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Sector Focus

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In re Qimonda AG Bankruptcy Litigation: the edge of discretion

KEY POINTS

- Despite recent gains around the world, intellectual property rights often receive disparate treatment and protection when an insolvent firm enters a cross-border restructuring or liquidation.
- Recent rulings in the Chapter 15 case of *Qimonda AG* highlight these disparities, and raise questions about the circumstances under which the US cross-border insolvency recognition statute should be used to further the uniform treatment and protection of intellectual property rights.
- *Qimonda AG* also raises more fundamental and general questions about the construction and application of Chapter 15. When parties to recognised cross-border insolvency proceedings have relative rights and protections in the US which differ from those available in the debtor's home jurisdiction, *Qimonda*'s analysis provides an important test case for how such rights and protections should be allocated.

In re Qimonda AG highlights the tension created when different jurisdictions involved in a cross-border insolvency treat differently the debtor's intellectual property. That tension creates challenges for the application of recognition statutes such as Chapter 15 of the US Bankruptcy Code.

The advent of the information age has given rise to economies built not on steel, but on ideas. Not surprisingly, therefore, intellectual property assets have become an increasingly important component of firm balance sheets – and firm value – throughout advanced economies worldwide.

And yet, though the value of intellectual property is universally recognised and the rights attaching to it are increasingly protected, a firm's 'knowledge assets' are not always treated in the same manner whenever – and wherever – the firm enters restructuring or liquidation.

The story of Qimonda AG is the story of what happens when one country's rules governing the treatment of an insolvent firm's intellectual property collide with those of another. It is also the developing tale of what sort of discretion – and how much of it – US bankruptcy courts ought to exercise in applying a cross-border recognition statute originally intended to promote global uniformity and predictability in insolvency proceedings.

QUIMONDA AG'S INSOLVENCY.

Qimonda AG ('Qimonda'), a producer of Dynamic Random Access Memory ('DRAM') chips, also holds a portfolio of approximately 12,000 patents. A little more than one-third of this intellectual property originated in the US (ie, it consists of US patents or pending applications); the balance is of German or other international origin.

Over a 13-year period, Qimonda entered into a series of joint venture and cross-licencing agreements with a number of semiconductor manufacturers. Under those agreements, Qimonda and these manufacturers cross-licenced tens of thousands of patents.

During 2007 and 2008, prices for PC-based DRAM technology collapsed. Despite efforts to restructure, Qimonda entered German insolvency proceedings in January 2009. The Munich court overseeing the proceeding appointed Dr Michael Jaffé as Qimonda's insolvency administrator.

Subsequently, Dr Jaffé sought and obtained recognition in the US for Qimonda's German insolvency proceeding. Dr Jaffé also obtained concurrent, discretionary relief making certain sections of the US Bankruptcy Code applicable to Qimonda's Chapter 15 proceeding. These sections included s 365, which governs executory contracts – including licencing agreements.

Both the German Insolvency Code and the US Bankruptcy Code address the administration of executory contracts. Practitioners familiar with US insolvency law will be aware that the US Bankruptcy Code – specifically, s 365(n) – protects the licencees of a bankrupt licencor of intellectual property. Under this sub-section, the licencee – at its own option – may preserve its rights under an intellectual property licence, despite the bankruptcy trustee's efforts to reject that licence.

At the time of Qimonda's insolvency, the German Insolvency Code provided no such protection. Instead, s 103 of that statute simply provided that the court-appointed insolvency administrator may elect performance of contractual obligations or affirm that they remain unenforceable against the estate by electing non-performance.

DR JAFFÉ'S PROPOSED TREATMENT OF QIMONDA'S CROSS-LICENCING AGREEMENTS

Sometime after obtaining recognition and discretionary relief in Virginia, Dr Jaffé, acting pursuant to German law, provided notification to certain of Qimonda's cross-licencing partners of his elected non-performance of Qimonda's patent cross-licencing agreements.

Those partners, understandably, protested – and argued further that s 365(n) (made applicable to Qimonda's Chapter 15 proceeding at Dr Jaffé's own request) now prohibited Dr Jaffé from electing non-

performance. In response, Dr Jaffe sought the US Bankruptcy Court's amendment of his previously granted relief in order to clarify the basis for his non-performance of the cross-licencing agreements. Specifically, Dr Jaffé sought a modification of the prior order to provide that s 365 (and, therefore, s 365(n)) would be applicable only in such instances where he sought rejection of agreements pursuant to the US statute.

THE CROSS-LICENCING PARTNERS' APPEAL

Following a hearing held 28 October 2009, US Bankruptcy Court Judge Robert Mayer issued a decision granting Dr Jaffé's further request, thereby clearing the way for Dr Jaffé' to elect non-performance of the cross-licencing agreements under German insolvency law.

