Schaner & Lubitz, PLLC

Venture Philanthropy Legal Report Spring 2012 #3:

EVERYTHING YOU EVER WANTED TO KNOW ABOUT ROYALTIES AND THEIR MONETIZATION BUT WERE AFRAID TO ASK

Since 1998, when most point to the transaction between Aurora BioSciences (now Vertex) and the Cystic Fibrosis Foundation as the first disease foundation Venture Philanthropy transaction, our firm has advised on approximately 300 Venture Philanthropy transactions ranging in size from $500K to over $150 million. Each transaction involves numerous complicated issues: governance, intellectual property ownership and licensing, termination, indemnification, and publication, among others, but the issue that encompasses the most negotiating time by far involves the amount of royalties to be paid by the awardee to the granting charity. The purpose of the series of questions and answers that follow is to shorten that time, thereby putting the award to work on the underlying research faster, and to look forward to the day when the research is successful and the royalty can be monetized.

1. WHY ARE ROYALTIES GENERALLY USED INSTEAD OF THE PURCHASE OF SHARES IN THE AWARDEE COMPANY?

There are several reasons. First, awardee companies generally are not public companies and shares of stock are, therefore, difficult to price unless the charity's investment is made in connection with a formal investment round. Moreover, equity investments are more difficult to direct toward the particular research that is of interest to the charitable grantor. Most equity investments are used for the general support of the company including infrastructure; however, awarding charities prefer their funds to be dedicated to specific research. Further, granting charities are often not interested in participating in the general governance of the grantee. Instead, they wish to devote their time and expertise only to a special advisory committee focused solely on the research program for which the award is made.

While some of the above goals can be accommodated if the awarding charity wishes to make an equity investment, there is another potential disadvantage of investing in stock. Stock investments are treated by accountants in the same manner as other general endowment investments; i.e.,investments in shares of a company that are made solely for financial reasons. Research investments in exchange for royalties, by contrast, are treated as program investments. Thus, an equity investment will have the effect of increasing overhead rates. For example, assume a charity has $100 to spend in a given year and has $25 of overhead. If the charity invests $20 in an equity investment and the remaining $55 is invested in program investments, the charity's cost ratio would be 31.25% ($25 divided by $80). However, if instead of making the $20 investment in equity, the charity made an investment in return for royalties, the charity's cost ratio would be 25% ($25 divided by $100). A charity's overhead ratio often is an important factor for donors in deciding whether to make a charitable contribution because donors understandably want to see as much money as possible devoted to a charity's mission. The overhead ratio issue as it relates to equity ownership versus programmatic grants generally is not

of concern to private foundations, which do not typically rely on donations from large numbers of individual donors.

Notwithstanding the above, we have completed a number of equity investments for tax exempt organizations, which have decided that, in particular circumstances (for example, when an awardee is a very small organization with only one technological asset), the benefits of equity ownership outweigh the disadvantages noted above.

2. WHAT ARE ROYALTIES?

Royalties are payments to a charity in return for use of a valuable right controlled by the charity. They are passive in nature in that they do not involve payment for any tangible good or service provided by the charity. We include a number of provisions within our Venture Philanthropy grant agreements so that return payments are properly characterized as royalties.

In disease foundation Venture Philanthropy transactions, a charity's right to receive payment typically is triggered by a grantee company's receipt or anticipated receipt of payments for commercialization of a product developed in part from one or more grants made by the disease foundation. Royalties can be paid as a percentage of sales, in the form of a periodic payment, or in lump sums after the accomplishment of defined milestones. Payments also may become due if the grantee company experiences early success through a sale or license of the technology underlying the research program financed by the disease foundation, or if a grantee company experiences a change in control through a merger or sale of stock.

3. HOW LIKELY ARE FUNDING CHARITIES TO RECEIVE ROYALTIES?

The likelihood of royalties is a function of the success of the technology funded by a disease foundation. There is a very high failure rate within the drug development industry, and successful technologies often take a decade or more to develop into products. To be sure, our disease foundation clients do not invest in drug development solely to reap royalties. Rather, they make grants in promising technologies to find cures and therapies for the diseases that are within their missions to eradicate. Royalties can be a happy by-product of charitable grant making programs that create additional funds for reinvestment in promising technologies, many of which might not otherwise be funded precisely because of the highly risky nature of drug development.

