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Royalty Interest Investing: Addressing the Out-License Assignability Issue

Legal considerations for effectively managing royalty interest transactions.

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The sale of interests in discrete product revenue streams has taken hold as an alternative financing source for holders of biopharmaceutical intellectual property (IP). Holders of these IP assets are often either constrained in their reasonable access to capital (e.g., small fast growing pharmaceutical companies) or limited in their interest in managing an IP portfolio, which may be diffuse or require commercialization beyond the development of the basic science involved (e.g., university medical centers). These sale

transactions fall broadly into two categories: structured sales of portions of future revenues from a specified compound or biopharmaceutical IP asset over a defined field for a specified period of time (revenue interest transactions) and structured sales of future revenues from an existing out-license, typically to a much larger pharmaceutical company (royalty interest transactions). Although these transactions have similar considerations at their core, such as strength of the underlying IP and assessment of the likelihood of longer-term commercial success, they



also present distinct issues from the perspectives of the typical financial investor (the buyer) and the owner of the compound or biopharmaceutical IP asset (the seller).

In royalty interest transactions, a core consideration is the allocation of rights and responsibilities with respect to the specific out-licensing arrangement. The same issue is substantially less significant for revenue interest transactions because they are modeled on the basis of a non-counterparty specific revenue stream and are documented to contain substantial consent protections relative to future out-licensing and other transfer transactions. Therefore, revenue interest transactions are generally independent of risks associated with obligor or counterparty concentration and are not subject to the pre-existing contractual regime present in a typical royalty interest transaction. Below, we examine the practical and legal considerations for evaluating the out-licensing arrangement in a royalty interest transaction, including the allocation of rights and obligations with regards to the out-licensing counterparty (the licensee). We also discuss mitigating considerations for resolving the often competing interests of the buyer and the seller relative to this core arrangement.

ROYALTY INTEREST TRANSACTION

The essence of a royalty interest transaction is the monetization of a generally well described, yet commercially speculative future cash-flow stream, from an existing out-license with an identified licensee of a specified product. From an analytical perspective, valuing the out-license presents two challenges: (1) assessing the likelihood of successful future commercialization by the licensee and (2) determining the rights of an assignee (whether in whole or in part) as a legal matter under the out-license

agreement (especially in relation to the licensee).

The analysis of the likelihood of successful future commercialization involves a combination of regulatory and IP due diligence to assess the likely success of subject IP in the marketplace. From a legal perspective, the focus is on the rights of the assignee (the buyer) under the out-license, including a review of the out-license to determine the scope of the field covered by the out-license to establish the benchmarking against which the competitive landscape can be measured, and the mechanics for determining the amount payable by the licensee to the licensor.

The standard out-license usually contains a broadly drafted, often bilateral, prohibition on assignment (e.g., "... neither party shall assign any of its rights or interests under this [a]greement"). This provision is, at first look, very problematic to the buyer of the subject royalty interest. Although the buyer's principal consideration is its analysis of the likely future cash flows from the out-license, it is necessarily concerned with its ability to ensure that its rights to those cash flows are superior to the rights of the seller and the seller's creditors, with respect to that asset.

The prophylactic measures taken by the buyer include structuring the transaction with the seller to maximize the possibility that the transaction will be treated as a sale rather than as a financing in a seller insolvency proceeding. Usually as a backstop, and less frequently as a primary position, the buyer takes steps to ensure that it enjoys the status of a senior secured creditor with respect to the cash flows.

UNIFORM COMMERCIAL CODE

In certain cases, usually as a result of either structural impediments or tax and accounting considerations, a royalty interest transaction

is structured purely as a secured financing, rather than a sale with a backstopping position as a secured financing. In doing so, the buyer is able to avail itself of the protections afforded by Article 9 of the Uniform Commercial Code (UCC) in dealing with the seemingly problematic anti-assignment provisions of the out-license. The UCC is a set of laws that are enacted in relatively uniform fashion by each of the states for dealing with the rights and obligations of parties to commercial transactions. Article 9 of the UCC deals with the subset of the commercial landscape consisting of secured transactions (dealing with most types of personal property).

Under the UCC, as a contract arrangement, the out-license is likely characterized as a general intangible. *General intangible* is defined in Section 9-201 of the UCC and is a catch-all category for collateral (i.e., if the collateral is personal property that doesn't meet the definitions of the other types of personal property subject to Article 9, in most cases it defaults to the category of general intangible.) If an analysis of the out-license demonstrates that the licensee's principal obligation is a monetary obligation, it will be classified as a special type of general intangible known as a *payment intangible*. This determination is relevant because different sections of Article 9 of the UCC address the anti-assignment problem depending on whether a general intangible is or is not a payment intangible.

The UCC deals with the issue of anti-assignment provisions broadly speaking by permitting the granting of security interests in general intangibles, explicitly including licenses, and other enumerated collateral types and providing that contractual provisions establishing default rights or otherwise prohibiting assignment are ineffective with respect to the granting of a security

interest in the subject agreement. This is shown in Sections 9–406 (dealing with payment intangibles) and 9–408 (dealing with other general intangibles) of the UCC.

These provisions do not, however, entitle the buyer to enforce the out-license. Those rights remain with the seller, where the UCC is concerned. In most out-licenses, the licensee's obligations are not restricted to the payment of money. They involve significant undertakings to commercialize the subject IP, to protect the IP and not transfer or sublicense rights therein, and to use the IP in accordance with applicable laws. If these other obligations are sufficiently broad, the better view is that the out-license is a general intangible and not a payment intangible. However, if the licensee's obligations under the out-license consist principally of a payment obligation, then the out-license would constitute a payment intangible.

The relevant distinction under the UCC between a general intangible

that is a payment intangible and one that is not is that Section 9–406 deals with security interests in payment intangibles and Section 9–408 deals with security interests in general intangibles that are not payment intangibles. These sections operate in a similar fashion. It should be noted that Section 9–408 also deals with sales of as opposed to security interests in payment intangibles.

To deal with the enforcement rights under the out-license, the buyer in a royalty interest transaction must maintain the continued involvement of the seller because the UCC does not render the anti-assignment provisions void relative to enforcement rights. At a practical level, this is often a highly negotiated issue, particularly in circumstances where all or nearly all of the seller's economic interest in the out-license is intended to be acquired by the buyer.

If the seller has no meaningful retained economic interest in the out-license, it has little incentive to

vigorously enforce its rights as putative licensor against the licensee. This problem is ultimately handled either by aligning the seller's interests with the buyer's interests (e.g., creating a concurrent or tail economic interest for the seller) or by specifically negotiating rights of prosecution in the name of the seller for the buyer with appropriate protections, usually in the form of expense reimbursement and indemnification for the seller.

CONCLUSION

As part of an established and growing source of alternative investing, royalty interest transactions draw on multiple analytical and legal disciplines. In dealing with the legal challenge presented by the out-license, the buyer has both legal protections available from the UCC and common structural techniques for maximizing its rights relative to the out-license in relation to the licensee and the seller and its creditors. ♦