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How Biotech Cos. Can Utilize Synthetic Royalty Financing

By **Todd Trattner and Ryan Murr** (February 1, 2024, 5:31 PM EST)

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Following the capital markets boom fueled by the Fed's accommodating monetary policy in 2020 and 2021, the biotech sector suffered nearly a 50% drop over a 12-month period from February 2021 to February 2022, and has generally traded flat, with some dips and spikes, since then through the end of 2023.[1]

Currently, there are more than 220 Nasdaq-listed biotechnology companies with a market capitalization below their net cash balance,[2] reflecting the ongoing negative market sentiment in this sector.

Against this backdrop, most biotechnology companies must continue to raise capital to fund operations and are increasingly seeking structures that are less dilutive for stockholders.

At the same time, institutional investors are increasingly looking for predictable returns that are uncorrelated with the overall stock market and broader economic cycles.

These two objectives have aligned in recent years to drive an increase in royalty financing transactions in the life sciences, including both traditional royalty monetizations and synthetic royalty transactions, or SRTs.

Traditional royalty monetizations have been in existence for several decades, though occupying a relatively small niche in the overall capital planning for biotechnology companies.

In these transactions, a licensor who invented a novel technology sells her anticipated future royalty stream for the risk-adjusted net present value. However, if the inventor has not licensed the innovation to a third party, and thus does not have an anticipated royalty stream from a licensee, a traditional royalty monetization is not an option.

In this case, the innovator may look to pursue an SRT to provide nondilutive capital. Increasingly, we are seeing both biotechnology companies and institutional investors expressing interest in SRTs, despite the fact that they are more complex and frequently riskier than a traditional royalty monetization.

In 2020, while biotech stocks saw increased volatility, the number of SRTs completed by the top royalty funds in the life sciences space increased by 350% year-over-year and steadily increased through 2021, while remaining high through 2023 despite a slight dip as the Federal Reserve began raising interest rates and thus increasing the cost of capital.[3]

Traditionally, SRTs have been styled as funding arrangements or royalty-backed loans,[4] rather than as purchase and sale agreements, with the latter more common in traditional royalty transactions.

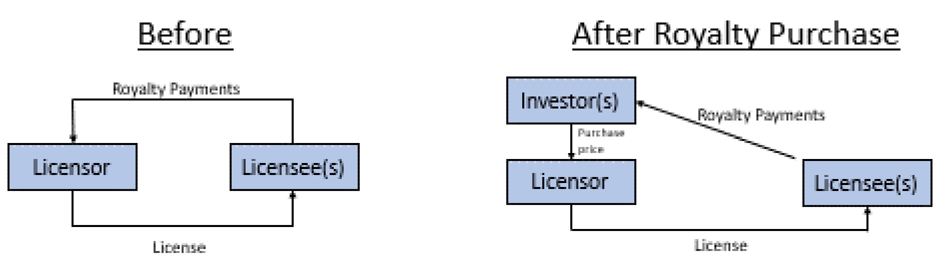
With the development of SRTs structured as true sales, questions have arisen throughout the industry as to what exactly was being sold: Is it an account, a payment intangible, a revenue interest, proceeds from intellectual property, an account receivable, or simply future revenue from sales of products? If the payment obligation does not exist currently, as it does in a traditional royalty transaction, then what exactly is being sold?

To provide context, a traditional royalty transaction is simply a sale of an existing contractual royalty entitlement due under a license agreement. An SRT, on the other hand, is a sale of future revenue generated from future product sales.

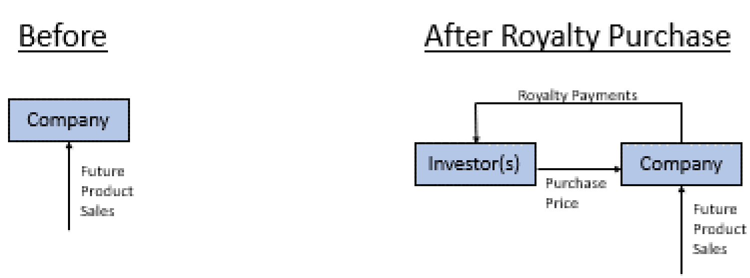
While they are both tied to future product sales, the contractual royalty entitlement sold under a traditional royalty transaction currently exists due to the contractual arrangement between licensor and licensee, whereas there is no royalty entitlement that currently exists with respect to the future product sales sold under an SRT.

The following diagram illustrates the structural difference between a traditional royalty and a synthetic royalty.

