

Lawyer Insights

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey
Published in Law360 | August 5, 2024



In its April *In re: Mallinckrodt PLC* decision, the U.S. Court of Appeals for the Third Circuit held that Mallinckrodt could discharge its obligation to pay future royalties to Sanofi-Aventis US LLC, a drug developer that sold "the rights to the drug outright" to Mallinckrodt for \$100,000 up front and a promise to pay a one percent royalty on all net sales over \$10 million a year in perpetuity.¹

The Third Circuit emphasized in its decision that drug developers may protect themselves from this fate by structuring such transactions differently. Specifically, the court wrote: "[t]o protect itself, [the drug developer] 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."²

This article will explain what sort of protections the drug developer would have had if, as the Third Circuit suggests, it structured similar transactions as a license — particularly as a nonexclusive license.

Ultimately, this article serves to inform developers of intellectual property to make sure to structure their transactions with bankruptcy considerations in mind.

The Contractual Problem in Mallinckrodt

Contracts in Bankruptcy

To understand the Third Circuit's decision in *Mallinckrodt*, it is helpful to give a short primer on contracts in bankruptcy.

One of the many considerations for an entity contemplating filing for bankruptcy is Section 365 of the U.S. Bankruptcy Code. Section 365 provides an entity-turned-debtor the power to "assume" or "reject" executory contracts or unexpired leases.³

Through this power, the debtor can keep in place executory contracts or unexpired leases it sees as favorable (so long as it cures most defaults, including monetary defaults) and leave behind others it sees as unfavorable — though the contract counterparty gets to file a rejection damages claim against the debtor.

This power, however, is not unlimited. Initially, Section 365 applies only to executory contracts and unexpired leases.

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey

Published in Law360 | August 5, 2024

A contract is executory if "under the relevant state law governing the contract, each side has at least one material unperformed obligation as of the bankruptcy petition date."⁴ If a contract is not executory, it cannot be assumed or rejected and will simply give rise to a claim — either for or against the debtor's estate.⁵

Further, Section 365 provides that the debtor must exercise this right within certain time limits and the subject contracts must be assumed or rejected in whole — not in part.⁶

The Third Circuit's Opinion

The Third Circuit's opinion points out how the drug developer's transaction in Mallinckrodt failed to take the bankruptcy contract rules discussed above into account.

The opinion mourns the drug developer's choice to structure its transaction with the debtor in such a way that it "[left] itself with only a contingent, unsecured claim for money."⁷

As the Third Circuit noted early in its opinion, the U.S. Bankruptcy Court for the District of Delaware and the U.S. District Court for the District of Delaware found that because the drug developer "had fully performed its side of the bargain by transferring ownership outright decades earlier, the contract was not executory."⁸

This ruling, which the Third Circuit agreed with, left the drug developer with virtually no choice but to argue that its future right to payment did not fall within the Bankruptcy Code's broad definition of a claim, and alternatively, if it did, the claim did not arise prepetition. The Third Circuit, as expected, was not persuaded by these tenuous arguments.

The Third Circuit readily dismissed the drug developer's argument that the right to receive future royalties was too indefinite to be considered a claim, emphasizing that the Bankruptcy Code's broad definition of "claim" in Section 101(5)(A) includes a "contingent and unliquidated" claim.⁹

The court explained that the right to receive future royalties was both contingent and unliquidated because the claim only accrued upon the triggering event of \$10 million in net sales each year, and the claim amount — i.e., the total amount of royalties to be paid out — was undeterminable.¹⁰

The Third Circuit also dismissed the drug developer's argument that its right to receive future royalties did not arise prepetition because the triggering event — i.e., the company reaching \$10 million in net sales each year — had not yet occurred, emphasizing that a claim can arise before it is triggered.¹¹

The court was not persuaded by the drug developer's attempt to analogize its contract claim to a tort claim, which requires that prebankruptcy exposure to the injurious conduct is found to be a prepetition claim.¹² The court found this analogy inapt, and stated it would follow the "regular rule ... [that] most contract claims arise when the parties sign the contract."¹³

Relying on this rule, the court held that the drug developer's claim arose prepetition when it signed the contract because the time of signing is when parties fix their liability — even if it is still unliquidated or contingent.¹⁴

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey

Published in Law360 | August 5, 2024

In summary, the Third Circuit concluded that the transaction structure failed to take into account these bankruptcy contract considerations, which left the debtor free to discharge its obligation to pay future royalties and continue selling the drug.

The Difference a Nonexclusive License Would Have Made

As the Third Circuit noted, "[t]o protect itself, [the drug developer] could have ... licensed the rights to the drug[.]"¹⁵

A general bankruptcy benefit of structuring a sale of intellectual property as a license is that courts generally characterize licenses as being executory in nature due to the ongoing obligations licenses impose on both licensors and licensees.¹⁶

Despite this general rule, however, courts do not always find licenses to be executory. Thus, due to this potential risk, and as discussed below, structuring a sale as a nonexclusive license is normally less risky than structuring it as an exclusive license.

In licensing intellectual property, the licensor can choose between two structures: exclusive and nonexclusive.

An exclusive license is one in which the licensor gives the licensee the sole ability to use the intellectual property to the exclusion of itself and third parties. Courts evaluating exclusive licenses have reasoned that, in certain instances, such licenses can resemble a sale due to the large portion of rights the licensor transfers under such licenses and, as such, can be found not to be executory.¹⁷

Therefore, if a debtor-licensee were to seek to continue to use the intellectual property in a scenario in which the exclusive license was found to resemble a sale, Section 365 would not require the debtor-licensee to assume the exclusive license, cure any monetary defaults or continue to pay royalties.

