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Client Alert Commentary

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Third Circuit Finds Future Royalty Obligations From Sale Transaction Dischargeable in Bankruptcy

The Third Circuit ruled that the obligations are prepetition "contingent and unliquidated" claims that can be discharged in a bankruptcy.

In the chapter 11 bankruptcy of Mallinckrodt plc and certain subsidiaries (*In re Mallinckrodt plc, et al.)*, Judge Dorsey of the US Bankruptcy Court for the District of Delaware ruled that future royalty payments in a prepetition asset purchase agreement were "claims" under the Bankruptcy Code and could thus be discharged upon the debtor's emergence from chapter 11.[1]

Judge Ambro (typically of the Third Circuit, but sitting by designation at the District Court for this appeal) affirmed the ruling.[2] The judge emphasized the broad nature of what constitutes a "claim" and suggested that if counterparties want to better protect themselves, they need to structure the transaction carefully.

On a recent appeal, a Third Circuit panel unanimously affirmed the District Court.[3] The Third Circuit agreed with Judge Ambro's reasoning and "rel[ied] on the regular rule: most contract claims arise when the parties sign the contract." The decision sets a new precedent in the Third Circuit on when a contract-based claim arises — one consistent with prior Third Circuit *dicta*.

Latham represented the Mallinckrodt debtors in the appeals and in the chapter 11 bankruptcy case.

The Royalty Agreement

Mallinckrodt plc and its direct and indirect subsidiaries (collectively, Mallinckrodt) produce and sell generic and branded pharmaceutical products.

In 2001, Mallinckrodt's predecessor entered into an asset purchase agreement, under which Mallinckrodt purchased the seller's intellectual property related to Acthar Gel™, as well as certain related assets. In exchange for that intellectual property, Mallinckrodt agreed to pay the counterparty (a) an up-front fee of $100,000 and certain inventory costs, plus (b) an annual royalty based on Acthar Gel sales. In connection with that agreement, Mallinckrodt granted the counterparty a security interest in the Acthar Gel intellectual property to secure the counterparty's up-front consideration — but not the royalty amounts. Over the years following the transaction, Acthar Gel became a very profitable product for Mallinckrodt.

Chapter 11 Bankruptcy Case

Nearly 20 years later (in 2020), various Mallinckrodt entities (the Debtors) voluntarily filed for chapter 11 bankruptcy protection in the US Bankruptcy Court for the District of Delaware.

The Bankruptcy Code (title 11 of the United States Code) grants a chapter 11 corporate debtor a discharge of nearly all claims that arose *prior* to the time the debtor's chapter 11 plan takes effect. Claims that arise *after* the discharge, however, typically must be paid in full as obligations of the "new" reorganized company.

In the Debtors' case, the Bankruptcy Court (Judge Dorsey) held that the counterparty's claims under its royalty contract were *prepetition* claims — even the counterparty's right to *future* royalties based on *future* sales. And thus, those claims could be discharged upon the Debtors' emergence from bankruptcy. The counterparty appealed the ruling to the District Court.

District Court Affirms Bankruptcy Court

Judge Ambro affirmed the Bankruptcy Court's ruling. Judge Ambro explained that the Bankruptcy Code defines a "claim" very broadly, as a "*right to payment* whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, *contingent*, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured" (emphasis added).[4]

This definition led to the overarching question: Did the counterparty have a "contingent" "right to payment" of royalties for post-bankruptcy sales, as of the date that the Debtors filed bankruptcy?

Judge Ambro first found that the counterparty's "claims for future royalty payments were plainly contingent" because they "depended on sales of Acthar Gel […] which in turn depended on several other [business] factors." This finding was made despite the counterparty's argument that a claim should not be considered "contingent" if the contingencies involved were in the debtor's control.

He then turned to whether the counterparty's royalty claims arose in 2001 when the parties entered the purchase agreement or instead arise in each year in which the royalty payments are triggered. Calling the answer "easy," he ruled that the counterparty's contingent claim for future royalties arose in 2001 when the parties entered into the purchase agreement — because "it is at that moment the parties fixed their rights against each other: [the counterparty] sold full title to the intellectual property, it received a right to future contingent payments in return, and having done so, it assumed the risk of Mallinckrodt's creditworthiness."

Judge Ambro thus affirmed the Bankruptcy Court's ruling. In closing, and in response to the counterparty's argument that such a ruling was unfair, Judge Ambro "flip[ped] the script" and explained that continuing the royalty obligations after bankruptcy would be unfair, because that "would give [the counterparty] special treatment over other unsecured creditors for which it did not bargain."

Third Circuit Affirms, Establishing Clear Default Rule for Contract Claims

A three-judge panel from the US Court of Appeals for the Third Circuit unanimously affirmed the District Court's and Bankruptcy Court's rulings. The Third Circuit held that the counterparty's claim was "contingent" because the future royalties were contingent on (i.e., depended on) future sales. And the counterparty's claim was "unliquidated" because the amount was unknown. Because the definition of "claim" in the Bankruptcy Code includes both "contingent" and "unliquidated" rights to payment, the counterparty's right to future royalties was a claim subject to discharge.

Distinguishing the counterparty's contract claim from tort claims, the Third Circuit "rel[ied] on the regular rule: most contract claims arise when the parties sign the contract." The court, partly in response to the counterparty's arguments, previewed that exceptions may exist to that default rule — for example, if the "debtor's post-bankruptcy conduct is so unexpected that the contract could not give the creditor notice" or if the "debtor games bankruptcy, wielding it as both a sword and a shield." But the court held that neither exception existed here.

Practice Tips

Bankruptcy can lead to severe consequences for creditors, particularly with respect to payment obligations. Companies and professionals should consider these consequences, especially when negotiating contracts that involve significant future payment obligations. The way a transaction is structured can affect whether those obligations survive a bankruptcy or are eliminated.

In their rulings, the Third Circuit and Judge Ambro offered suggestions on various transaction structures that might have protected the counterparty and which could potentially protect other parties from facing a similar outcome. For example, parties should consider:

- taking a security interest to secure the future payment obligations;
- structuring the transaction as a license; or
- forming a joint venture to retain part ownership of the assets.

Contracting parties that arrange these protections (and perhaps others) should not be impacted by the Third Circuit's decision. But the Mallinckrodt transaction was a purchase-and-sale transaction, with no protections like the above afforded to the royalty obligation in the parties' contract. Therefore, Mallinckrodt's bankruptcy, filed nearly 20 years after the royalty agreement was signed, indicates that proper protective structuring (or, at a minimum, risk awareness for the transacting parties) remains critical even if the paying party shows no financial distress, as bankruptcy may nonetheless occur down the road.

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Endnotes

[1] *In re Mallinckrodt plc, et al.*, Case No. 20-12522-JTD (Bankr. D. Del.), Docket No. 5210 (Nov. 8, 2021).

[2] *In re Mallinckrodt plc, et al.*, Case No. 21-1636-TLA (D. Del.), Docket No. 32 (Dec. 20, 2022).

[3] *In re Mallinckrodt plc, et al.*, Case No. 23-1111 (3d Cir.), Docket No. 39 (April 25, 2024).

[4] 11 U.S.C. § 101(5).