

Royalty Monetization: A Post-License Value-Creation Strategy

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University¹ technology managers handle university intellectual property assets to achieve a multiplicity of goals, including: public benefit, faculty satisfaction and recognition, community and economic development, industry ties, and income generation. Technology managers utilize a variety of licensing and business development mechanisms to achieve these technology transfer goals. The need to balance different, and oftentimes, competing or incompatible goals, as well as the need to consider both short-term financial needs and longer-term growth strategies can present a significant challenge even to seasoned technology management professionals. These challenges are further compounded by the complex and diverse knowledge and skills inherent in the technology transfer process, the unpredictability of intellectual property, and the diverse roles and responsibilities of technology managers.

Technology transfer agreements with companies, investors, and entrepreneurs are critical to universities' ability to move discoveries from the laboratory to the market. However, consummation of these transactions—collaborations, licenses, and startups—is not the end of the technology transfer value-creation process. Beyond negotiating agreements, technology managers also need to consider post-license value-creation strategies and manage alliance relationships with licensees and collaborators. Post-transaction management includes defending intellectual property and transfer agreements, as well as the forward-going value of these activities. The relatively recent practice of royalty monetization is a powerful post-licensing value-creation tool and intellectual asset-management strategy. In these transactions, the owners of royalty streams sell all or part of the royalty streams to a buyer (financing source) in return for cash (paid upfront and/or in tranches).

Since 2000, there has been substantial growth of the market for royalty monetization transactions in the life science arena.

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During 2000-2003, there were more than \$500 million in product revenue stream monetizations; whereas, there was a ten-fold increase to more than \$5 billion from 2004-2007. These sales include both the sale of existing royalties as well as from synthetic royalties created by companies to sell product revenue interests. This dramatic increase is a reflection of the increased number of royalty buyers who understand healthcare products,² markets, and companies. There are also royalty monetization facilitators (i.e., bankers, attorneys, and valuation consultants) who can provide transactional expertise and experience. The increased availability of capital, buyers, and facilitators creates an excellent environment for sellers—patent owners, licensors, and others with healthcare royalty interests. This article presents points to consider in determining whether, when, and how to incorporate royalty monetization as a post-license value-creation and intellectual asset-management strategy to advance university technology transfer goals, optimize innovation capacity, and mitigate risk. Following discussion of the overarching concepts and issues related to royalty monetization is a how-to guide.

Royalty Monetization as a Strategic Tool

In its most basic sense, royalty monetization is a transaction that converts an intellectual property asset that is expected to generate a stream of future royalty income into current cash with a present value.

For most technology managers, the focus on financial terms in licensing transactions is often near- and midterm economics—fees (upfront, annual, milestone, sublicense sharing, and royalty rate), patent cost reimbursement, and equity realization. Yet, for successful healthcare product licenses, near- and midterm economics represent a relatively small portion of actual economic potential over the life of the license. Long-term value creation typically is predicated on the commercial

success of products that generate royalty streams.

In the past decade, nearly thirty academic institutions and groups of faculty inventors have utilized royalty monetization to access capital and mitigate risk. The value of university royalty monetization transactions has been increasing since 2000. In 2007 alone, almost \$2 billion in healthcare product royalty monetization and revenue interest financing transactions were concluded, and two university-based transactions accounted for the majority of this amount. This growth is reflected in the increasing portion of AUTM members who report that licensing income is being monetized at their institutions.³

Most importantly, the financial interest that universities hold in worldwide biopharmaceutical sales is growing, rising from 1.4 percent in 2001 to 3.6 percent today.³ Current annual global biopharmaceutical sales are in excess of \$500 billion, corresponding to \$18 billion in royalties each year, not including sales of medical devices, diagnostics, and other life science products in which universities hold a royalty interest.

Royalty Monetization: The What and the Why

Transaction Structure: The What

Royalty monetization is an emerging financing approach whereby a patent owner, licensor, or other entity or individual with an economic interest in future royalties sells or securitizes all or a portion of those future royalties in exchange for a certain set of payments. In a royalty monetization transaction, the seller transfers/assigns the right to receive that portion of the royalties sold to the buyer.

