In re Mallinckrodt Update—Third Circuit Agrees with Lower Courts: Royalty Obligations Not Tied to IP License Are Dischargeable Unsecured Claims

ALERT

MAY 9, 2024

In re Mallinckrodt Update—Third Circuit Agrees with Lower Courts: Royalty Obligations Not Tied to IP License Are Dischargeable Unsecured Claims

May 9, 2024, *Covington Alert*

As we previously reported in **Royalty Rights as Unsecured Claims: The Relevance of Mallinckrodt to M&A, Revenue or Royalty Interest Financings, and Other Transactions Involving Future Payment Streams**, a decision arising out of the Mallinckrodt plc bankruptcy cases**[1]** had 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%.

The United States Court of Appeals 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 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."**[3]** 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. [. . . .]

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 Covington's updated review of publicly available **synthetic royalty deal structures** shows 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.

If you have any questions concerning the material discussed in this client alert, please contact the members of our Bankruptcy and Finance practices.

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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, WL 1786660 (April 25, 2024).

[3] *Id.* at *2.

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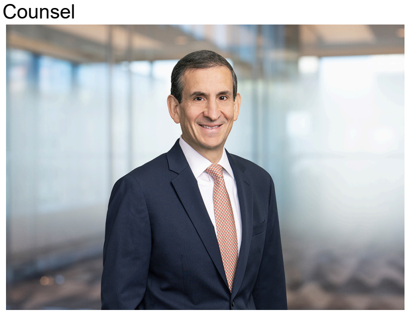

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