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Structuring Royalty Monetizations: Bankruptcy and the Risk of Contract Rejection

By Peter A. Schwartz, Martin E. Beeler and Dianne F. Coffino*

Suppose that a biotech company sells a pharmaceutical royalty stream and that thereafter the biotech company files for bankruptcy protection. What happens to the royalty payments?

A biotech company discovers a novel compound that could lead to a promising new drug. After several years of development, the company licenses patents on the compound to a pharmaceutical company for further development. In return, the pharmaceutical company agrees to pay royalties on sales of the product to the biotech company if the drug is successfully commercialized. The drug is approved and brought to market, performs well, and begins to generate royalties. In order to raise funds for its other activities, the biotech company sells the future royalty stream (a royalty monetization) to a buyer in exchange for an upfront cash payment.

The biotech company that sold the royalty stream later files for bankruptcy protection. What happens to the royalty payments?

RISE IN ROYALTY SALES AND BIOTECH BANKRUPTCIES

Biotech companies had a difficult 2023, with fundraising proving to be a particular challenge. This has caused many companies to look for creative financing structures, including royalty monetizations.

The most important consideration for a purchaser in any royalty monetization is the future sales outlook for the licensed products. But following a record year for biotech bankruptcies in 2023,[1] bankruptcy risk has come into focus as another potential concern, with two of those bankruptcy filings involving companies with royalty monetizations.[2]

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[1] Forty one biotech companies filed for bankruptcy protection in 2023, up from twenty in 2022 and nine in 2021. Kate Goodwin, Athersy Adds to Surge of Biotechs Filing for Bankruptcy, Sells to Healios, BioSpace (January 9, 2024), https://www.biospace.com/article/athersys-adds-to-surge-of-biotechs-filing-for-bankruptcy-sells-to-healios-/.

[2] In re Athenex, Inc., et al., Case No. 23-90295 (Bankr. S.D. Tx.); In re Infinity Pharmaceuticals, Inc., et al., Case No. 23-11640 (Bankr. D. Del.). Athenex is discussed further

BASIC ROYALTY MONETIZATION STRUCTURE

In its simplest form, a royalty monetization involves the sale by a licensor of its right to receive future royalty payments under a license agreement. In this structure, the buyer does not become a party to the license agreement, but instead simply purchases the right to those future payments.

The treatment of this structure in bankruptcy seems like it should be straightforward. During the course of the bankruptcy case, the biotech company will need to either "assume" or "reject" the license agreement.[3] If an agreement is "assumed," the agreement remains in effect and can be used in the reorganized business or assigned to a buyer in bankruptcy. If it is "rejected," the agreement is treated as having been breached by the debtor as of the date of the bankruptcy filing, and the licensor-debtor is no longer obligated to perform its obligations. Upon rejection of a license of "intellectual property," as defined in the Bankruptcy Code[4] the licensee can elect to either accept the rejection and assert a claim against the bankrupt company for any damages resulting from the rejection, or assert its rights under Section 365(n) of the Bankruptcy Code, which, in summary, allow it to continue to use the licensed intellectual property, as it existed on the date of the bankruptcy filing, so long as it continues to make required royalty payments.

REJECTION RISK IN THE BASIC MONETIZATION STRUCTURE

At first glance, it appears that the royalty buyer in this basic monetization structure would continue to be paid the royalty payments by the licensee following the bankruptcy of the biotech company. If the license agreement is assumed, the licensee must continue to make royalty payments under the terms of the agreement; and if it is rejected and – crucially – the licensee elects to continue to use the licensed intellectual property, the licensee will be required to make royalty payments under Section 365(n). However, the situation may not always play out this way.

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below. The treatment of the royalty monetizations in the Infinity case is pending final resolution of that case.

[3] Executory contracts are contracts under which both parties have material unperformed obligations. License agreements are typically executory contracts. Bankruptcy law gives the debtor broad discretion to determine whether to assume or reject an executory contract. As a general rule, if an executory contract provides an ongoing burden to the company that outweighs the benefits of the contract, it will be a good candidate for rejection.

