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M&A considerations in licensing and collaboration agreements

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The life sciences industry is seeing historic mergers and acquisitions activity. There has been $326.4 billion in M&A transactions in the pharmaceutical, medical and biotechnology industries in the first half of 2019 — the highest half-yearly value ever.[1]

This surge of M&A activity has reemphasized the need for life sciences companies to draft license and collaboration agreements with one eye toward the future acquisition of either party.

This commentary highlights sections of life science license and collaboration agreements that drafters must carefully weigh in consideration of future M&A activity.

These sections range from the obvious (such as change-of-control provisions) to provisions with more subtle implications on M&A.

This analysis aims to help those drafting and negotiating these agreements avoid inadvertently binding their company to a contract that obstructs its future M&A goals or loses sight of risks presented by a change in control of its counterparty.

CHANGE-OF-CONTROL PROVISIONS

When the negotiators of collaboration agreements consider the potential for M&A activity, they often seek to include provisions that allow for either termination or an adjustment of the parties' rights upon a change of control.

A party is often spurred to propose such a provision by the worry that a counterparty may be acquired by a competitor.

A licensor may worry about a competitor having access to its IP. Licensees may also worry about being required to share information about a licensed product with its competitors.

A change-of-control provision can (and should) be difficult to negotiate, however, because it can act as a poison pill, or at least a bitter pill, for a potential acquirer of the party that agrees to it.

Consider the simplest case: a provision that allows a licensor to terminate the license agreement upon a change of control of the licensee. If the licensee were to agree to such a provision, it would reduce the value of its company in the eyes of any potential acquirer.

No acquirer could ascribe any value to a license agreement with such a termination right knowing the agreement could be terminated upon its acquisition of the licensee.

In other words, whatever investment the licensee paid to acquire the license or invest in the licensed products would potentially have no value for an acquirer, which would depress the value of the licensee as a company.

For this reason, such termination provisions are exceedingly rare.

Almost any flavor of change-of-control provision can present the same issue to the affected party — it can make the agreement less valuable in the hands of an acquirer.

> Parties to a license or collaboration often agree to not compete with one another in specific fields relating to the licensed IP.

For example, a termination right that applies only in the event of an acquisition by one of the licensor's competitors still might depress the value of the licensee, depending on the circumstances and how "competitor" is defined.

Nonetheless, if the change of control of a counterparty would raise serious business concerns for a party, the concern can be addressed by more nuanced provisions.

For example, if a party is concerned about the future acquisition of its counterparty, it might seek the right to dissolve certain governance structures in the agreement (such as a joint steering committee) or cease sharing certain information with its counterparty if it is acquired by a competitor.

Alternatively, a party could seek the right to end a scientific collaboration with its acquired counterparty without terminating IP licenses it granted such counterparty in the same agreement, essentially transforming a research collaboration into a straight license agreement.

Such nuanced provisions attempt to address the key business concern presented by the change of control of a counterparty, but they are usually viewed more favorably by the impacted party than

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a blunt termination right because they do not strip away the value of the agreement in the event of its change of control.[2]

EXCLUSIVITY CLAUSES

Parties to a license or other collaboration often agree to not compete with one another in specific fields relating to the licensed IP.

These exclusivity clauses typically restrict a party from developing or commercializing any product that competes with a licensed product.

Although such an exclusivity clause may be perfectly sensible from a commercial perspective, parties should consider how it will be viewed by a potential acquirer.

> How a collaboration or license agreement defines the technology being licensed can have significant repercussions for an acquisition.

For example, a seemingly benign exclusivity clause that bars a small biotech company from developing or commercializing a certain type of competitive product may act as a poison pill to an acquisition by a large global pharmaceutical company that happens to be developing or commercializing just such a competing product.

To avoid this problem, parties can structure an exclusivity clause to give a potential acquirer of the affected party some flexibility.

The most straightforward (and lenient) approach is to simply grandfather in any competing product of any potential acquirer, while perhaps requiring the acquirer to establish a firewall between the competing program and the licensed program.[3]

A stricter approach is to give the acquirer an opportunity to divest its competing product within a specific reasonable time period after the closing of the acquisition, thereby giving it a grace period before it would be in breach of the exclusivity clause.[4]

These approaches seek to strike a balance between the legitimate business goal behind the exclusivity clause — aligning the parties' interests by prohibiting competition between them with respect to the licensed product — and the parties desire not to create a poison pill that inhibits a possible acquisition and thereby depresses the value of the company for shareholders.

LICENSED TECHNOLOGY DEFINITIONS

How a collaboration or license agreement defines the technology being licensed can have significant repercussions for an acquisition.

In developing a collaboration for a therapeutic product, licensees often seek a license for all IP owned or controlled by the licensor or its affiliates during the term of the agreement that is necessary or useful for the licensed program.

This common style of license ensures that the licensee receives rights under all relevant IP controlled by the licensor and its related companies.

Although very common in collaboration agreements relating to the research, development and commercialization of therapeutic products, this broad type of license grant can create issues for a potential acquirer of the licensor.

For example, if the licensor is acquired by a large pharmaceutical company with a vast patent portfolio, that patent portfolio would be swept into the license, thereby providing the licensee with a significantly broader license than it originally paid for.

Thus, defining licensed technology in this way could operate as a bitter pill to an acquirer that would prefer not to license any useful patent in its patent portfolio to the licensee for use in the licensed program.

> Strategic collaboration agreements between public companies often involve the licensee making an equity investment in the licensor and entering into a "standstill agreement."

To avoid this problem, licensors should draft the agreement so that the IP of an acquirer is not considered to be controlled by the licensor and licensed to the licensee.