In some cases, such as those in which the licensed technology has been commercialized, the royalty stream may already be active. As the licensee generates revenue on licensed products, income flows to the licensor in the form of royalty payments.



In situations when licensed products are in development or awaiting regulatory approval, a royalty stream may be projected, but not yet realized. It is increasingly possible and may be beneficial for universities to monetize a portion of a not-yet-realized, future royalty stream for products in late-stage development, with a tranche payment structure that minimizes discount for approval risk.

Regardless of whether or not there is current cash flow from a product, royalty monetization provides cash in return for a defined portion of future payments from the licensee. Given the availability of capital for these structured finance transactions, sellers are able to construct deals that allow them to meet their current financial needs while potentially, depending on structure, preserving long-term value and upside potential.

For example, royalty monetizations do not have to be a complete sale of the royalty, but rather can comprise only a portion of the royalties, allowing the seller to retain a future economic interest. The agreed-upon structure may allow the seller to limit the royalty interest being sold to certain products, defined countries/regions, or even a certain period of time, thus providing a cap on aggregate payments and allowing the seller to retain royalties in excess of the cap.

Payments also can be structured as payments over time—exchanging potential revenue for defined revenue—to allow for covering defined obligations such as technology licensing office personnel, operations, and patent expenses for a designated period of years. This approach provides a mechanism for covering these costs in the intervening period while waiting for the next success in the license pipeline.

Sellers' Motivations: The Why

The diversity of sellers' motivations reflects the different needs and interests of sellers in general, and universities and their faculty inventors in particular. It

should be noted that the increasingly flexible design and structure of royalty monetization transactions allow diverse institutional stakeholders to address their unique objectives, including:

- Accessing capital in the near-term,
- Mitigating and diversifying risk,
- Providing financial recognition for a significant innovation, and
- Managing conflict of interest.

Accessing Capital

For institutional sellers, a prime motivation is early access to capital to meet current financial obligations, develop and fund programs, recruit faculty, build facilities, capitalize innovation/gap funds, and otherwise expand education, research, and innovation capacity. While current income from licensing activities provides some near-term cash flow, the significant payout is typically years into the future. In addition, given mandated use of proceeds of license revenues, as required by institutional patent policies, license income provides little, if any, flexibility, such as the funding of initiatives. In contrast, royalty monetization transactions can be structured to provide substantially larger amounts of cash over a much shorter period of time.

Mitigating and Diversifying Risk

Universities and inventors may consider royalty monetization to mitigate and diversify the risk associated with a specific asset. Universities typically derive substantial income from only a small number of licenses. As with any portfolio of assets, but especially a concentrated one, diversification is a customary and standard risk-mitigation approach. A portion of monetized royalties may be invested in other assets, including revenue-generating vehicles or even royalty monetization funds themselves, thus diversifying the institution's asset portfolio and mitigating the risk that could result from the diminution or loss of a single, substantial source of income.

Risks associated with university licensed

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healthcare product royalties are numerous, including patent and license challenges, regulatory stumbles (pulled from the market, product recall, label restriction), delayed launch, sales underperformance, unanticipated competition, and reduced reimbursement by health insurance companies and managed-care organizations.

For many faculty inventors, future income streams flowing from their interest in their inventions may account for the majority of their long-term asset holdings. The failure to realize these income streams may have a significant impact on the individual's overall financial health. A key tenet of responsible investing is maintaining a diversified asset portfolio that balances risk and reward. Royalty monetization offers inventors the opportunity to take some money off the table and invest it elsewhere, enabling them to engage in prudent financial planning and asset management. While risks associated with unanticipated reduced license income may not be catastrophic to universities, they may be to individual inventors. As with institutional transactions, inventors can structure a royalty monetization to retain a portion of long-term value and upside potential.

