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# SECURITY INTERESTS IN ROYALTY FINANCINGS

GIBSON DUNN

# Today's Panelists



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# Royalty Finance

## 3-Part Series



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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)

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



Todd Trattner



Ryan Murr

1. Part 1 – Royalty Finance: Structures and Trends (Ryan Murr & Todd Trattner)
2. **Part 2 – Synthetic Royalty Financings and the UCC (Jin Hee Kim, Anthony Hajj & Kali Jelen)**
3. Part 3 – Synthetic Royalty Financings: Risks of Recharacterizing a True Sale (Jeff Krause)

# Introduction to Royalty-Based Financing

- Royalty financing (a/k/a revenue-based financing) involves an investor advancing capital to a company in exchange for a contractually agreed percentage of future revenue, usually derived from intellectual-property (“IP”) or product sales.
- Frequently used in life sciences, entertainment, software, and natural-resource sectors where revenue streams can be forecast and collateralized.
- Security interests are commonly required to (i) protect the investor’s right to receive royalties, (ii) enhance enforceability, and (iii) improve priority versus competing creditors.
- Consideration delivered up-front (lump-sum funding) or in tranches tied to milestones.
- Investor typically receives (a) a royalty agreement (or equivalent) and (b) a security agreement (sometimes combined).

# Why Take a **Security Interest**?

- Converts a purely contractual payment obligation into a property right enforceable against the debtor and third parties.
- Positions the investor ahead of unsecured creditors in the debtor's capital structure.
- Facilitates remedies such as foreclosure on royalty receivables or step-in rights to license agreements.
- Can lower the borrower's cost of capital by reducing perceived investor risk.

# Structuring Considerations

- Parties
  - Servicer holds operating liabilities
  - Bankruptcy remote special purpose vehicle holds receivable
- Benefits
  - Isolate assets
  - Mitigate bankruptcy risk
  - Simplify accounting
  - Allow for equity pledge
- Control mechanisms
  - Independent director
  - Limited purpose provisions

# Identifying the Collateral

- Primary collateral: present and future royalties, receivables, and revenue proceeds.
- Ancillary collateral: underlying IP (patents, copyrights, trademarks, trade secrets) and related agreements (licenses, distribution contracts).
- Deposit accounts into which royalties are paid (“collection accounts”) and general-intangible rights thereto.
- Equity pledges of special-purpose entities that hold the IP/royalty contracts.
- Backup security interest vs. sale

# Diligence

## Best Practices

- Copies of the agreements with obligors under which the receivable was created (usually license, sale or servicing agreements)
- Assignment and change of control, payment mechanics and termination rights
- Lien and IP searches against seller entity
- Chain of title documents (if applicable)
- Copies of documents related to any secured debt of the seller
- Dispositions negative covenants



# Drafting the Security Agreement

- Clearly describe collateral classes (royalty contracts, IP, proceeds, accounts). *UCC §9-108*
- Include “after-acquired property” clause to capture future enhancements and new revenue streams.
- Provide affirmative covenants requiring segregation of royalty proceeds and periodic reporting.
- Embed negative covenants restricting (among other things) additional liens, transfers of IP, amendments to royalty-generating agreements, and cross-licenses.
- Reserve step-in, audit, and offset rights to support enforcement.

# Perfection Under Article 9 of the UCC

- Royalty receivables = “accounts” or “payment intangibles”: perfected by filing a UCC-1 in the debtor’s jurisdiction of organization.
- Prepare UCC-1 and file immediately upon execution.
  - [Sale version of UCC financing statement and Security Interest/Backup Security Interest version of the UCC financing statement](#)
- IP collateral:
  - Patents – filings with the USPTO supplement but do not substitute for UCC perfection.
- Deposit accounts – perfection only by control (tri-party control agreement or lender-as-bank).
- Equity interests – determine whether securities are certificated or uncertificated; perfection by control or possession. Retain originals and undated stock powers accordingly.

# Priority Considerations

- First-to-file (or perfect) rule under UCC § 9-322 governs most assets.
- Purchase-Money Security Interests (PMSIs) rarely implicated but monitor.
- Statutory liens (e.g., taxing authorities, mechanics) may prime a royalty lender.
- Subordination arrangements may be required vis-à-vis senior bank lenders or mezzanine creditors.

# Intercreditor and Subordination Arrangements

- An intercreditor agreement is an agreement where two or more sets of creditors negotiate lien-subordination or priority sharing.
- In a standard “true sale” royalty financing, an intercreditor agreement is typically not required by a royalty financing purchaser.
- Where an intercreditor agreement is important from the royalty financing purchaser’s perspective is where the back-up security interest is more critical for some structural or other reason.
- Where a seller does not have existing senior debt in place, sometimes “term sheet” like provisions are negotiated and added to the documentation for royalty financings in order to give the seller flexibility to incur future senior debt

# Intercreditor and Subordination Arrangements

## Selected Considerations

- Typically, the Senior Debt Provider will want to have the exclusive right of enforcement in any Liens on any “shared” collateral will be senior other than with respect to the purchased royalties (to the extent this is “shared” collateral)
- Consider sales within an enforcement scenario outside of the context of an insolvency proceeding as well as within the context of an insolvency proceeding.
  - If a sale occurs in an enforcement outside of an insolvency proceeding, the ROYALTY PURCHASER typically will have consent rights over the sale if the Shared Collateral is not transferred subject to the rights of the ROYALTY PURCHASER with respect to the purchased royalties
- after the occurrence of an insolvency proceeding
  - the ROYALTY PURCHASER will typically agree to support a disposition of the Shared Collateral so long as the Shared Collateral so disposed of are purchased subject to the rights of ROYALTY PURCHASER with respect to the purchased royalties AND
  - the Senior Debt Provider will agree that if the Shared Collateral is not transferred subject to the rights of the ROYALTY PURCHASER with respect to the purchased royalties, then the proceeds from such sale, transfer or other disposition shall be subject to a waterfall which is often highly negotiated

# Enforcement and Remedies

- Upon an event of default, investor may:
  - Notify obligors under royalty contracts to redirect payments or deliver a notice of exclusive control with respect to the deposit account.
  - Foreclose on royalty receivables through Article 9 disposition (private sale) or strict foreclosure.
  - Assume/assign IP licenses if permitted under §365(n) of the Bankruptcy Code.
  - Exercise step-in rights to exploit IP directly or via sublicense.

# Cross-Border and Choice-of-Law Issues

- Important to consider cross border impacts because not all jurisdictions have a regime similar to the US and/or a “true sale” concept may not apply.
- Foreign IP registrations require separate perfection steps in each country.
- Include governing-law and submission-to-jurisdiction clauses that facilitate enforcement where assets and obligors reside.

# Practical Tips and Best Practices

- Conduct deep diligence on agreements with obligors.
- Consider whether the seller should move the receivable to a SPV.
- File UCCs and record IP liens concurrently to avoid priority gaps.
- Obtain control of collection accounts to perfect and monitor cash flow.
- Embed covenants requiring counterparty consents before modifying royalty contracts.
- Maintain robust post-closing tickler system for continuation filings.



# Conclusion

A royalty financing strategically aligns an investor's return with a borrower's revenue growth.

By taking and properly perfecting security interests in the royalty stream, the underlying IP, and related proceeds, the investor substantially mitigates credit risk, elevates its priority in the capital structure, and preserves optionality in distressed scenarios.

Careful drafting, rigorous perfection, and proactive monitoring are therefore indispensable to capturing the full intended benefits of a secured royalty transaction.

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