[4] Under Bankruptcy Code Section 101(35A), "intellectual property" includes certain trade secrets, patents, patent applications, plant varieties, copyrights, and mask works.

If a company sells its economic rights under a license agreement to a buyer and files for bankruptcy protection, it may no longer have a reason to continue the licensing and royalty sale transactions and decide to reject any applicable executory contracts. Assuming that the licensed intellectual property generates revenue for the licensee, you might expect the licensee to exercise its rights under Section 365(n). But consider what would happen if the licensee chooses not to do so, and instead proposes to purchase the underlying intellectual property from the company in exchange for up-front cash and/or future royalties. The licensee could obtain ownership of the intellectual property it needs to continue selling the licensed products, without having to rely on the imperfect protections of Section 365(n), and the company could raise additional cash to satisfy claims of its creditors.

Where does that leave the royalty monetization buyer? It purchased a right to royalties payable under the license agreement, but that license agreement has been rejected, with no further royalties payable to it. The buyer presumably has a significant claim against the bankruptcy estate related to its obligations under the royalty purchase agreement.

But this claim will be unsecured, and if there are other significant creditors, an unsecured claim could be worth pennies on the dollar. Perhaps the buyer also has breach of contract, tortious interference, or some other type of claim against the licensee or the bankrupt company, but it faces potentially expensive litigation with no certainty that those claims will be resolved in its favor.

ATHENEX–SPV WITH POTENTIAL REJECTION OF SUPPLY AGREEMENT

An alternative to the basic structure outlined above involves the use of a bankruptcy-remote special purpose vehicle (SPV). In this structure, the biotech company transfers the license agreement and the underlying licensed patents to an SPV, which then sells the royalty stream under the license to the royalty buyer. The SPV structure separates the license and royalty stream from the bankruptcy risk of the company by removing ownership of the license and patents from the company, thus allowing the royalty monetization to operate on a stand-alone basis.

Complications can arise, however, when the separation of the royalty producing assets owned by the SPV is incomplete and a critical part of the licensing transaction remains subject to contract rejection, which happened in the Athenex bankruptcy case.

Athenex, a public biotech company, entered into an agreement in 2017 with a pharmaceutical company under which Athenex licensed the patent and other

rights to a compound that would become the prescription drug Klisyri. Under a separate agreement (the Supply Agreement), Athenex agreed to provide the licensee with the active pharmaceutical ingredient (API) for the drug. In turn, the licensee agreed to pay Athenex future royalties and milestone payments related to sales of Klisyri, and, under the Supply Agreement, to pay separate consideration for the API as purchased from time to time.[5]

Seeking to raise capital, Athenex sold its rights to certain royalty and milestone payments under the license agreement in 2022 to two investors (the Klisyri Purchasers) for $85 million. To structure the royalty purchase, Athenex placed the license agreement, the underlying patents, and certain related assets into a bankruptcy-remote SPV that was jointly owned by Athenex and the Klisyri Purchasers. The SPV then sold the rights to the purchased royalty and milestone payments to the Klisyri Purchasers.[6]

Following the Klisyri royalty purchase, Athenex faced challenges related to drug approvals and suffered major cash-flow problems. In 2023, Athenex and certain affiliated companies filed for Chapter 11 bankruptcy protection. Athenex, operating at a net loss under the Supply Agreement and having sold most of the Klisyri related economics to the Klisyri Purchasers, no longer had an economic incentive to continue the API supply. The Supply Agreement thus appeared to be a good candidate for rejection. But rejection would have cut off supply of Klisyri to the market, cut off the Klisyri Purchasers' access to royalty streams from the marketing and sale of Klisyri[7] and in turn exposed Athenex to indemnification claims by the Klisyri Purchasers.[8]

Rather than reject the Supply Agreement, Athenex, the licensee and the Klisyri Purchasers negotiated a settlement under which Athenex agreed to continue manufacturing the API for a short period of time, the licensee agreed to pay for existing inventory of API and the continued manufacturing activities, at a negotiated price that provided a profit to Athenex for its continued efforts, and the Klisyri Purchasers agreed to release funds from an escrow account that had been set up at the closing of the royalty purchase to pay for a future transfer

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[5] See Debtors' Emergency Motion for Entry of an Order Approving Debtors' Entry into Global Settlement Agreement Relating to Athenex Pharma Solutions, LLC and Authorizing Actions Consistent Herewith, Dkt. No. 250 at ¶ 1.

