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U.S. Court of Appeals for the Third Circuit Agrees with Lower Court: Royalty Obligation Not Tied to Intellectual Property License Is a Dischargeable Unsecured Claim

By Martin E. Beeler, Dianne F. Coffino, Peter A. Schwartz and Julian Wright*

In this article, the authors discuss a court decision that has broad implications for any transaction involving rights to future payment streams, including royalty or revenue interest financings and other deals with contingent or deferred payment rights.

A decision arising out of the Mallinckrodt plc bankruptcy cases[1] has broad implications for any transaction involving rights to future payment streams, including royalty or revenue interest financings and other deals with contingent or deferred payment rights.

The *Mallinckrodt* court held that royalty payments to a seller of intellectual property were dischargeable unsecured claims in bankruptcy. That holding meant that the buyer could continue to sell the drug developed from the acquired IP during and upon emergence from bankruptcy without paying the seller its contractual share of the revenue. The seller was instead left with an unsecured claim to be paid pro rata out of the funds available to other unsecured creditors, with an estimated recovery on the claim of about 4%.

CIRCUIT COURT RULING

The U.S. Court of Appeals for the Third Circuit recently affirmed the decision of the *Mallinckrodt* district court.[2]

The crux of the seller's argument on appeal was that Mallinckrodt's obligation to pay the seller royalties arose as the sales occurred and therefore had to be satisfied in real dollars going forward if Mallinckrodt wanted to continue to sell the drug.

Largely adopting the reasoning of the lower courts, the Third Circuit held that the debtor's obligation to make the royalty payments, "like most contract

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[1] Sanofi-Aventis U.S. LLC v. Mallinckrodt plc (In re Mallinckrodt), 646 F. Supp. 3d 565 (D. Del. 2022).

[2] In re Mallinckrodt plc, – F. 4th – (3d Cir. 2024), Case No. 23-11112024 (April 25, 2024).

claims," arose when the parties signed the agreement: "Once the parties agree to a contingent right to payment, the claim exists. And once the claim exists, bankruptcy can reach it."

The court of appeals noted, like the district court, that the seller could have protected its claim, and it ended with words of warning for creditors contemplating similar deal structures:

- To protect itself, [the seller] could have structured the deal differently. It could have licensed the rights to the drug, kept a security interest in the intellectual property, or set up a joint venture to keep part ownership. . . .
- Bankruptcy frees debtors from lingering claims like this one. [The seller] kept no property or security interest in Acthar Gel, but only a contractual right to a royalty. Because that contingent claim arose before Mallinckrodt went bankrupt, it is dischargeable in bankruptcy.

CONCLUSION

The outcome in the *Mallinckrodt* cases throws in sharp relief the difference between deal structures that are wholly unsecured – and thus exposed to the bankruptcy risk of the buyer – and other structures, such as out-licensing or secured transactions, that offer more favorable downside protection.

It is worth noting that it appears that no unsecured synthetic royalty financings by public biotech companies have hit the market since the *Mallinckrodt* district court decision came down in December 2022.