PDL BIOPHARMA, INC.
Form 10-Q
August 18, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)
ý Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2014
OR
¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For transition period from to
Commission File Number: 000-19756

PDL BIOPHARMA, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-3023969
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

932 Southwood Boulevard
Incline Village, Nevada 89451
(Address of principal executive offices and Zip Code)
(775) 832-8500
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer ý Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨
(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes ¨ No ý
As of July 29, 2014, there were 160,637,802 shares of the Registrant's Common Stock outstanding.

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GLOSSARY OF TERMS AND ABBREVIATIONS

Abbreviation/term	Definition
'216B Patent	European Patent No. 0 451 216B
'761 Patent	U.S. Patent No. 5,693,761
2012 Notes	2.0% Convertible Senior Notes due February 15, 2012, fully retired at June 30, 2011
Abbott	Abbott Laboratories
Accel 300	Accel 300, LLC, a wholly-owned subsidiary of kaléo, Inc.
Avinger	Avinger, Inc.
AxoGen	AxoGen, Inc.
AxoGen Royalty Agreement	Revenue Interests Purchase Agreement between PDL and AxoGen.
Biogen Idec	Biogen Idec, Inc.
Chugai	Chugai Pharmaceutical Co., Ltd.
Depomed	Depomed, Inc.
Depomed Royalty Agreement	Royalty Purchase and Sale Agreement among Depomed and Depo DR Sub, LLC, a wholly owned subsidiary of Depomed, and PDL
Direct Flow Medical	Direct Flow Medical, Inc.
Durata	Durata Therapeutics Holding C.V. and Durata Therapeutics International B.V. and Durata Therapeutics, Inc. (parent company)
Elan	Elan Corporation, PLC
ex-U.S.-based Manufacturing and Sales	Products that are both manufactured and sold outside of the United States
ex-U.S.-based Sales	Products that are manufactured in the United States and sold outside of the United States
EBITDA	Earnings before interest, taxes, depreciation and amortization
Facet	Facet Biotech Corporation. In April 2010, Abbott Laboratories acquired Facet and later renamed the company Abbott Biotherapeutics Corp., and in January 2013, Abbott Biotherapeutics Corp. was renamed AbbVie Biotherapeutics, Inc. and spun off from Abbott Laboratories as a subsidiary of AbbVie Inc.
FASB	Financial Accounting Standards Board
FDA	U.S. Food and Drug Administration
February 2015 Notes	2.875% Convertible Senior Notes due February 15, 2015, fully retired at September 30, 2013
February 2018 Notes	4.0% Convertible Senior Notes due February 1, 2018
GAAP	U.S. Generally Accepted Accounting Principles
Genentech	Genentech, Inc.
Genentech Products	Avastin®, Herceptin®, Lucentis®, Xolair®, Perjeta®, and Kadcyla®
Hyperion	Hyperion Catalysis International, Inc.
kaléo	kaléo, Inc. (formerly known as Intellijject, Inc.)
LENSAR	LENSAR, Inc.
Lilly	Eli Lilly and Company
May 2015 Notes	3.75% Senior Convertible Notes due May 2015
Merus Labs	Merus Labs International, Inc.
Michigan Royalty Agreement	Royalty Purchase and Sale Agreement between The Regents of the University of Michigan and PDL
Novartis	Novartis AG
OCI	Other Comprehensive Income (Loss)

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Paradigm Spine	Paradigm Spine, LLC
PDL, we, us, our, the Company	PDL BioPharma, Inc.
Queen et al. patents	PDL's patents in the United States and elsewhere covering the humanization of antibodies
Roche	F. Hoffman LaRoche, Ltd.
SAB	Staff Accounting Bulletin
SDK	Showa Denka K.K.
SEC	Securities and Exchange Commission
Series 2012 Notes	2.875% Series 2012 Convertible Senior Notes due February 15, 2015
Settlement Agreement	Settlement Agreement amongst PDL, Genentech and Roche, dated January 31, 2014
SPCs	Supplementary Protection Certificates
Spin-Off	The spin-off by PDL of Facet
Term Loan	Credit agreement among PDL, the Royal Bank of Canada and lenders thereto, dated October 28, 2013, as amended
U.S.-based Sales	Products sold in the United States or manufactured in the United States and used or sold anywhere in the world
VB	Viscogliosi Brothers, LLC
VB Royalty Agreement	Royalty Purchase and Sale Agreement between Viscogliosi Brothers, LLC and PDL
VWAP	Volume weighted average share price
Wellstat Diagnostics	Wellstat Diagnostics, LLC
White Oak	White Oak Global Advisors, LLC

