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In re Weinstein and *Mallinckrodt*: Implications for Royalty Financings, M&A Earn-Outs, and Other Transactions Involving Future Payment Obligations

By Richard G. Gervase, Jr., Eric R. Blythe and William W. Kannel*

In this article, the authors explore a recent decision by a federal circuit court of appeals that a creditor's right to future royalty payments in a non-executory contract could be discharged in the counterparty-debtor's bankruptcy.

Deal structure matters, particularly in bankruptcy. The U.S. Court of Appeals for the Third Circuit recently ruled that a creditor's right to future royalty payments in a non-executory contract could be discharged in the counterparty-debtor's bankruptcy. The decision highlights the importance of properly structuring mergers and acquisitions, earn-out, and royalty-based transactions to ensure creditors receive the benefit of their bargain – even (or especially) if their counterparty later encounters financial distress.

BACKGROUND

In the Chapter 11 bankruptcy of Mallinckrodt plc and 63 of its subsidiaries (Debtor), the Debtor sought to discharge its obligation to continue paying royalty payments after it emerged from bankruptcy. The obligation arose from a transaction that occurred nearly 20 years before the bankruptcy filing, whereby the Debtor purchased from the counterparty under an Asset Purchase Agreement (APA) certain assets relating to the counterparty's Acthar Gel product, including trademarks, the New Drug Application for Acthar Gel, inventory, and know-how (collectively, the Acthar Gel IP) in exchange for a $100,000 up-front payment and a perpetual 1% royalty of all annual net sales of Acthar Gel in excess of $10 million per year. Critically, the counterparty received a purchase money security interest in the Acthar Gel IP to secure the $100,000 payment, but not the perpetual royalty. The drug was incredibly successful, with annual sales hitting almost $1 billion by 2019. But in 2020, after facing enormous liabilities stemming from numerous opioid-related lawsuits, the Debtor filed for Chapter 11 bankruptcy.

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BANKRUPTCY COURT PROCEEDINGS

One of the central issues in the Mallinckrodt bankruptcy, at least according to the counterparty, was whether the APA was an executory contract or a non-executory contract. Executory contracts are contracts where the debtor and the non-bankrupt counterparty each have material obligations left to perform as of the bankruptcy filing. The Bankruptcy Code provides a debtor with the flexibility to assume (i.e., continue) or reject (i.e., breach) executory contracts. To assume an executory contract, the debtor must cure existing defaults and put the contract in the same place as if the bankruptcy never happened. Some courts have found it helpful to view executory contracts "as a combination of assets and liabilities to the bankruptcy estate: the performance the non-bankrupt owes to the debtor constitutes an asset, and the performance the debtor owes to the non-bankrupt is a liability."[1] Non-executory contracts, on the other hand, are those in which one party has performed all material obligations and the other has not. Where the debtor has performed all material obligations but the counterparty has not, the contract is not executory and can be viewed as only an asset of the estate with no liability. Conversely, where the non-bankrupt counterparty has performed all material obligations but the debtor has not, the contract is also not executory and can be viewed only as a liability of the estate with no asset value.

During the bankruptcy proceedings, the Debtor filed its plan of reorganization seeking to discharge The counterparty's perpetual royalty on future sales

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[1] In re Columbia Gas Sys. Inc., 50 F.3d 233, 238 (3d Cir. 1995) (citing Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 106-07 (1986)) (Columbia). The Third Circuit further elaborated in Spyglass Media Group, LLC v. Bruce Cohen Productions (In re Weinstein Co. Holdings), 997 F.3d 497 (3d Cir. 2021)(Weinstein):

> Under this framework, a contract where the debtor fully performed all material obligations, but the non-bankrupt counterparty has not . . . that contract can be viewed as just an asset of the estate with no liability. Treating it as an executory contract risks inadvertent rejection because the debtor would in effect be giving up an asset by rejecting it. . . . On the other extreme, where the counterparty performed but the debtor has not, the contract is also not executory because it is only a liability of the estate. . . . Treating it as an executory contract risks inadvertent assumption, for the debtor would effectively be agreeing to pay the liability in full when the counterparty should instead pursue the claim against the estate like other (typically unsecured) creditors. It logically follows that "where the only remaining obligation is the [debtor's] ability to pay" – the contract is not executory. Thus, only where a contract that has at least one material unperformed obligation on each side – that is where there can be uncertainty if the contract is a net asset or liability for the debtor – do we invite the debtor's business judgment on whether the contract should be assumed or rejected." Id. at 504-505 (citations omitted).

while at the same time continuing to sell Acthar Gel royalty-free upon emerging from bankruptcy.[2] The Debtor listed the APA on its schedule of executory contracts that the Debtor planned to reject. The counterparty filed a motion seeking a determination that either (i) the APA is a non-executory contract and the Debtor cannot discharge royalty payments that arise post-bankruptcy, or (ii) the APA is an executory contract and (if the bankruptcy court authorizes Debtors to reject the APA) Debtors can no longer sell the Acthar product.