Qimonda's partners promptly appealed to the US District Court for Virginia's Eastern District, arguing (i) that s 365 – including s 365(n) – applies automatically to foreign proceedings recognised under Chapter 15 (and, presumably, may therefore not be 'modified' by the Bankruptcy Court in the manner proposed by Dr Jaffé); and, further (ii) that principles of comity applicable under US case law (and the provisions of Chapter 15) did not require the requested modification of the Bankruptcy Court's prior order.

In an appellate decision issued 2 July 2010, US District Judge Thomas Selby (Tim) Ellis III remanded the matter back to Judge Mayer for further clarification of two issues – one factual, one legal. *See In re Qimonda Bankruptcy Litigation*, 2010 WL 268026 (ED Va 2010). Along the way, however, Judge Ellis offered several important observations regarding the construction of ss 1521(a) (governing the provision of 'any appropriate relief' to the representative of a recognised foreign proceeding) and 1509(c) (governing a recognised administrator's requests for comity).

SECTION 1521(A)

A significant portion of Judge Ellis' lengthy decision is devoted to the conclusion that s 365 of the US Bankruptcy Code does not apply automatically upon recognition of a foreign 'main proceeding'. This seems unremarkable, given that a simple reading of s 1520(a) makes only select provisions of the Bankruptcy Code applicable automatically in Chapter 15, and that s 365 is not among them. As a result, s 365 – available to a foreign representative only through specific request pursuant to s 1521(a) – is susceptible to selective or otherwise limited application by the US Bankruptcy Court. Indeed, the Bankruptcy Court may determine it does not apply at all.

Far more interesting is Judge Ellis' conclusion that Dr Jaffe's request had been granted without the requisite balancing test set forth in s 1522. That section requires that, upon a request for modification of relief previously granted through s 1519 or 1521, the court may so modify only after ensuring that 'the interests of the creditors and other interested entities, including the debtor, are sufficiently protected'. 11 U.S.C. §1522(a). Because the evidence relied upon by the Bankruptcy Court to balance creditors' interests was 'anemic', Judge Ellis remanded the matter for a more full-bodied factual inquiry. 2010 WL 268026 at *6.

Specifically, Judge Ellis directed focus on two primary issues:

- How the application of s 365(n) would, as the Bankruptcy Court concluded, unavoidably 'splinter' or 'shatter' the Qimonda patent portfolio 'into many pieces that can never be reconstructed', thereby diminishing its value and rendering the Qimonda patent portfolio essentially unsalable ('Left unexplained, in particular, is why this is so, given that the continuation of appellants' non-exclusive licenses for an unspecified percentage of the Qimonda patent portfolio would preclude neither the sale of the patents themselves nor the grant of additional, non-exclusive licenses.") *Id* at *6.
- The nature of the US patents licenced to appellants, and whether cancellation of licences for those patents would put at risk appellants' investments in manufacturing or sales facilities in this country for products covered by the US patents ('At best, the bankruptcy court stated (i) that the application of dissimilar bankruptcy laws to different portions of Qimonda's patent portfolio "may well be detrimental to parties who are or wish to license patents," and (ii) that appellees' demanding that appellants pay new licensing or royalty fees was an "unfortunate but an inevitable result" of Qimonda's insolvency ... It is not readily apparent why this is so.') *Id* at *7.

Though leaving little doubt that s 365's applicability to a Chapter 15 proceeding was entirely within the Bankruptcy Court's sound discretion, Judge Ellis nevertheless observed that 'the Bankruptcy Code nonetheless "limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor," as "statutory provisions governing nondischargeability reflect a congressional decision to exclude from the general policy of discharge certain categories of debts."' *Id*. at *7.

Under Judge Ellis's reading of ss 1521 (and 1522), a Bankruptcy Court enjoys broad discretion – not only to provide 'any appropriate relief' to a foreign representative in the first instance, but to further amend, modify, or terminate the same relief – provided that the court engage in the affirmative exercise of articulating why the interests of the debtors and the creditor are protected.

SECTION 1509(C)

Judge Ellis' treatment of judicial discretion did not end with s 1521. On appeal, Qimonda's cross-licencing partners also called into question the Bankruptcy Court's decision to grant comity to Dr Jaffé's application of German insolvency law to the cross-licencing agreements.

