a balancing of the interests under section 1522(a) of the Bankruptcy Code weighed in favor of the licensees, and, separately, that applying German law to terminate US IP licenses would be manifestly contrary to US public policy. After an initial ruling, appeal to the district court, and four-day evidentiary hearing on remand, the bankruptcy court ultimately ruled in favor of the licensees, concluding that a balancing of Qimonda’s and the licensees’ interests weighed in favor of making section 365(n) applicable to the administration of Qimonda’s US IP and that applying German law to cancel the US licenses would be manifestly contrary to US public policy.

On appeal to the Fourth Circuit, the foreign representative made three principal arguments: (i) the lower courts erred in even considering section 1522(a) because that section applies only to relief granted under section 1521 “at the request of the foreign representative,” and Jaffé,

as the foreign representative, never requested the inclusion of section 365(n) as part of the discretionary relief; (ii) the bankruptcy court incorrectly applied a balancing test that did not place all creditors on an equal footing; and (iii) in balancing the competing interests, the bankruptcy court overstated the risks to the licensees.

The Fourth Circuit described the foreign representative's first argument as "too myopic." It did not matter, the court reasoned, that the foreign representative had not specifically requested application of section 365(n) as part of the overall relief he was seeking from the US bankruptcy court. The foreign representative had requested discretionary relief under section 1521 of the Bankruptcy Code. The Fourth Circuit reasoned that the bankruptcy court may grant such discretionary relief "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected," 11 U.S.C. § 1522(a),<sup>2</sup> and, accordingly, the bankruptcy court was required to determine whether the interests of creditors and others were sufficiently protected pursuant to section 1522(a).

The foreign representative also argued that the bankruptcy court applied section 1522(a) of the Bankruptcy Code incorrectly in determining that the protections of section 365(n) were required for Qimonda's US patents. The foreign representative argued that the bankruptcy court erred by applying a test that could place creditors on unequal footing and that would yield a result in tension with German law, the law of the foreign main proceeding. Drawing support from legislative history, however, the Fourth Circuit held that the analysis required under section 1522(a) of the Bankruptcy Code is "best done by balancing the respective interests based on the relative harms and benefits in light of the circumstances presented"—i.e., a balancing test.

The foreign representative further argued that the bankruptcy court simply reached an

incorrect result, even if the court applied an appropriate balancing test. The foreign representative argued that the bankruptcy court overstated the harm to the licensees, especially in light of the foreign representative's offer to re-license the US IP to the licensees on relatively reasonable terms. The bankruptcy court, however, concluded that if section 365(n) were not made applicable to the US IP in Qimonda's chapter 15 case, the licensees would face the immediate threat of a hold-up and infringement litigation, and that a general destabilization of the licensing regime in the industry could result. The bankruptcy court also found that the foreign representative's offer could not sufficiently protect the licensees' interests from, among other things, subsequent owners of the US IP and the uncertainty attendant therewith. The Fourth Circuit ultimately concluded that the bankruptcy court's analysis was "comprehensive and eminently reasonable."

## Concluding Thoughts

Because the Fourth Circuit affirmed the bankruptcy court's determination that, upon a balancing of the harms under section 1522(a) of the Bankruptcy Code, application of section 365(n) was necessary to provide licensees with sufficient protection in connection with the foreign representative's administration of US IP, the Fourth Circuit did not reach whether application of section 365(n) was mandated by the public policy exception in section 1506 of the Bankruptcy Code. Nor did the Fourth Circuit make any sweeping pronouncements that application of section 365(n) is mandated in all chapter 15 proceedings where IP is a significant asset of the foreign debtor. Moreover, the application of section 1522(a) of the Bankruptcy Code is a question of fact generally left to the lower court's discretion on appeal. For these reasons, the *Jaffé* decision may be limited to its facts and thus have limited precedential value.

Under different facts and circumstances, a bankruptcy court might determine that a balancing of the harms under section 1522(a) weighs *in favor* of the foreign representative. Or a foreign representative simply might refrain from requesting discretionary relief under section 1521 and bypass the section 1522(a) balancing test altogether where US IP is a significant asset of the foreign debtor.

Under those circumstances, however, licensees may argue that application of section 365(n) is necessary to prevent a result that is manifestly contrary to the public policy of the United States. In this regard, the Fourth Circuit strongly suggested, without holding, that the licensees have the better argument: “by affirming the bankruptcy court’s application of § 365(n) following its balancing analysis under § 1522(a), we also indirectly further the public policy that underlies § 365(n)” in that “licensees have a strong interest in maintaining their right to use intellectual property following the licensor’s bankruptcy” and that denial of “that right would impose a burden on American technological development that was never intended by Congress.”

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*For more information about the topics raised in this legal update, please contact the authors below or your usual Mayer Brown lawyer.*

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**Endnotes**

<sup>1</sup> Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043 (4th Cir. 1985) (“Lubrizol”).

<sup>2</sup> The bankruptcy court also has the authority to “subject” any discretionary relief “to conditions it considers appropriate.” 11 U.S.C. § 1522(b).

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