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PDL BIOPHARMA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues				
Royalties from Queen et al. patents	$115,066	$143,617	$231,092	$235,464
Royalty rights - change in fair value	34,498	—	46,205	—
Interest revenue	12,613	4,903	21,684	8,651
License and other	575	—	575	—
Total revenues	162,752	148,520	299,556	244,115
Operating expenses:				
General and administrative	6,920	6,783	11,502	13,969
Operating income	155,832	141,737	288,054	230,146
Non-operating expense, net				
Interest and other income, net	82	60	132	150
Interest expense	(9,858)	(6,051)	(20,383)	(12,051)
Loss on extinguishment of debt	—	—	(6,143)	—
Total non-operating expense, net	(9,776)	(5,991)	(26,394)	(11,901)
Income before income taxes	146,056	135,746	261,660	218,245
Income tax expense	54,001	42,004	96,722	71,032
Net income	$92,055	$93,742	$164,938	$147,213
Net income per share				
Basic	$0.57	$0.67	$1.06	$1.05
Diluted	$0.52	$0.62	$0.94	$0.96
Weighted average shares outstanding				
Basic	160,256	139,825	155,752	139,821
Diluted	177,228	152,224	175,811	152,784
Cash dividends declared per common share	$—	$—	$0.60	$0.60

See accompanying notes.

PDL BIOPHARMA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$92,055	$93,742	$164,938	$147,213
Other comprehensive income (loss), net of tax				
Change in unrealized gains on investments in available-for-sale securities:				
Change in fair value of investments in available-for-sale securities, net of tax	(204)	(3)	(1,296)	(6)
Adjustment for net (gains) losses realized and included in net income, net of tax	—	—	—	—
Total change in unrealized gains on investments in available-for-sale securities, net of tax[a]	(204)	(3)	(1,296)	(6)
Change in unrealized losses on cash flow hedges:				
Change in fair value of cash flow hedges, net of tax	264	(1,265)	331	2,302
Adjustment for net (gains) losses realized and included in net income, net of tax	2,027	(268)	2,755	979
Total change in unrealized losses on cash flow hedges, net of tax[b]	2,291	(1,533)	3,086	3,281
Total other comprehensive income (loss), net of tax	2,087	(1,536)	1,790	3,275
Comprehensive income	$94,142	$92,206	$166,728	$150,488

[a] Net of tax of ($110) and ($2) for the three months ended June 30, 2014 and 2013, respectively, and $(698) and ($3) for the six months ended June 30, 2014, and 2013, respectively.
[b] Net of tax of $1,234 and ($825) for the three months ended June 30, 2014 and 2013, respectively, and $1,662 and $1,767 for the six months ended June 30, 2014, and 2013, respectively.

See accompanying notes.

PDL BIOPHARMA, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	June 30, 2014 (unaudited)	December 31, 2013 (Note 1)
Assets		
Current assets:		
Cash and cash equivalents	$214,525	$94,302
Short-term investments	3,243	5,238
Receivables from licensees and other	1,352	300
Deferred tax assets	2,535	377
Notes receivable	6,599	1,208
Prepaid and other current assets	1,793	6,272
Total current assets	230,047	107,697
Property and equipment, net	69	41
Royalty rights - at fair value	247,116	235,677
Notes and other receivables, long-term	413,720	193,840
Long-term deferred tax assets	17,395	6,700
Other assets	8,058	—
Total assets	$916,405	$543,955
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$341	$287
Accrued liabilities	61,935	11,857
Accrued income taxes	10,817	—
Term loan payable	37,364	74,397
Convertible notes payable	197,957	320,883
Total current liabilities	308,414	407,424
Convertible notes payable	272,824	—
Other long-term liabilities	38,506	23,042
Total liabilities	619,744	430,466
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, par value $0.01 per share, 10,000 shares authorized; no shares issued and outstanding	—	—
Common stock, par value $0.01 per share, 350,000 shares authorized; 160,266 and 139,935 shares issued and outstanding at June 30, 2014, and December 31, 2013, respectively	1,603	1,399
Additional paid-in capital	(120,590)	(233,173)
Accumulated other comprehensive loss	(3,098)	(4,888)
Retained earnings	418,746	350,151
Total stockholders' equity	296,661	113,489