Traditional Royalty



Synthetic Royalty



An analysis of the Uniform Commercial Code helps shed light on the above questions. An SRT structured as a true sale is primarily a sale of the right to payments arising from the future sales of products, which the UCC defines as an account. Article 9 of the New York UCC defines an account, in relevant part, as follows:

> "Account" … means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of.[5]

The scope of the provision is quite broad, and encompasses rights to payments for the sale of property, whether arising in the future or currently existing.

Nothing in the definition restricts the property that is to be sold to property that must already be under contract to be sold. It is the "right to payment" that is the operative language, whether currently existing or arising in the future, and not the existence of the property itself or any preexisting contractual rights to payment.[6]

"A sale of accounts, chattel paper, payment intangibles, or promissory notes" are the different types of sales that are covered by Article 9 of the UCC, and as such, are not included in a bankrupt debtor's estate, which provides the investor safeguards in case the company later files for bankruptcy.[7]

Article 9 of the UCC, however, does not delineate when or how a particular transaction is classified as a true sale versus being characterized as a loan, which depends on several factors that generally reflect how risk is allocated among the parties. In general, for a transaction to be considered a true sale, the investor should retain most of the risk associated with the asset.

In case the transaction is recharacterized from a true sale to a loan in a bankruptcy proceeding, most royalty purchasers will seek a backup security interest in at least the acquired royalties, and in certain cases, they will also seek a backup security interest in the underlying intellectual property, regulatory approvals and other assets related to the product generating the royalties in order to more comprehensively secure their claim.

In order to avoid such potential recharacterization, parties to a royalty financing transaction should carefully consider the structure of the transaction, and whether it will be respected as a true sale in a bankruptcy proceeding, as just labeling it a true sale is not sufficient.

This issue was recently litigated in CapCall LLC v. Foster (In re: Shoot the Moon) in 2021, in which the U.S. Bankruptcy Court for the District of Montana considered whether the cash advance company CapCall's acquisition of Shoot the Moon's receivables was not a true sale, but in fact was a loan, as was argued by the bankruptcy trustee. The court agreed with the bankruptcy trustee and held that simply calling a transaction a true sale does not make it so.[8]

Rather, the court focused its discussion around a fact-intensive investigation of factors representing the totality of the circumstances.[9] The court found that a common consideration underlies all of the factors — how the parties allocate risk, with the risk of loss transferring to the buyer in a sale.[10]

The court held that the transaction was a loan and not a sale, based on the following facts of the case:

- The security interests granted were extremely broad, e.g., all of Shoot the Moon's "payment and general intangibles … goods; inventory; equipment and fixtures … and all proceeds of the foregoing";

- The remedies granted were also very broad and expanded beyond just recourse against property of Shoot the Moon, e.g., a personal guaranty and confession of judgment from its principal; and

- The parties referred to the transactions as loans and the UCC-1 financing statements were marked "debtor" rather than "seller."[11]

The court noted that these facts all reduced CapCall's risk in the transaction and were more typical in loans rather than sales.[12]

In addition to the risk of recharacterization, parties to an SRT — whether characterized as a loan or a true sale — should consider the amount of damages negotiated in case of breach.

In Clovis Oncology's recent bankruptcy filing, Sixth Street Partners — the largest creditor, with a secured loan of $175 million arising from a clinical funding arrangement — filed a $350 million prepetition secured claim.[13]

In the clinical funding arrangement, Clovis Oncology had agreed to pay Sixth Street a percentage of net sales of the cancer drug Rubraca until Sixth Street received a total of $350 million in the aggregate, i.e., twice the amount of capital provided by Sixth Street.

In case of an event of default, including bankruptcy, the funding arrangement provides that the repayment term accelerates up to the full $350 million capped amount. The committee of unsecured creditors in the Clovis bankruptcy proceeding sought to characterize the accelerated payment term not as liquidated damages, but rather as a penalty that would be unenforceable under state law.[12]

The committee further suggested that the funding arrangement should be characterized as an equity interest, which would be subordinate in priority to general unsecured claims because of the "exceedingly high rate of return, lack of interest or maturity date, and the dependence of payment upon the success of the Debtors' Rubraca business."[13]

While this was a clinical funding arrangement structured as a loan and not an SRT, similar issues are present in SRTs. Clovis Oncology and the committee of unsecured creditors settled with Sixth Street, so the court did not rule on the merits of the challenges brought by the creditors' committee.