Providing Recognition

For both institutions and inventors, royalty monetization is a dramatic expression of financial recognition for a significant innovation. While academic recognition through traditional means (such as promotion) can occur relatively soon after important discoveries are made, substantive financial recognition of academic achievement may take more than a decade.

Managing Conflict of Interest

The decision to monetize a royalty may also be influenced by nonfinancial factors, such as conflict-of-interest management. Faculty members who speak of or advocate for particular products are coming under increased scrutiny with respect to real

or perceived personal financial interest. In some cases, the institution may stand to benefit from the success of the product in question even when the individual has no direct financial interest in it. In the current environment, even this indirect relationship may create a barrier for those faculty members interested in educating their peers on the latest biomedical and scientific advances.

Royalty monetization of the entire interest in an asset that is subject to such scrutiny provides a mechanism for effectively managing, possibly even avoiding, both real and perceived conflicts while allowing the institution to realize the value of the asset. Institutional and inventor involvement in clinical trials of products in which they have an existing or potential financial interest, including study of a new indication for an approved drug currently generating royalties, also creates a conflict of interest that may be well-managed by the sale of the entire royalty interest. Universities and inventors may also utilize royalty monetization to resolve conflicts that arise when the product itself or the source of the royalty is in opposition to the mission, ethics, or beliefs of the organization or individual.

Inventors Matter

As discussed above, unlike universities, faculty inventors as individuals have few alternatives to royalty monetization to access life-altering capital on a reasonable basis. In addition, as important as risk mitigation and diversification may be to institutions, it is even more critical to individual inventors.

It should be noted that institutions and inventors with beneficial interests in royalty income may have different time horizons with respect to the need for capital and may have very different risk-mitigation/diversification needs. While inventors cannot deliver to royalty buyers the full package of rights that can be provided by institutional owners of the intellectual

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property, they are well-positioned, with some institutional support, to participate in the structuring of these transactions.

Clearly, faculty inventors are a critical component of an institution's intellectual assets. As such, the needs of these innovative individuals must be considered in the context of licensing deals and post-licensing value-creation strategies. Whether or not institutions wish to proceed with royalty monetizations, it is in their best interest to educate their faculty inventors about the risks and benefits of these transactions and cooperate with those individuals who seek to use royalty monetization to meet their financial objectives.

The Why Notes

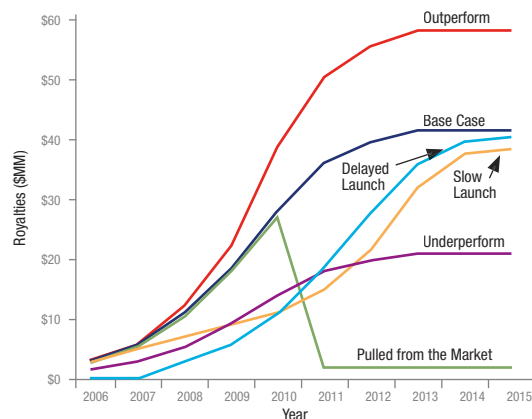
Just as there are diverse motives for pursuing royalty monetization, there are concerns that should give potential sellers pause. These concerns should be considered carefully in the context of an overall risk-benefit assessment. The growing number of transactions demonstrates that risks and concerns can be readily addressed with thoughtful transaction structures.

A key concern is that royalty monetization creates a discount in value over the life of the license. While this is almost always the case, it must be balanced against the additional value that accrues from accessing capital to fund today's needs. A well-structured deal that provides funds to further a robust strategic plan should provide sufficient return on investment to balance the discount associated with the monetization.

Thus, the real issue is the magnitude of the discount, rather than the discount per se. Moreover, it is important to recognize that, of the possible scenarios for product sales (which are the ultimate drivers of royalty income), only one provides a superior return compared with baseline assumptions (Figure 1). Given the potential for product failure, delay, and under performance and other events that may materially impair

the value of the royalty stream, there is a reasonable possibility that a royalty without monetization will generate income at or below the baseline assumption.