4. ARE ROYALTIES TAXABLE?

Charities can be taxed on their unrelated business income, but royalties are specifically excluded by the Internal Revenue Code. It is important, therefore, that Venture Philanthropy grant agreements are drafted such that return payments are properly characterized as royalties for federal income tax purposes.

5. WHAT FORM OF ROYALTY SHOULD WE USE FOR OUR VENTURE PHILANTHROPY TRANSACTION?

This is not a question that can be answered with a "one size fits all" response. The form of royalty depends on the timing of the investment, the stage of research at which the award is made, the therapy being developed and the size of the investment. If the product is a device as opposed to a compound, the agreed upon royalty is generally smaller because the development time for a device is typically substantially less than the required time for development of a drug. If the award is for a compound at a pre-clinical stage when the risk is the highest, the corresponding royalty should be increased. However, here are some additional guidelines that could be helpful:

- Smaller Grants. If the grant is small, say below $5MM, you should expect a royalty that is a multiple of your award—an "X" royalty. The X royalty is generally paid in installments after regulatory approval. Sometimes our clients have been successful in securing an initial payment upon filing of the IND, though most companies are reluctant to commit to any payment until cash flow from sales begins. Some grantees have requested that any payment be further capped by a percentage of sales. However, we try to resist such requests, because they subject our clients to a risk of the marketplace in a context where they have no corresponding reward; i.e., they are already capped by the X royalty and, therefore, if the product is very successful, they will not share in that success, so subjecting the payment of a royalty to a second, sales-based, cap only adds risk with no corresponding up-side reward. Nevertheless, some of our clients have consented to a sales cap. As to the amount of X you should expect to achieve:

    1. An X royalty of 3-6X repaid over a 3 year period; and

    2. Bonus X royalties, if product sales reach certain aggregate amounts. Thus, for example, you might get two additional X's if sales achieve aggregate $'s Y and Z in a measured period.

- Larger Grants. If the grant is $5MM or above, we try to negotiate an uncapped royalty, especially if an investment is made in a preclinical stage. As a general rule of thumb, one looks to achieve 2-3% of product net sales for a $5MM investment, and then an increasing percentage point for each $5MM investment. Obviously, this will differ based on various situations, but before settling on a capped royalty, we recommend that clients contrast the economics of a $10MM investment with a 5X royalty or, instead, a royalty for 3% of net sales. In the former, the grantor would receive a return of $50MM (and possibly a bonus royalty for successful sales) - clearly a very good result. In the latter, the grantor takes the risk of the marketplace, but assuming a 10 year life and $500MM average annual sales, the grantor would receive $150MM, which is obviously a much higher return.

All grant opportunities are unique. The point of the above example is to present the possibility of an uncapped royalty for substantial grants. The difference could result in an extra pool of research funds that could make a real difference in the search for a cure for your disease.

6. SHOULD THE GRANTOR RECEIVE A PAYMENT PRIOR TO REGULATORY APPROVAL OR FIRST COMMERCIAL SALE?

As we alluded to earlier, some of our clients have been successful in receiving payments upon filing of the IND and some even earlier when a therapy enters or completes Phase 3. However, the most likely early payment you might receive is at the time of disposition of the research program technology to a third party, either by licensing it or in connection with a change of financial control over the grantee company. In such situations, the company or its shareholders will have reaped a financial return on their investments, even though the success of the therapy being developed is still at risk. We see no reason why the grantor charity should not share in this disposition event by receiving some return.

Particularly in the event of a change of control, the issue is how much of a return should the grantor receive? This depends on a number of facts and circumstances that must be weighed at the time of negotiating the grant agreement, including the presence of other research and the importance of the research to the overall value of the company that is supported by the charity's grant. We often receive push back from grantees in requesting such an early return, but we have found that through patient negotiation and explanation of why such an early return is justified, grantees most often ultimately come to agreement on this point.

7. WHAT DOES MONETIZATION OF A ROYALTY INTEREST MEAN AND HOW IS IT DONE?

Monetization means the disposition of a royalty interest to a third party buyer. It is a present valuation by a third party buyer of the charity's future right to receive payments from the company that received the grant (or the company's assignee).

There is a lively market for monetization of royalty interests. In a recent monetization transaction in which we represented a seller of a royalty interest, over 50 potential buyers expressed interest and 20 bidders emerged. In order to guide a seller of a valuable royalty interest, we recommend hiring a firm specializing in the valuation of royalty streams. Such a firm can give you a realistic view of what your royalty interest is worth and the risks involved in holding it or selling it. In addition, depending on the value of your royalty interest, you might also consider hiring an investment banker to guide you in the auction process and stimulating market interest. While their fees can be substantial, a banker may produce potential buyers that you could not have found on your own.