The Debtor filed an objection to the counterparty's motion, asking the court to determine that the counterparty's claims for royalty payments due for past or future sales under the APA were pre-petition claims subject to discharge under the Bankruptcy Code because the counterparty was not presently conferring any right on the Debtor to sell Acthar and had no right to stop the Debtor from selling Acthar based on the Debtor's breach of the APA by non-payment of royalties.

The bankruptcy court agreed with the Debtor and denied the counterparty's motion, ruling that:

i. The APA was not an executory contract for purposes of Section 365 of the Bankruptcy Code and cannot be rejected under Section 365 of the Bankruptcy Code; but

ii. That the counterparty's claims for post-petition date breaches of the APA, including the failure by the Debtor to pay royalties thereunder, resulted in only pre-petition unsecured claims that may be discharged on confirmation of the Debtor's plan of reorganization.

The bankruptcy court recognized that the Third Circuit had addressed a similar issue in another context and had concluded that "[i]n cases where the non-bankrupt party [h]as fully performed it makes no sense to talk about assumption or rejection. At that point a liability exists for the debtor, a simple claim held by the non-bankrupt against the estate. . . ."[3] Accordingly, the bankruptcy court concluded that "[w]hile the right to payment under the APA may accrue post-petition, any claims arising from the APA are pre-petition general unsecured claims."

Importantly, the bankruptcy court also recognized that "[the counterparty] did not retain any type of ownership interest in the Acthar Gel IP" because "the contract at issue is not a license, but rather was an outright sale of Acthar and

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[2] In a Chapter 11 bankruptcy, pre-petition [unsecured] claims arising before confirmation of the debtor's plan of reorganization generally can be discharged, allowing the debtor to emerge from bankruptcy with a fresh start free from liability from such claims.

[3] In re Columbia Gas Sys. Inc., 50 F.3d 233, 239 (3d Cir. 1995).

all related assets that was consummated pre-petition." As a result, the bankruptcy court held that the pre-petition contractual claims "are subject to discharge under the debtor's proposed plan."

DISTRICT COURT APPEAL (D. DEL.)

The counterparty appealed to the district court, accepting that the APA was not executory but challenging the bankruptcy court's determination that its claims for future royalties under the APA were contingent claims that were dischargeable. The counterparty argued that the bankruptcy cannot discharge the Debtor's royalty obligation because no "claim" exists unless and until the Debtor voluntarily sells Acthar Gel after exiting bankruptcy and that in order to be a dischargeable contingent claim, "[the] contingent claim must be contingent on something other than debtor's own future conduct and must depend on events beyond the debtor's control)."[4] As an alternative, The counterparty argued that that it retained a property interest in the Acthar Gel IP.

The district court (Judge Ambro of the Third Circuit, sitting by designation) affirmed the bankruptcy court, holding that the counterparty's rights to post-petition royalty payments under the APA are contingent claims that arose before the Debtor's bankruptcy filing that could be discharged upon confirmation of the Debtor's plan of reorganization. The district court looked first to the relevant statutes. The Bankruptcy Code provides that confirmation of a plan of reorganization "discharges the debtor from any debt that arose before the date of such confirmation."[5] The Bankruptcy Code defines "debt" as any "liability on a *claim*," and "claim," in turn, is defined 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."[6] The court concluded that "[p]ut together, the takeaway is that a contingent right to payment arising before the date of the plan's confirmation may be discharged by that confirmation."

Thus, the counterparty's rights to future royalties boiled down to two issues: (a) whether the counterparty's claim for future royalties was a contingent claim

[4] According to the counterparty, "If a creditor's claim depends on the debtor's voluntary future conduct, that is not a pre-confirmation contingent claim at all, given that it will exist solely at the discretion of the debtor. The debtor decides whether to incur a new liability by selling the product, or to avoid future liability by not selling the product."