Figure 1: Revenue Forecast Scenarios



Also of concern is the potential for a royalty sale to be misinterpreted as a lack of confidence in the product. While it is possible for external audiences to arrive at this conclusion, effective communication around the transaction can reduce the likelihood of this perception. Making it clear that the transaction is part of an overall licensing, business-development, and capital-formation strategy should go a long way to providing appropriate context in which to assess its true meaning and value.

The status of the buyer also impacts a seller's ability to position a royalty monetization in a positive light and as a strategic intellectual property asset-management activity. If the buyer is recognized as highly knowledgeable, in both the scientific and commercial aspects of the life sciences, his or her interest in owning a portion of a specific royalty stream after an extensive due-diligence process may, in fact, provide additional validation for the product and the underlying intellectual property asset. Royalty monetization is and can be seen as a value-creation tool and asset-management strategy.

Time and cost concerns also create a barrier to pursuing royalty monetization,



even when the benefit of the transaction is recognized. Again, technology managers and other institutional decision makers need to consider any individual transaction in the context of a global asset- and financial-management strategy. That said, there are several factors that impact the actual time and cost requirements of these transactions.

Investment Bankers

There is an established pool of experienced life science royalty buyers (identified below) and bankers active in this area. The company making royalty payments should also be approached. Institutions may opt to directly contact the pool of known buyers. Such a direct approach may avoid costs and delays incurred when using an investment bank or financial adviser to identify a buyer. However, experience has shown that, in large transactions involving hundreds of millions of dollars, investment bankers, serving as financial advisers, can add value in terms of maximizing bids. Investment bankers' fees, however, are generally prohibitive in smaller transactions.

Valuation Consultants

The use of valuation consultants should be considered carefully. In addition to providing a value, valuation consultants may help build sales and royalty forecast models. If such capabilities are not available from internal institutional resources, their engagement should be considered. The monetization of life science royalties has become reasonably efficient in recent years, and the value of a particular asset is as much determined by demand as any other parameter. Third-party valuations are required in monetizations transactions as their independent reports establish the value for the asset.

Outside Legal Counsel

Outside legal counsel with particular expertise and experience in structured

finance, generally, and a track record representing universities and inventors in royalty monetization transactions, specifically, can help make the process more efficient with respect to time and cost. These are complex, specialized transactions, and experienced outside counsel can provide invaluable support to university general counsel and inventors' personal attorneys and tax and finance advisers. Experience suggests that, in the absence of knowledge about structured finance among members of the office of the general counsel, the needs of universities and inventors are best met when outside counsel is a member of the transaction team. Institutions and inventors should recognize that buyers have substantial legal resources at their disposal, and institutions and inventors need comparable expertise representing their interests. This balanced approach is essential to executing deal terms that meet the needs of all parties involved in the transaction.

Buyers' Expertise (or Lack Thereof)

Buyers' knowledge and understanding of the product; its market; and the underlying patents, license, and technology also impact the hassle factor of monetizing a royalty. Selecting a well-qualified, experienced royalty buyer allows all parties in the transaction to proceed with a shared understanding and aligned interests of risks, rewards, needs, and wants. Sellers must appreciate that these are complex financial transactions and that buyers are seeking to maximize their returns on investment. Of course, the ability of the buyer to make money and the seller to achieve appropriate short-term value and, in some cases, retain long-term value, are not mutually exclusive, and a well-structured transaction will enable both.

Does When Matter?

A key question about the potential value of royalty monetization relates to timing a transaction for maximum gain. Tradition-

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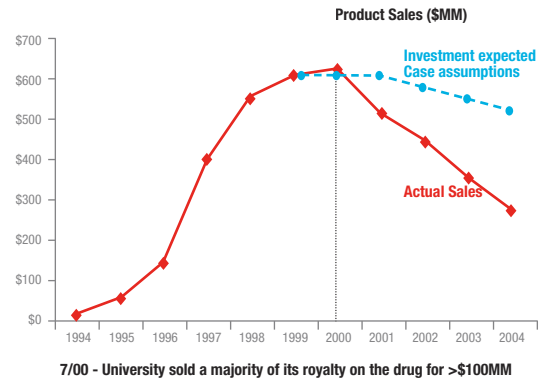
ally, technology managers have focused heavily on optimizing value by market timing. However, as experience in the stock and real estate markets has shown, trying to time purchases and sales to maximize investment returns is risky not only for investment professionals, but especially for amateurs.