However, parties should nevertheless consider these issues in negotiating liquidated damages and events of default, recognizing that these and other key terms are on a continuum that will affect how the arrangement is viewed in the totality in a future potential bankruptcy proceeding.

The following graphic illustrates the continuum of debt-like to equity-like SRTs, with different terms that distinguish the types of transactions. Those that are on the debt-like end of the spectrum are more likely to be characterized as a loan in bankruptcy, while equity-like structures are more likely to be respected as true sales.

	Debt-like ←	→ Equity-like
Economic return	Capped return (e.g. 2.0x invested capital)	Uncapped return
Protections	Debt-like covenants (including incurrence covenants) Broader liens, including blanket liens on all assets Possible use of SPV to hold product assets	Light covenants and fewer protections Targeted liens on royalty interest and product rights
Economic terms	Possible catch-up payments (e.g., 1x by 5 years) Make-whole payment at maturity date	Simple payment of royalty Possible step-up in royalty rate based on return

Parties should also consider the quantum of a potential future claim for nonperformance in bankruptcy. Many SRTs do not have a cap on the total potential return for the royalty interest that is being purchased. In those instances, courts will need to ascribe a value to the claim of the holder of the royalty interest if the synthetic royalty is recharacterized as a loan.

If the synthetic royalty is not recharacterized as a loan and is respected as a true sale, the holder of the royalty interest will still need to ensure that it has a mechanism in place to receive proceeds from the royalty interest where the underlying product rights are sold in bankruptcy to a third party.

Anticipating this possibility, UCC-1s should be filed perfecting the true sale of the royalty stream, and we also often see back-up liens filed on the underlying product assets — specifically, the patents and regulatory approvals — in order to ensure that the property interest runs with the land in a subsequent sale of the product rights to a third party.

The rise of SRTs offer biotechs the opportunity to raise financing that is nondilutive and divorced from the turbulence of the capital markets and for funds to deploy capital to realize attractive returns with an asset class that is uncorrected with overall market performance.

Synthetic royalty sales are secure assets that fall under Article 9 of the UCC. Parties should consider whether and how to implement a true sale structure versus a loan, whether to seek liquidated damages, and if so, whether the amount comports with the structure of the transaction, and what assets should make up the collateral package.

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[1] The XBI Biotech Index dropped by 45% from February 1, 2021 to January 27, 2022 (versus a 16% increase in the S&P 500 Index).

[2] Data provided by Ladenburg Thalmann & Co. Inc, as of December 11, 2023.

[3] Data was compiled from a Gibson Dunn survey of SRTs from 2018-2022 by Royalty Pharma, DRI Capital, Healthcare Royalty Partners, OMERS, Oberland Capital, CPPIB, and Blackstone. The data excludes traditional royalty transactions (i.e., where an existing license agreement provides an

underlying royalty entitlement) and SRTs executed by other funds.

[4] One of the first royalty-backed funding arrangements involved the sale of bonds with the coupon tied to royalties from David Bowie's music library (so-called "Bowie Bonds").

[5] NY UCC § 9-102(a)(2).

[6] For example, an "account" could include revenue generated in the future from the sale of inventory that has not yet been manufactured.

[7] (NY UCC § 9-109(a)(3)).

[8] CapCall v. Foster (In re Shoot the Moon), 635 B.R. 797, 819 (Bankr. D. Mont. Sept. 10, 2021).

[9] The factors include: "(1) whether the buyer has a right of recourse against the seller; (2) whether the seller continues to service the accounts and commingles receipts with its operating funds; (3) whether there was an independent investigation by the buyer of the account debtor; (4) whether the seller has a right to excess collections; (5) whether the seller retains an option to repurchase accounts; (6) whether the buyer can unilaterally alter the pricing terms; (7) whether the seller has the absolute power to alter or compromise the terms of the underlying asset; and (8) the language of the agreement and the conduct of the parties." Id., 813 (referencing Robert D. Aicher & William J. Fellerhoff, Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor, 65 AM. BANKR. L.J. 181, 186-94 (1991)).

[10] Id., 813.

[11] Id., 814-816.

[12] Id., 817.

[13] In re: CLOVIS ONCOLOGY, INC., et al., Debtors, Case No. 22-11292 (JKS).

[14] Id., 3.

[15] Id., 3.

[16] The core Gibson Dunn royalty financing team in the life sciences includes Ryan Murr, Karen Spindler, Todd Trattner and Artin Au-Yeung, as well as Jin Hee Kim on the leveraged finance side.