Conversely, a nonexclusive license is one in which the licensor gives the licensee the ability to use the intellectual property but does not exclude third parties nor itself from using the intellectual property. Nonexclusive licenses of intellectual property are almost always considered by courts to be executory contracts because they do not involve the licensor transferring a large portion of its rights.¹⁸

As such, if a debtor-licensee were to seek to continue to use the intellectual property in a nonexclusive license scenario, Section 365 would require the debtor-licensee to assume the nonexclusive license, cure all existing monetary defaults, and continue to perform in the future by, inter alia, paying any ongoing royalties to the licensor.

Thus, drug developers would likely benefit from structuring their transactions as nonexclusive licenses, as such licenses, due to their more clear executory nature, usually force debtors to either assume or reject the contract.

Put to this choice, a debtor would likely be reluctant to reject the contract as doing so would deprive it of the right to sell the drug, which in the case of the debtor in Mallinckrodt "hit almost one billion dollars" in sales prior to the bankruptcy.^{19 20}

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey

Published in Law360 | August 5, 2024

Key Takeaways

The Third Circuit's Mallinckrodt decision provides the following key bankruptcy takeaways for developers of intellectual property.

Developers of intellectual property may be left exposed in the event of a contract counterparty bankruptcy if they do not carefully structure their transactions with bankruptcy in mind.

Specifically, the Mallinckrodt decision highlights the risk of structuring a grant of intellectual property rights in a way that allows the debtor contract counterparty to argue that one or more parties to the contract have no material obligations left to perform under the agreement underlying the grant of rights — i.e., that the contract underlying the transaction is not executory.

Developers of intellectual property can consider what transaction structures to use, depending on the situation, to position themselves to receive the available protections of the Bankruptcy Code.

One example of such a transaction structure, depending on the situation, is a nonexclusive license, which allows the developer to grant certain rights in the intellectual property, retain certain rights in the intellectual property and receive bankruptcy protections in the event the contract counterparty files for bankruptcy.

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey

Published in Law360 | August 5, 2024

Notes

1. In re Mallinckrodt PLC , 99 F.4th 617, 620 (3d Cir. 2024).
2. Id. at 622.
3. 11 U.S.C. § 365(a).
4. In re Weinstein Co. Holdings LLC , 997 F.3d 497, 504 (3d Cir. 2021).
5. See id. at 504–05 (explaining that if a debtor or counterparty has fully performed so as to make the subject contract nonexecutory, then the contract simply becomes an asset or liability of the estate).
6. See 11 U.S.C. § 365(d); Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984) ("a debtor may not assume the favorable aspects of a contract . . . and reject the unfavorable aspects of the same contract . . .").
7. Mallinckrodt, 99 F.4th at 622.
8. Id. at 620.
9. Id. at 621.
10. Id.
11. Id.
12. Id.
13. Id.
14. Id.
15. Id. at 622.
16. In re Kmart Corp. , 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code . . . [and] can impose any number of on-going performance obligations on the parties, including responsibilities relating to reporting, labeling, policing, service, maintenance, and technological upgrades").
17. See Kmart Corp., 290 B.R. at 619 ("An exclusive license to use intellectual property . . . may transfer title or ownership to the subject intellectual property. Accordingly, an

3rd Circ. Ruling Shows Benefits Of IP Licenses In Bankruptcy

By Gregory Hesse and Kaleb Bailey

Published in Law360 | August 5, 2024

exclusive intellectual property license would be more likely to constitute a sale because an exclusive license confers upon the licensee (and divests the licensor of) all or some portion of the ownership rights and interests associated with the intellectual property pursuant to well-established principles of patent, copyright and trademark law.").

18. See *Id.* ("A non-exclusive license typically grants a licensee the mere right to use certain intellectual property; the licensor retains the rights and remedies associated with ownership of the intellectual property. An exclusive license to use intellectual property, by contrast, may transfer title or ownership to the subject intellectual property.").

19. *Mallinckrodt*, 99 F.4th at 620.

20. Though not the main focus of this article, drug developers have had an additional benefit if such intellectual property sales are structured as a non-exclusive license. As a general rule, Section 365 overrides any anti-assignment provisions in executory contracts or unexpired leases, and, thus, debtors have the right to freely transfer their contract rights. One of the exceptions to this right is in the context of non-exclusive licenses of intellectual property. If a non-exclusive license of intellectual property includes a clause prohibiting the assignment of the non-exclusive license without the consent of the licensor, Section 365 has been interpreted to make such anti-assignment provisions enforceable in bankruptcy. See e.g., *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300, 310 ("prevailing case law holds that nonexclusive intellectual property licenses do not give rise to ownership rights and cannot, as a matter of law, be assigned without the consent of the licensor").

Gregory Hesse is a partner in the firm's Bankruptcy / Restructuring group in the firm's Dallas office. For the past 35 years, Greg has focused his practice on searching for pragmatic solutions to complex problems in the context of restructuring, insolvency, and bankruptcy. He can be reached at +1 (214) 468-3335 or ghesse@HuntonAK.com.

Kaleb Bailey is an associate in the firm's Bankruptcy / Restructuring group in the firm's Houston office. Kaleb focuses his practice on complex restructuring and bankruptcy matters and related litigation. He can be reached at +1 (713) 220-3604 or kbailey@HuntonAK.com.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.