Conventional wisdom holds that monetizing early in the development-to-commercialization continuum typically may yield lower valuations, creating the potential for a significant discount over the life of the product. This depends upon many factors including: phase of development, risk for both development and commercialization, the capabilities of the marketer, and the nature of the market opportunity, to name a few.

Similarly, it is generally accepted that monetizing later in the continuum may yield higher valuations more likely to be in alignment with actual performance, although some of the same factors noted above may impact overall performance. However, it is very difficult to accurately predict the commercial trajectory of any given healthcare product, particularly if it is a new chemical entity or market opportunity. Sometimes early promise fails to bear the expected fruit, leading to a situation in which monetizing earlier might have resulted in an enhanced rather than discounted return over the life of the product.

The challenge of trying to time the market is exemplified in the following example. In mid-2000, a leading university monetized its royalty on an antiviral drug. A major pharmaceutical company markets the drug worldwide, which was approved in the mid-1990s. Under the terms of the monetization, the university sold a majority percentage of its royalty on this drug for more than \$100 million. Although robust sales for 2000 and beyond were projected, annual sales of the drug actually declined precipitously (Figure 2). Looking back, it was clear that this was a timely sale for the university, and the majority of risk had

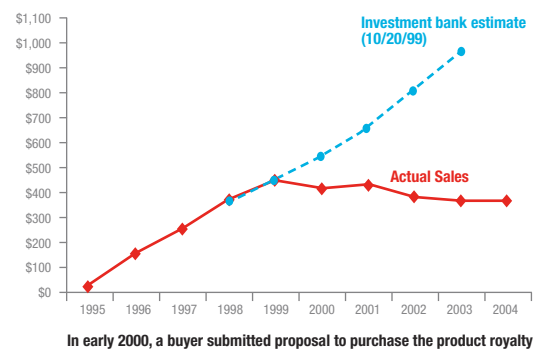
Figure 2: Timely Royalty Sale for a University



been transferred to the buyers as a result of the transaction.

Other examples—and there are many—highlight the dangers of trying to outsmart the market with timing strategies and suboptimal deal structures. One case involves a well-known therapeutic product, which the Food and Drug Administration approved in the mid-1990s, that is manufactured and sold on a global basis by two major pharmaceutical companies. In late 1999, a research report from an investment bank with significant expertise in the biopharmaceutical industry estimated that annual sales of the product would continue to rise over the next five years. In early 2000, a royalty buyer submitted a proposal to monetize the royalty. At the time of the offer, actual sales had dipped below the bank’s estimate (Figure 3). The holder of the royalty interest chose not to monetize the asset. In subsequent years, actual sales have been significantly below market forecasts and the potential buyer’s estimates.

Figure 3: Product Sales (\$MM)





In another case, a top-tier institution accepted an unsolicited offer by the company paying royalties to purchase a portion of future royalties on a successful therapeutic product. At the time of the offer, the product had been on the market for a number of years and the amount offered in return for the royalty was substantial. Given the expectation that sales would decline over time and the large amount of money offered by the buyer, the seller agreed to the terms of the monetization. The product has continued to be a mainstay therapy in its indication, and it is estimated that the sale has cost the institution \$1 billion in lost royalties.