This is often accomplished in the definition of "control" in a collaboration agreement, but it can also be folded into the definition of "licensed technology" or in any change of control.

This solution should be acceptable to the licensee in concept, as it is not bargaining for a license under a future acquirer's patent portfolio.

However, licensees should make sure that any IP of the licensor's acquirer that the acquirer uses in furtherance of the collaboration does get included within the licensed technology licensed to the licensee.

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CONFIDENTIALITY AND STANDSTILL PROVISIONS

Strategic collaboration agreements between public companies often involve the licensee making an equity investment in the licensor and entering into a "standstill agreement," in which the licensee agrees not to make a hostile bid to acquire the licensor.

In this situation, there in an important interplay between restrictions on use of confidential information in the collaboration agreement and the hostile bid restrictions in the standstill agreement. Parties should carefully consider this interplay to avoid handicapping their company in a future acquisition scenario.

In collaboration agreements, use of confidential information is typically restricted to uses in furtherance of the collaboration.

Among other things, this use restriction would prohibit the licensee from leveraging its knowledge of the licensor learned in the collaboration for the purpose of making a hostile bid to acquire the licensor.

Of course, such a use restriction does not provide complete protection from hostile bids from a counterparty.

In theory, a counterparty could set up a clean team to run the bid process without any knowledge of the confidential information from the collaboration and thereby avoid breaching the confidentiality restrictions.

That said, most large companies are not comfortable with the risk entailed in setting up internal walls to allow a clean team to take hostile action. As a result, standard confidential information use restrictions generally protect against hostile bids from the licensee.

Meanwhile, standstill agreements, which are designed to forestall a hostile acquisition by a collaboration partner, come with their own unique risks.

Standstill agreements are typically seen in the M&A context and are used to prevent a previously friendly bid from flipping hostile.

Due to this narrow purpose, market practice is to have standstills last only one year.

However, in a collaboration agreement, the licensee will receive a continuous flow of confidential information from the licensor for much longer.

Therefore, in this context licensees often seek to have the standstill last at least as long as the collaboration term.

Licensees typically push back on this, however, due to the wide divergence between the typical one-year standstill term and the much longer collaboration term, which can last 20 years or more.

This exposes a major risk of asking for a standstill: By asking for it, the licensor must expect that it will not last for the length of the collaboration.

If this is the result, licensors often cannot rely on the confidential information section of the collaboration agreement providing additional protection to hedge against the lapse of the standstill.

This is because licensees who are to be bound by the standstill often insist that when it expires, the conduct that was prohibited under it is explicitly allowed, including the use of confidential information to submit a hostile bid.

Thus, the licensor may find that asking for a standstill and receiving one that expires before the end of the collaboration has the effect of limiting the confidential information use restriction in the collaboration agreement and thereby may leave the licensor less protected than it would have been without the standstill.

This illustrates the tradeoff between standstills and confidential information use restrictions: Standstills provide better protection from a hostile action, but for a shorter period of time.

This tradeoff is not always the result, however. Standstill provisions tied to an equity investment made as part of the collaboration often survive much longer than they do in the M&A context, often for the term of the collaboration.

In this context, equity-investing collaboration partners may be more amenable to a limited standstill, whereby they can use confidential information with respect to securities voting but cannot publicly agitate for change of the board or take hostile action that the board does not support.

FOOD FOR THOUGHT

Licensing and collaboration agreements are critical tools that allow a life science company to share risk and financial responsibilities with a partner company and leverage the partner's unique expertise to bring products to market.

In the current environment, however, the negotiators of these agreements must ensure that they do not inadvertently obstruct their company's M&A goals.

This article can provide some food for thought for attorneys on a selection of the more interesting effects decisions made in drafting these agreements can have on subsequent acquisitions.

Notes

[1] Global & Regional M&A Report 1H19, Mergermarket, https://bit.ly/2mnCJx9.

[2] Here is an example of such a provision: If a competitive company acquires control of either party in a change of control transaction during the research term, then upon written notice from the non-acquired party to the acquired party delivered within 30 days of the public announcement of the consummation of the change-of-control transaction, the joint research committee will dissolve and Article 3 (research collaboration) Section 5.4 (progress reports) and any other provision requiring the collaboration of the parties and sharing of information for the purpose of developing and commercializing the compounds and products will cease to have effect, with the effect of making this agreement a conventional license with the licensee

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having sole responsibility to develop the licensed products in the territory. In all other respects this agreement will remain in full force and effect.

[3] Here is an example of such a provision: If a third party becomes an affiliate of licensor after the effective date through merger, acquisition, consolidation or other similar transactions (a "merger"), then such new affiliate and any affiliates of such new affiliate that existed prior to such merger may engage in a competing program and such activity will not constitute a breach of licensor's exclusivity obligations; provided that such new affiliate (or its then-existing affiliates) conducts such competing program independently of the activities of this agreement and does not use or access any of licensor's intellectual property rights or confidential information in the conduct of such competing program.

[4] Here is an example of such a provision: Licensor and its new affiliate will have 12 months from the closing date of such transaction to wind down or complete the divestiture of such competing program, and licensor's new affiliate's conduct of such competing program during such 12-month period will not be deemed a breach of licensor's exclusivity obligations set forth above; provided that such new affiliate conducts such competing program during such 12-month period independently of the activities of this agreement and does not use or access any of licensor's intellectual property rights or confidential information in the conduct of such competing program. "Divestiture" means the sale or transfer or exclusive license of rights to the competing program to a third party without receiving a continuing share of profit, royalty payment or other economic interest in the success of such competing program.

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