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Royalty Rights as Unsecured Claims: The Relevance of *Mallinckrodt* to M&A, Revenue or Royalty Interest Financings, and Other Transactions Involving Future Payment Streams

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

Consider this scenario: A company sells intellectual property rights to a buyer that plans to develop the intellectual property (IP) into a profitable product. The buyer pays a minimal upfront purchase price in cash, with the most valuable consideration taking the form of future "royalties" and/or "milestone payments" related to the development and sale of the product.

Upon closing the buyer obtains ownership of the IP.

The product does well and perhaps the seller even starts receiving the promised milestone and/or royalty payments. But then an unanticipated event changes the way the scenario plays out. For reasons that may or may not be related to the product, the buyer files for bankruptcy protection. The buyer continues to develop, market and sell the product, but stops paying royalty or milestone payments to the seller, claiming that the seller is now only entitled to a lump sum payment of a tiny fraction of the future payments it bargained for.

A recent decision from the Chapter 11 case of Mallinckrodt plc illustrates the material downside risk that a seller faces when it receives consideration in the form of future payment rights. Although the *Mallinckrodt* case only directly addresses the treatment of royalty rights under an asset purchase agreement for IP, the holding is relevant for any deal structure in which a party bargains for a right to receive future payments. The outcome in *Mallinckrodt* 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.

PRE-BANKRUPTCY SALE OF THE ACTHAR GEL IP

In 2001, sanofi-aventis U.S. LLC (Seller) entered into an asset purchase agreement (APA) with Mallinckrodt under which the Seller agreed to sell to Mallinckrodt intellectual property relating to Acthar Gel, a therapeutic product for the treatment of inflammatory and autoimmune conditions. The purchase

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price for the Acthar Gel IP consisted of a $100,000 up-front payment plus annual royalty payments equal to 1% of all net sales of the product exceeding $10,000,000 in each year. The future royalty payments were unsecured.

MALLINCKRODT BANKRUPTCY

In addition to Acthar Gel, Mallinckrodt produced and distributed a wide variety of other products, including opioids. As with other drug manufacturers and distributors involved in the nationwide opioid crisis, Mallinckrodt was subject to widespread litigation and faced enormous liabilities. In October 2020, it filed for bankruptcy protection in the U.S. Bankruptcy Court for the District of Delaware to resolve these liabilities.

In connection with the confirmation of Mallinckrodt's bankruptcy plan, the Seller made a number of arguments in an effort to retain the right to its future royalty payments. First, it filed a motion seeking a determination that the royalty payments due under the APA could not be discharged in bankruptcy. The Seller then claimed that its royalty claim should be considered a trade claim rather than an unsecured claim.[1] The bankruptcy court ruled against the Seller on all issues.

WHAT WAS AT STAKE: VALUE OF THE ROYALTY RIGHTS

Sales of Acthar Gel generated royalty payments due to the Seller totaling approximately $71.4 million from 2014 to 2020, ranging from a low of about $7.8 million in 2020, to a high of almost $12 million in 2016.[2] The debtors' disclosure statement for the plan of reorganization included financial projections that showed a healthy continuing revenue stream from Acthar Gel sales, which constituted an important cash resource for the reorganized business.[3]

THE BANKRUPTCY DISCHARGE

One of the principal benefits for a debtor in a Chapter 11 case is the ability to discharge claims against the company that arose prior to the confirmation of a plan of reorganization. If a claim is discharged, the debtor is relieved of any post-bankruptcy liability on the claim and the creditor is barred from enforcing the claim against the debtor, and is limited to sharing on a pro rata basis in the assets that are available for distribution to similarly situated creditors in the bankruptcy case for recovery.

The distribution to unsecured claimants often amounts to pennies on the dollar of the claim amounts. Indeed, under the Mallinckrodt plan, the

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[1] In re Mallinckrodt plc, 639 B.R. 837 (Bankr. D. Del. 2022) (Confirmation Opinion).

[2] Order Approving Stipulation Between the Debtors and Sanofi-Aventis U.S. LLC Regarding Historical Royalty Amounts in Connection with Confirmation Hearing, Dkt. No. 5693.

[3] Confirmation Opinion, 639 B.R. at 857.

estimated recovery for general unsecured creditors – the class that Seller's claim would fall into if its arguments failed – was estimated at around 4% of the allowed claim amount.[4] By contrast, trade creditors would receive 100% of their prepetition claim amounts.

The bankruptcy court justified this radically different treatment of unsecured creditors because Mallinckrodt continued to receive goods and services from the trade creditors that were essential to the reorganization plan.[5] The bankruptcy court concluded that the Seller did not continue to supply any goods or services, or otherwise provide benefits, under the APA that could render it a trade creditor for plan purposes. To the contrary, because the debtor owned the Acthar Gel IP in full, it did not need the Seller's participation in any way to continue to monetize the property, and any royalty payments due to the Seller only burdened the debtor with future liabilities.[6]

THE ROYALTY CLAIMS AROSE WHEN THE APA WAS EXECUTED

Bankruptcy court decisions are subject to review, in the first instance, by U.S. federal district courts, and the Seller appealed the rulings against it. The main question on appeal was whether the contingent royalty claims under the APA could in fact be discharged under the plan as proposed by the debtor.[7] The court held that under the applicable statutory provisions, "a contingent right to payment arising before the date of a plan's confirmation may be discharged by that confirmation."[8] Straightforward enough, but the more difficult question remained: when did the claims to future royalty payments – which related to sales that would continue for years after the confirmation date – arise?