Beyond playing Monday-morning quarterback, these retrospective analyses provide compelling evidence that deal timing is a risky business. Rather than trying to time the market, sellers should leverage the competitive nature of the current market for royalty monetizations and structure transactions to meet their needs regardless of whether product performance is at, above, or below expectations. Deal structure—when done well—will trump timing, transforming royalty monetization from a form of legalized gambling to a strategic asset-management and capital-formation tool. As previously mentioned, deal structure factors to consider include:

- Selling only a portion of the royalties, thus putting a cap on aggregate payments made to the buyer, with excess royalties (above the cap) to be retained by the seller. This enables the seller to retain a defined future economic interest.
- Limiting royalty interests being sold to certain indications, certain countries/regions, and/or a certain period of time.
- Providing annual payments designed to cover technology licensing office expenses for personnel, operations, and patents for a designated period of years (while waiting for the next success in the license pipeline).
- Selecting the buyer based on reputation, probability of success, and deal factors in addition to absolute price.

Who's Buying?

While a variety of financial organizations are theoretically capable of purchasing royalties, in reality, the majority of royalty monetization transactions have been executed by a small number of specialized funds, including Capital Royalty, Cowen Healthcare Royalty Partners, DRI Capital, Paul Capital Healthcare, and Royalty Pharma. These funds, generally, have a high level of understanding of the essential, underlying elements of these transactions—patents, technologies, licenses, products, markets, risks, benefits, and deal structures. Such knowledge helps to ensure that sellers and buyers enter into the royalty monetization process with a shared perspective. Given some variation in parameters other than price, these buyers have considerable expertise and experience in structuring and consummating these complex transactions. In addition, the marketer of the product that pays the royalty, the licensee, or sublicensee, should also be considered as a potential buyer as the company certainly has first-hand knowledge about the asset.

While a few investment banks have established capabilities to facilitate royalty monetization transactions, they are not buyers themselves. Rather, these banks typically seek to run auctions for sales. Bankers active in this field include Morgan Stanley, Goldman Sachs, and Citigroup. Royalty monetizations managed by bankers are usually associated with increased costs (in the form of transaction fees) and time (in getting various buyers up to speed on the technology and market potential of the auctioned asset). While the increased time and cost of using an investment bank may provide benefit in the case of a multiple hundred million dollar sale, most selling institutions are likely to have the capabilities to manage less complex deals directly, obviating the time for additional fees and time delays.



Points to Consider Before Undertaking Royalty Monetization (The How)

Four Critical Issues

Successful execution of these transactions necessitates a forthright appraisal of what is at stake, who stands to be affected, and why the transaction is being undertaken. In preparing for these transactions, technology managers must address four critical issues:

1. understand the motivations for and goals of the transaction;
2. consider the interests of all stakeholders, including faculty inventors;
3. conduct internal due diligence in advance of the sales process to fully understand their opportunities and limitations, including a comprehensive review of the underlying license and patents, and;
4. model revenue projections so as to better understand potential income streams associated with a variety of regulatory and market scenarios.

With this information in hand, technology managers and their institutions are well-positioned to advocate effectively and pragmatically for their institutions' and their inventors' interests. Such preparation is also likely to assure the continued involvement of technology managers in the transaction, thereby increasing the likelihood that the needs and interests of the technology licensing office will be considered.

A How-To Guide

1. Prepare for a possible transaction.

- a. Educate yourself so that you can help to educate others, thereby enabling an informed discussion and consideration of the opportunity.
- b. Analyze license and related agreements.
 - i. Determine your ability to assign the license and requisite consents to do so (which a buyer may require).
 - ii. Determine confidentiality restrictions.
 - iii. Identify ambiguities that may be of concern to a potential buyer.
 - iv. Assemble history of royalty and other payments from the licensee and any sublicensees, including sales and audit reports, if any, royalty rate, royalty base, possible deductions (stacking and combination discounts).
- c. Analyze the relevant patent portfolio.
 - i. Identify all patent holdings including filing, issuance, and expiration dates and territories.
 - ii. Consider a review of potentially competitive patent positions that may impact the value of the institution's patent.
- d. Develop a valuation model/tool.
 - i. Actual or projected product revenues and royalties due
 - ii. Current and future market and competition
 - iii. Regulatory risks
 - iv. Reimbursement risks (uptake by healthcare providers)
- e. Understand stakeholders' interests, goals, objectives, needs, and wants.
 - i. Technology transfer office, including the need for license income to fund operations in future years
 - ii. Inventors (both laboratory and personal shares)
 - iii. Finance and administration
 - iv. General counsel
 - v. Deans/department chairs
 - vi. Provost/president
 - vii. Trustees
- f. Consider institutional review and approval processes and key personnel, including to whom, when, and how to share your considerations and what authorizations you need to initiate the consideration process.
- g. Identify internal process stakeholders and advisory teams.