By contrast to the broad discretionary application of 'appropriate relief' under s 1521, Judge Ellis found that a US Bankruptcy Court's discretion regarding the comity to be afforded determinations rendered under foreign law and pursuant to s 1509 is far more limited:

> Section 1509 states, in mandatory terms, that 'a court in the United States *shall* grant comity or cooperation to the foreign representative.' 11 U.S.C. § 1509(b)(3) (emphasis added) ... [U]nder the plain terms of § 1509(b)(3), the Bankruptcy Court lacked general discretion to deny the Foreign Administrator's request for comity; rather, the Bankruptcy Court could only

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Biog box

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> have refused to defer to German Insolvency Code § 103 on the ground that applying German law, instead of § 365(n), would be "manifestly contrary to the public policy of the United States" under § 1506. Put another way, §§ 1509(b)(3) and 1506, read *in pari materia*, provide that comity shall be granted following the US recognition of a foreign proceeding under Chapter 15, subject to the caveat that comity shall not be granted when doing so would contravene fundamental US public policy. *Id.* at *12.

What sort of foreign relief would 'contravene fundamental US public policy?'

Judge Ellis' review of decisions addressing the 'public policy' exception to Chapter 15's comity mandate indicated that the focus of this exception is on (i) procedural inequity (eg, a lack of 'due process' as that term is commonly understood by US courts); and (ii) frustration of a US court's ability to administer the Chapter 15 proceeding and/or severe impingement of a US constitutional or statutory right, particularly if a party continues to enjoy the benefits of the Chapter 15 proceeding (eg, frustration of the 'automatic stay' made applicable upon recognition of Chapter 15). *Id.* at *14, 16.

However, Judge Ellis further found that – as with the 'balancing test' required by s 1522 – the Bankruptcy Court had not gone far enough in its analysis. *Id.* at *16.

Congress enacted s 365(n) in direct response to contrary case law and in order to protect the US-based licencees of intellectual property. See Id. at *13 (discussing 365(n)'s enactment for the express purpose of overturning the result in *Lubrizol Enterprises, Inc v Richmond Metal Finishers, Inc (In re Richmond Metal Finishers, Inc)*, 756 F.2d 1043 (4th Cir 1985)). Yet despite Congress' apparent concern in enacting the s 365(n), s 365 in its entirety is subject to modification or amendment in Chapter 15, or – upon the Bankruptcy Court's discretion – not applicable at all.

In light of these mixed legislative signals, is the protection of s 365(n) 'fundamental' to US public policy? Or not? In granting Dr Jaffé's request, the Bankruptcy Court had not explicitly decided this question, so Judge Ellis directed that it do so upon remand.

WHAT DOES *QIMONDA* MEAN?

Judge Ellis' *Qimonda* decision is significant for its analysis of ss 1509 and 1522 – it appears to endorse, at least in general terms, the flexibility required of an internationally oriented recognition statute and the latitude potentially available to recognised foreign representatives.

However, Judge Ellis' *Qimonda* analysis is perhaps most significant for what it *doesn't* say.

First, it leaves unanswered what general factors courts might apply to the 'balancing test' of creditors' and debtors' interests mandated by ss 1521 and 1522.

Second, it describes the outer bounds of 'fundamental US public policy' such that otherwise-mandatory comity ought not to apply to the determinations of non-US tribunals. But it does little to address the import (if any) to be derived from Congressional amendments specifically intended to protect the rights (or the interests) of general or special US economic interests.

Third, these open questions lead to still more fundamental ones, with potentially far-reaching implications for the construction and application of Chapter 15 in a variety of contexts. For example:

- How exactly should a Bankruptcy Court perform the 'balancing test' required under s 1522? Should it be oriented toward predictable 'bright lines', which further the uniformity and predictability necessary for a workable cross-border recognition statute? Or should the court instead take a more detailed, 'fact-specific' – but likely less predictable – approach?
- Is intellectual property licencing so critical to the derivation of value from intellectual property that it protection is 'fundamental' to US policy? Or are licencees' protections embodied in s 365(n) of the US Bankruptcy Code more the product of special economic interests who – like so many others – have successfully curried favor with US lawmakers for the protection of their particular concerns? Is Congress' omission of s 365 from the relief 'automatically' applicable to recognised foreign proceedings any indication of s 365(n)'s importance in this regard? Or is its absence from s 1520(a) a mere legislative oversight? In determining what Congress meant when it enacted the provisions of s 365(n), to what extent should Bankruptcy Courts – or Courts of Appeal – engage in an historical analysis of the Code's development, as opposed to a construction of the 'plain meaning' of the text?
- If s 365(n) is found *not* to be 'fundamental' to US policy – and therefore, subject to selective application, modification, or complete omission – won't multinational firms have added incentive to 'forum shop' the treatment of intellectual property assets which derive their principal value from the efforts of US-based licencees? Aren't US-based licencees of such assets then in much the same position as they were under *Lubrizol* – and prior to Congress' prior amendment?

> "The Bankruptcy Code ... limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor as statutory provisions governing nondischargeability reflect a congressional decision to exclude from the general policy of discharge certain categories of debts."

These questions – and others – await determination by the *Qimonda* Bankruptcy Court. No matter what the outcome, *Qimonda*'s case will play an important role in determining. ■