Decisions from the U.S. Court of Appeals for the Third Circuit, which governed this dispute, have generally opted to give this question an "expansive treatment" that would maximize the types of claims subject to discharge.[9] In the context of contract claims, contingent claims are considered dischargeable prepetition claims if the claims referred to obligations that "will become due upon the happening of a future event that was within the actual or presumed contemplation of the parties" at the time of contracting.[10]

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[4] Id. at 911, appx. 1 (estimated recoveries waterfall).

[5] Id. at 856-58.

[6] Id. at 857.

[7] District court decision.

[8] Id.

[9] Id.

[10] Id. (quoting Olin Corp. v. Riverwood Int'l Corp. (In re Manville Forest Products Corp.), 209 F.3d 125, 128-29 (2d Cir. 2000)).

The Seller argued that the royalty payments did not constitute dischargeable contingent claims because they did not depend solely on extrinsic events over which the debtor had no control, but instead flowed from voluntary actions taken by the debtor – e.g., its decision whether to market and sell Acthar Gel at all, and if so under what conditions. The court rejected this proposed distinction, explaining that limiting dischargeable claims to those depending largely on the debtor's voluntary actions gave "far too narrow a construction to the word 'contingent.'"[11]

The future royalty payments constituted a key feature of the purchase-price structure under the APA and were clearly in the contemplation of the parties when the APA was signed. Most importantly, the parties' rights and obligations became fixed at the time of the sale under the APA. At that time, Mallinckrodt acquired full title – rather than a license or some other lesser property right; in exchange the Seller received the contractual right to royalty payments, "and having done so, it assumed the risk of Mallinckrodt's creditworthiness."[12]

THE ROYALTY OBLIGATIONS DID NOT CREATE ANY PROPERTY RIGHT OF THE SELLER IN THE TRANSFERRED IP

As an alternative, the Seller argued that by virtue of the royalty obligations it held a property right – as distinct from a contractual claim – in the Acthar Gel IP that could not be "discharged" by confirmation of the plan and thus continuing royalty payments were due so long as Mallinckrodt sold Acthar Gel. The Seller analogized the sale of intellectual property under the APA to sales and leases in the oil-and-gas context, in which the ownership and use of mineral rights may be (depending in large part on the treatment under state law) encumbered by royalty rights that are deemed covenants that "run with the land."[13]

The court held that the "boilerplate" language that the Seller relied upon – a statement that the sale of the IP was "subject to" the terms and conditions of the APA – was only general language that could not be construed to override or conflict with the very specific terms of the APA.

Specifically, it did not override the provisions that set out the structure of the purchase price, including the payment of royalties, and the exchange of that price in return for the full and unconditional ownership of the IP. There was thus no basis in the text of the APA that supported the purported property interest in favor of the Seller.

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[11] Id.

[12] Id.

[13] Id.

UNSECURED CONTINGENT ROYALTY RIGHTS WOULD BE ESTIMATED TO FIX THE CLAIM AMOUNT

The Seller only had an unsecured prepetition claim against the estate, but it still had the right to have the value of the entire future royalty stream valued for purposes of calculating its claim. How should it be valued? As the district court pointed out, the Bankruptcy Code expressly addresses this situation. Section 502(e) authorizes the bankruptcy court to "estimate" contingent or unliquidated claims for purposes of fixing distribution amounts under a plan. The court acknowledged that the estimation process "is certainly not certain," but the bankruptcy court could presumably extrapolate past sales to estimate the present value of the unsecured claim for future royalties.[14]

APPEAL TO THIRD CIRCUIT

The Seller has appealed the district court's decision to the Third Circuit. Although this further appeal remains in its early stages, in its initial filings, the Seller identifies the issue on appeal as whether "a reorganized debtor's voluntary, post-confirmation conduct under a non-executory contract gives rise to a post-confirmation obligation that is not discharged under a Chapter 11 plan."[15]

TAKEAWAYS

The *Mallinckrodt* decision highlights the bankruptcy issues that an investor needs to assess as it considers the value of an unsecured right to future royalty or other payments related to the development and sale of products backed by valuable IP.

- Contingent future payment rights could be considered dischargeable prepetition claims.
- A transfer of IP subject to contingent "royalty" rights will not vest any property rights in the seller unless the transaction documents expressly and legally provide for such a right.
- The buyer/owner of the IP post-bankruptcy may be able to continue to use and monetize the IP without making the required future payments.

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[14] Id.

[15] See Appellant's Concise Summary of the Case, Dkt. No. 13, Case 23-1111 (3d Cir. Feb. 6, 2023). The Seller also asserts on appeal that the bankruptcy court entered an inconsistent ruling under the "law-of-the-case" doctrine because it had ruled that certain antitrust claims related to sale of Acthar Gel arose at the time of each sale, despite the anti-competitive conduct occurring prepetition.

The district court itself noted a couple of structuring points that could have led to a better outcome for the Seller.[16] These points can be generalized to other transactions in which a contingent future payment right constitutes a material part of the exchange.

- *Secure the Claim*. Take a security interest in the IP that was sold in order to secure the royalty payments. Even though the claim may still be discharged, the investor will have the right to the value of the IP collateral, rather than sharing pro rata with unsecured claimants in what is usually a limited pool of unencumbered assets.
- *Out-License*. Retain ownership of the IP and grant a license that generates royalty payments. If the debtor wants to continue to use the IP, it generally will need to continue to make royalty payments.
- *Joint Venture or Similar Structure*. Form a structure that allows the seller to retain part ownership of the assets while sharing some portion of the profits.

Each of these options, though, carries with it costs and limitations that may not comport with the business objectives in a given deal.

The fundamental takeaway of the *Mallinckrodt* decision is that parties that enter into royalty or revenue interest financings, or other deals with contingent or similar deferred payment rights (whether styled as "royalty" payments or something else), need to work closely with knowledgeable counsel to understand the bankruptcy ramifications of various deal structures.

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[16] Id.

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