[5] See 11 U.S.C. § 1141(d)(1)(A).

[6] See 11 U.S.C. §§ 101(12); 101(5) (emphasis added).

(the counterparty argued that it was not), and (b) if so, whether that contingent claim arose before the plan's confirmation (the counterparty argued that it did not).

The Counterparty's Claim for Future Royalties is a Contingent Claim

In rejecting the counterparty's argument that its claims for future royalties should not be considered 'contingent,' the district court relied on the Second Circuit's decision in *Olin Corp.*, wherein the court stated that "in the context of a contract claim, . . . contingent claims refer 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 the original relationship between the parties was created*."[7] Applying *Olin* to the instant case, the court found:

> [The counterparty]'s claims for future royalty payments were plainly contingent. They depended on sales of Acthar Gel reaching the threshold that triggered the payments, which in turn depended on [Debtor's] ability to sell the product, customer demand, and the lack of external events making sales difficult or impossible (like regulatory obstacles for instance). Further, the APA parties clearly contemplated the possibility of future royalties when the APA was signed pre-petition.

The Counterparty's Contingent Claim for Future Royalties Arose Pre-Petition Upon Execution of the APA

The court noted that a tougher question, at least at first glance, was whether the counterparty's claims for royalties arose at the time the APA was signed or instead arose in each year the sales threshold is reached, triggering the royalty payments. While the court acknowledged that the Third Circuit had never directly dealt with the issue and that other courts are not unanimous in their treatment of whether claims for post-confirmation breaches of pre-petition contracts are pre- or post-bankruptcy, the court found persuasive the analogous case of *In re Grossman's*,[8] where the Third Circuit held that for bankruptcy purposes, "a [tort] 'claim' arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury . . . [that] underlies a 'right to payment."[9] Thus, where the creditors' were exposed to debtor's asbestos-

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

[8] In re Grossman's, 607 F.3d 114 (3d Cir. 2010).

[9] Id. at 25.

containing products before the bankruptcy, their personal injury claims arose for bankruptcy purposes at the time of exposure even if their injuries appeared only later. In so holding, the *Grossman's* court expressly overruled *In re Frenville*, which held that a tort "claim" arises under the Bankruptcy Code when the cause of action accrues under state law (i.e., when the injury manifests, which can be long after the tortious conduct occurred). According to the court, it did so because *Frenville*'s rule was "universally rejected" as conflicting with the Bankruptcy Code's broad definition of "claim."

Relying on *Grossman's*, the court concluded that the counterparty's contingent claim arose at the time the parties entered into the APA:

> [The counterparty]'s contingent claim for future royalties arose at the time of the sale of the Acthar Gel IP under the APA. It is at that moment the parties fixed their rights against each other: [The counterparty] sold full title to the intellectual property, it received the right to future contingent payments in return, and having done so, it assumed the risk of Mallinckrodt's creditworthiness. . . . That the Royalty's amount was meant to track the future success of the product (and thus depended on it) does not transform it from a contingent claim for future payments to one that survives discharge and received special priority over other unsecured claims. And by analogy to the tort context in *Grossman's*, it is no matter that a state law cause of action would accrue only when Mallinckrodt failed to make a payment in a given year.

In so ruling, the court rejected the counterparty's reliance on the Third Circuit case *Weinstein*.[10] *Weinstein* involved whether a work-for-hire contract between a producer (Cohen) and a bankrupt movie company (i.e., the debtor) was an executory contract. The Cohen contract provided that the bankrupt movie company would own all of the intellectual property in the motion picture, and, in return, pay Cohen an up-front fee and a 5% royalty on the picture's net profits. At issue in *Weinstein* was whether the proposed buyer of the Cohen contract must cure existing defaults before the sale's closing.[11] If the

[10] Spyglass Media Group, LLC v. Bruce Cohen Productions (In re Weinstein Co. Holdings), 997 F.3d 497 (3d Cir. 2021).