- i. Business issues (technology transfer office, external consultants)
 - ii. Legal issues (general counsel, outside counsel)
 - iii. Financial issues (finance and administration)
 - h. Develop nonconfidential and confidential information packages for review by potential buyers.
 2. **Structuring the transaction**
 - a. Consider the institution's and the inventor's goals.
 - b. With general counsel, retain outside counsel.
 - c. Develop transaction goals, needs, and wants to communicate to outside counsel and potential buyers.
 - d. With outside counsel, evaluate possible deal types (sale, securitization), structures, sales, and approval processes and related issues, including accounting and tax treatment; experienced outside counsel will develop and manage the purchase agreement and related agreements.
 3. **Sales process⁴**
 - a. Auction: The auction process typically consists of multiple rounds of bids, with the first round used for indication of interest and subsequent rounds comprising binding bids. Consider the:
 - i. Pros (perhaps a better price)
 - ii. Cons (more time and confusion)
 - b. Documents used in the auction process include:
 - i. Confidentiality agreements with potential buyers
 - ii. Process letter (informs bidders of intended process)
 - iii. Information memorandum
 1. License and related agreements
 2. Patent portfolio
 3. History of royalty payments
 4. Draft royalty purchase agreement
 5. Valuation information
 4. **Royalty buyers**
 - a. Licensee and sublicensees
 - b. Healthcare royalty buyers
 - i. Capital Royalty LP (www.capitalroyalty.com)
 - ii. Cowen Healthcare Royalty Partners (www.cowenroyalty.com)
 - iii. DRI Capital (www.dricapital.com)
 - iv. Paul Capital Healthcare (www.paulcapitalhealthcare.com)
 - v. Royalty Pharma (www.royaltypharma.com)

Several of these Web sites provide case studies or lists of transactions that demonstrate how royalty monetization transactions can be deployed to achieve a variety of goals and objectives.
- ## Conclusions
- Universities and technology managers should feel confident that royalty monetization is an established, effective intellectual asset-management strategy. Royalty monetization offers flexibility with respect to deal structure and terms. Currently, an active market helps to ensure that sellers will find one or more buyers able and willing to meet their needs. A high level of knowledge on both sides of the table is critical to structuring win-win transactions. Universities and technology managers will benefit from conducting rigorous internal due diligence, addressing the interests of their various stakeholders, and identifying potential buyers who are knowledgeable and experienced.
- ### In summary,
- Royalty monetization is an intellectual asset-management strategy that should be considered as part of the post-license process.
 - Structuring royalty monetization transactions as win-win, as technology managers endeavor to do in all negotiations, is far more likely to achieve the goals of institutions and inventors than trying to time the market to optimize gains.

Research

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- Universities should alert faculty inventors to the opportunity to monetize royalties and provide reasonable cooperation.

Royalty monetization transactions are able to create value long after the ink has dried on licenses. ▾

Notes

¹ In this article, *university* includes degree-granting academic institutions and not-for-profit research institutions, organizations, foundations, teaching hospitals, and the like.

² Products include therapeutics, vaccines, devices, and diagnostics.

³ Royalty Monetization Workshop D8, March 1, 2008, at the AUTM Annual Meeting in San Diego, California.

⁴ Royalty Monetization Workshop B8, February 29, 2008, at the AUTM Annual Meeting in San Diego, California.