8. WHY SHOULD GRANTORS CONSIDER MONETIZING THEIR ROYALTIES AND AT WHAT POINT SHOULD THEY DO SO?

Some charities believe that disposition of a royalty dependent on net sales is important to eliminate an appearance of conflict. In addition, monetization will eliminate the future risks associated with the drug, e.g. manufacturing, health and commercial risks. (Please note, however, that such risks are taken into account by potential buyers in setting the price they will pay.) As a practical matter, monetization cannot be considered until a drug enters Phase 3, because, before that point, the market risks will discount value so substantially that the charity is

unlikely to receive a substantial return on its investment. Even after Phase 3 is completed, and before regulatory approval, value will be discounted substantially for approval risk. Thus, you should make your own assessment of approval risk and the advantages of awaiting approval or proceeding earlier.

Because they are capped, X royalties are not good candidates for monetization. Moreover, the potential conflict of interest of holding an interest in the financial success of a therapy is mitigated because an X royalty is generally retired in the early years after approval and its payment is usually not dependent on drug sales. Thus, the potentially uncomfortable position of having to take positions on the benefits of a drug in which a grantor holds a royalty interest is not present in the context of an X royalty or disappears rapidly.

9. MUST A SELLER WISHING TO MONETIZE A ROYALTY STREAM SELL ALL OF ITS ROYALTIES?

Depending on its motivations for monetization, a seller can sell its entire royalty stream or retain a part. If the seller's principal motivation is to rid itself of perceived conflicts, the sale of the entire royalty stream is an effective way to do so.

There are often practical considerations, however, that could cause a seller to sell only a portion of its royalty stream. For example, the seller's main motivation may be to hedge against future risk that the underlying product could be pulled from the market permanently or for some time period because of health and safety risks or manufacturing difficulties. Monetization of a portion of the royalty stream would allow the seller to realize some value from its royalty asset and mitigate these risks, while retaining the remaining portion of the royalties to realize the upside of market success.

Sales of portions of the royalty streams are generally referred to as selling a "slice". Owners of royalty streams can sell a horizontal slice, which means that they can sell royalties up to a certain dollar amount. Thus, for example, an owner can sell for $1 million, the first $1.2 million of future royalty rights. Thus, the seller receives $1 million immediately, and once the buyer receives $1.2 million, the seller once again has the right to receive remaining royalties (the non-slice portion). The price in such a transaction depends on prevailing market conditions, including interest rates.

Another type of monetization is the sale of a vertical slice. In such a transaction, the seller sells a percentage of its total future royalty rights, e.g., 20% of all of its royalties. Here, the seller realizes immediate value and de-risks 20% of its royalty asset, while retaining the remainder.

Still another method of monetization is to borrow against future royalties by issuing a debt instrument, sometimes referred to as a royalty bond. A bond allows the holder of the royalty interest to borrow money in return for pledging future payments to bond holders from the royalty stream. The terms of the debt instrument can be tailored to avoid default because of temporary disruptions in the marketplace relative to the drug. Thus, the bond terms could provide that a default would not occur for several consecutive payment periods if the debtor fails

to pay all or part of the bond interest in order to protect against a temporary interruption in supply. Such debt instruments are generally secured only by the royalty stream; the holder of the bond has no recourse against other assets of the seller. Thus, if a product were pulled from the market because of health risks, the debtor's default would not expose its other assets to attachment by bond holders. The form of monetization used by a seller is dependent on a comprehensive analysis of all of the prevailing facts and circumstances.

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The above is the second of our "Afraid to Ask" series. Our first, "Everything You Ever Wanted to Know About Venture Philanthropy but Were Afraid to Ask," is posted on our web-site: www.schanerlaw.com.

About the authors:

Ken Schaner has practiced law for more than 40 years. He began his legal career at the Internal Revenue Service, where he was part of the team that drafted the 1969 amendments to the tax code pertaining to exempt organizations. He was a founding partner of Swidler Berlin, LLP, where he also served as managing partner and head of the corporate practice, and then a partner at Bingham McCutchen, LLP before founding Schaner & Lubitz, PLLC.

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