[11] Whether a contract is executory or non-executory has significant implications in a bankruptcy sale. To assume an executory contract, a debtor must cure existing defaults and put the contract in the same place as if the bankruptcy never happened. In practice, an executory contract can be "assumed" and then "assigned" under § 363 of the Bankruptcy Code to a buyer, provided all existing defaults are cured. A non-executory contract, on the other hand, can be sold under § 363 to a buyer, who must satisfy post-closing obligations but need not worry about

Cohen contract were executory and assumed and assigned to the buyer under § 363 of the Bankruptcy Code, the buyer would be responsible for approximately $400,000 in pre-petition unpaid royalties. If the buyer instead purchased the Cohen agreement as a non-executory contract under § 363, the buyer would be responsible only for obligations (including the royalty payments) on a go-forward basis after the sale closed. The *Weinstein* court found the Cohen contract to be non-executory because Cohen had fully performed all of his obligations under that agreement.

The counterparty argued that because the non-debtor buyer in *Weinstein* was required to pay an ongoing royalty to Cohen under a non-executory contract that it purchased from the bankruptcy estate, the royalty payable under the APA should also survive. The court rejected this argument because the non-debtor buyer in Weinstein voluntarily assumed an obligation to Cohen under the Cohen agreement. The court pointed out that, importantly, "[i]f no buyer came forward, [Cohen] would only have an unsecured claim against the debtor, on which it can typically expect to recover merely cents on the dollar."[12] Because there was no buyer of the Debtor's interest under the APA, the counterparty was left with a claim against the Debtor.

The Counterparty Had No Property Interest in the Acthar Gel IP

The court next addressed the counterparty's alternative argument that the counterparty retained a property interest in the Acthar Gel IP that is not severable by the bankruptcy and requires any owner to pay the royalty. The counterparty claimed that its interest was created by language in the APA that says the "sale" of the Acthar Gel IP was "subject to the terms and conditions of [the APA]," which includes the obligation to pay the royalty. Analogizing to the oil-and-gas context where many state statutes recognize royalties from oil and gas leases as real property interests,[13] the counterparty suggested its royalty interest was akin to a covenant that "runs with the land." The court rejected this argument, characterizing the "subject to" language in the APA as "boilerplate" that was far too general to create a property right in the Acthar Gel IP (assuming that was even possible). Thus, the court found the counterparty's royalty to be "merely a contractual right to a deferred portion of a purchase price contingent on future sales."

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pre-closing breaches or defaults, which typically remain unsecured claims against the estate.

[12] Weinstein, at 506.

[13] See, e.g., In re Ursa Operating Company, LLC, __ F.3d __, 2023 U.S.App. LEXIS 31759 (3d Cir. Dec. 1, 2023).

Fairness Concerns Weigh Against the Counterparty

Finally, the court addressed the counterparty's argument that it would be unfair to allow the Debtor to continue selling Acthar Gel without paying royalties to the counterparty. The court was not persuaded:

> That argument flips the script, for to allow the Royalty to survive discharge would give [the counterparty] special treatment over other unsecured creditors for which it did not bargain. For example, it could have sought to protect itself against a potential [Debtor] bankruptcy by taking a security interest in the assets sold to secure the Royalty payments (like it did for the Up-Front Consideration), structuring the transaction as a license, or even forming outside bankruptcy a joint venture to retain part ownership of the assets. Because it failed to do so, [the counterparty]'s fairness arguments fall flat against the Bankruptcy Code's theme of a "fresh start."

THIRD CIRCUIT APPEAL

The counterparty appealed to the Third Circuit, arguing that the future royalties were too indefinite to be a claim subject to discharge because one never knows in advance whether there will be any royalties or how much they will be. The Third Circuit rejected this argument for largely the same reasons as the lower courts, finding that the counterparty's claim, while not yet defined and liquidated, clearly fell within the Bankruptcy Code's broad definition of "claim," which specifically contemplates contingent and unliquidated claims, and like most contract claims, arose at the time of the agreement. Accordingly, the Third Circuit ruled that the counterparty was an unsecured creditor whose claim to future royalties could be discharged in the Debtor's bankruptcy.[14]

CONCLUSION

These decisions should be a reminder to M&A, finance professionals, and their clients of the importance of security and ownership in a bankruptcy context. The Third Circuit reinforced this by emphasizing that there were numerous ways the counterparty could have protected itself, including:

(1) By licensing the rights to the drug (as opposed to selling it);

(2) By securing the royalty stream with the Acthar Gel IP (as opposed to

[14] The counterparty did not appeal the lower courts finding that the counterparty has no property right in the Acthar Gel IP.

securing just the up-front payment); or

(3) By retaining an ownership interest in the drug (including through a joint venture with the Debtor).