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INVESTORS PROFIT FROM BIOTECH BANKRUPTCY

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Biotechs and bankruptcy don't often go together. But that may be changing, according to some industry observers.

"I have never seen companies file for bankruptcy as much as I have now," said Colleen Sproul, a principal at Contracts Associates Inc., a Boston-based firm that outsources legal consultants to life science companies.

Many biotechs today, however, are up against a financial wall, and see bankruptcy as a faster route to cash than trying to find a buyer directly and having to clear all the associated regulatory hurdles.

For investors, bankrupt biotechs offer an opportunity to buy assets on the cheap, especially considering the shrinking alternatives. Sam Zucker, a partner in the Silicon Valley office of O'Melveny & Myers, refers to it as an "evolution born of crisis."

"Successful bankruptcies will never be a common occurrence in the biotech industry, but because the IPO market is so constrained and the merger and acquisitions market is limited, investors will look for good investments in areas where they would not have before, and I believe we are seeing some of that now," Zucker said.

In particular, investors are increasingly trying to extract as much value as possible out of the intellectual property of bankrupt biotechs. James E. Malackowski, president and chief executive officer of Ocean Tomo, a Chicago-based intellectual capital equity firm, said that banks and financial firms see that IP as potential collateral.

"Intellectual property is more important to these businesses than it has been historically," he said of biotechs. "Without it, these businesses don't have the same premium in the marketplace."

According to Ocean Tomo's index of 300 companies, there has been a "striking" shift in value to intangible assets from tangible assets, primarily intellectual property - rising to 75 percent of the industry's total market capitalization in 2008 from less than 20 percent of market capitalization in 1975.

One factor contributing to this shift, he said, is the increased transparency of these intangible assets through such relatively new venues as IP auctions.

"Investors, shareholders and trustees in a bankruptcy pay more attention to the value of those assets in making loans and investing and liquidating." Malackowski said.

The biotech bankruptcy trend is playing out in other life science hubs beyond California.

That in turn has led investors to jump in and take advantage of the situation, according to Jay de Groot, co-chair of the emerging companies and venture capital group in the San Diego office of Morrison & Foerster.

"As the capital market has become somewhat unavailable to small cap biotechs, and completely unavailable if they've suffered a certain level of failure, opportunistic buyers are using the bankruptcy process to buy assets very inexpensively," he said.

An added bonus: Assets are "cleansed" of contingent liabilities by the bankruptcy court, de Groot said. This can be risky for the so-called "stalking horse," or initial buyer of the company, but it can pay off big time if they prevail at auction.

In a recent transaction, de Groot represented a Delaware subsidiary of a United Kingdom company, the stalking horse of a clean-tech enterprise, which successfully acquired at auction the assets at a fraction of their value.

"Not only do you get cleansed of liability, you get to pick and choose which contracts you assume," he said. "If a failed biotech, for instance, had a big lease on a building, the buyer doesn't need to take that lease on in the bankruptcy process. You can reconfigure the business to actually succeed."

For many veteran lawyers, it's a whole new world out there.

"I've been involved in three of these transactions in the last 15 months," said de Groot, a new trend in his long career. "It's quite the rage in our bankruptcy group."

Michael J. Shuster, co-chair of Fenwick & West's life sciences group in San Francisco, said that the key to successfully structuring these types of deals is attention to due diligence. That's what he advised his client, Goldman Sachs, last year when it was considering the merits of resecuring a loan worth tens of millions of dollars it had made to Xoma, a biotech fallen on hard times when its business partner, Genentech, was forced by the FDA to pull a product for safety reasons.

"They needed to understand what they owned in the IP, who would be using it, what products were covered, what licenses had been granted, and the international reach of it," Shuster said. "Goldman wanted a 'deep dive' analysis to decide whether or not to pull the loan or resecuritize it."

As it turned out, the biotech ended up selling off a piece of its business, and raised enough money to satisfy the debt.

"I don't think Goldman would have been delighted to own a bunch of patents, because that's not its core expertise," he said. "At the end of the day, they were content to get their money back."

Nonetheless, IP has proven to be a useful leveraging device for investors, according to Jennifer A. DePalma, who works with Zucker in O'Melveny & Myers' Silicon Valley office.

"They don't know if they want to give you another million, but they think, 'Maybe we can get the IP, and make something out of this,'" she said. "By having the collateral, they have more of a chance of getting their money back."

There are, however, larger issues to consider, such as whether selling off valuable IP assets to organizations that don't necessarily add value to them is really the best way to promote scientific progress, said Brenda Simon, a fellow in the Center for Law and the Biosciences at Stanford Law School who will be joining the faculty of Thomas Jefferson School of Law in San Diego this fall.

For small inventors who may not have the means to commercialize their inventions, having a middle man to license the technology could be good for society as a whole, she said.

"On the other hand, if biotechs, facing financial difficulties, have to sell their assets, and venture capitalists or others are only using the patents to extract rent, I don't think it's the most effective way to promote progress," Simon said.

Either way, biotechs should beware of showing all of their cards during due diligence, Sproul said.

"These companies are turning over everything they have in hopes of getting big pharma backing," she said. "What makes me suspicious is that the first in line for these auctions for IP, the big pharma companies, a few months earlier, were looking to partner with these businesses."

"It's only the beginning," Sproul added. "Pharmas will be expanding their portfolios at bargain-basement prices."

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