[6] Id. at ¶ 13.

[7] Id.

[8] Id. at ¶ 2.

of manufacturing obligations to a third party. The Klisyri Purchasers also agreed to waive their indemnification and all other claims against Athenex.[9]

Athenex illustrates a number of bankruptcy issues that could arise in royalty deals.

First, the bankruptcy remote SPV structure was validated: the SPV did not become a party to the bankruptcy case, and as a result the license agreement, which had been placed in the SPV, remained in effect and was not subject to rejection by Athenex.

Second, the case highlights the risk that royalty purchasers and third parties face when the economics of a license agreement are sold, but supply or other material obligations remain with the seller. The threat of losing supply of the Athenex API put the ongoing value of the royalty stream at risk. Because of that risk, the licensee and the Klisyri Purchasers had to provide funding to ensure the continued supply of the API.

Finally, although Athenex involved the potential rejection of a supply agreement and not a licensing agreement, it is instructive to see how a bankrupt company will treat an agreement that it has no economic incentive to keep extant. From the Athenex debtor's point of view, the settlement deal allowed it to generate additional cash flow to the estate and eliminate substantial claims.

The case illustrates the need to carefully assess the timeline for the transition of essential technology and manufacturing obligations from a licensor to a licensee. Any delay in that process could expose the licensee and royalty buyer to the insolvency risk of the licensor.

TAKEAWAYS

No one expects their contract counterparty to go bankrupt. But the current economic environment has illustrated the need for buyers, sellers and license counterparties to consider bankruptcy risks when negotiating and evaluating royalty monetization transactions. Fortunately, there are structures that can be used to mitigate against those risks in the appropriate circumstances.

- *Use a Bankruptcy Remote SPV.* As we saw in Athenex, one of the best ways a buyer can protect against the risk of rejection of a license agreement is to place the agreement and underlying IP into a bankruptcy remote SPV. This can add time and complexity to the transaction, however, and must be permitted by the underlying commercial agreements.

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[9] Id. at ¶ 3.

- *Take a Security Interest in the Underlying IP.* Another potential avenue for protection is for the royalty purchaser to take a security interest in the underlying intellectual property. This will prevent the biotech company from transferring or licensing intellectual property after rejection of the related license and royalty agreements without adequate protection for the royalty purchaser.
- *Require Contractual Privity with the Licensee.* A buyer may be able to protect itself by requiring the seller to obtain the agreement of a licensee that it will continue to pay royalties to a buyer, even after the rejection of the license agreement in bankruptcy. But this may be difficult to achieve, because the licensee may not be willing to agree to the arrangement.
- *Ensure That Critical Ancillary Assets and Services Can Be Used By the Licensee.* Commercial considerations will determine whether a licensee can obtain all of the supplies, technical know-how and other assets and services necessary to fully exploit the licensed IP. If possible within these commercial constraints, however, these ancillary assets and services should be transitioned to the licensee or a creditworthy third party.
- *Be Prepared to Take an Active Role in Any Licensor Bankruptcy Case.* Bankruptcy cases can move quickly and result in relief that impairs other parties' rights with shortened notice and, in some instances, limited rights of appeal. A licensee or royalty buyer should monitor the licensor's financial situation to the extent possible and, if aware of a bankruptcy filing, seek the advice of bankruptcy counsel and be prepared to take an active role in the bankruptcy case in order preserve its rights.