Total liabilities and stockholders' equity	$916,405	$543,955

See accompanying notes.

PDL BIOPHARMA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Six Months Ended June 30,	
	2014	2013
Cash flows from operating activities		
Net income	$164,938	$147,213
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of convertible notes and term loan offering costs	9,568	6,552
Change in fair value of royalty rights - at fair value	(45,390)	—
Loss on extinguishment of convertible notes	6,143	—
Other amortization, depreciation and accretion of embedded derivative	(94)	(214)
Hedge ineffectiveness on foreign exchange contracts	(3)	(5)
Stock-based compensation expense	616	373
Tax expense from stock-based compensation arrangements	—	(13)
Deferred income taxes	(2,564)	(548)
Changes in assets and liabilities:		
Receivables from licensees and other	(1,052)	366
Prepaid and other current assets	1,759	1,156
Accrued interest on notes receivable	(10,165)	(5,339)
Other assets	(29)	935
Accounts payable	54	(959)
Accrued liabilities	4,426	(290)
Accrued income taxes	10,817	18,753
Other long-term liabilities	7,129	(5,271)
Net cash provided by operating activities	146,153	162,709
Cash flows from investing activities		
Purchases of investments	—	(6,375)
Maturities of investments	—	16,405
Purchase of royalty rights - at fair value	(15,500)	—
Proceeds from royalty rights - at fair value	49,451	—
Purchase of notes receivable	(215,000)	(27,304)
Repayment of notes receivable	—	16,779
Purchase of property and equipment	(39)	(2)
Net cash used in investing activities	(181,088)	(497)
Cash flows from financing activities		
Repurchase of convertible notes	(29,906)	—
Proceeds from the issuance of convertible notes, net	300,000	—
Payment of debt issuance costs	(9,824)	—
Purchase of call options	(30,951)	—
Proceeds from the issuance of warrants	11,427	—
Repayment of term loan	(37,500)	—
Cash dividends paid	(48,088)	(41,964)
Excess tax benefit from stock-based compensation	—	13
Net cash provided by/(used in) financing activities	155,158	(41,951)
Net increase in cash and cash equivalents	120,223	120,261
Cash and cash equivalents at beginning of the period	94,302	131,212
Cash and cash equivalents at end of period	$214,525	$251,473

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Supplemental cash flow information		
Cash paid for income taxes	$81,000	$55,000
Cash paid for interest (including convertible debt inducement)	$8,676	$5,498
Stock issued to settle debt	$157,591	$—

See accompanying notes.

PDL BIOPHARMA, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014
(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with GAAP for interim financial information. The financial statements include all adjustments (consisting only of normal recurring adjustments), except as discussed under Correction of Immaterial Error and Reclassification below, that management of PDL believes are necessary for a fair presentation of the periods presented. These interim financial results are not necessarily indicative of results expected for the full fiscal year or for any subsequent interim period.

The accompanying Condensed Consolidated Financial Statements and related financial information should be read in conjunction with the audited Consolidated Financial Statements and the related notes thereto for the year ended December 31, 2013, included in our Annual Report on Form 10-K filed with the SEC. The Condensed Consolidated Balance Sheet at December 31, 2013, has been derived from the audited Consolidated Financial Statements at that date.

Principles of Consolidation

The Condensed Consolidated Financial Statements include the accounts of PDL and its wholly-owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. Our condensed consolidated financial statements are prepared in accordance with GAAP and the rules and regulations of the SEC.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Notes Receivable and Other Long-Term Receivables

We account for our notes receivable at amortized cost, net of unamortized origination fees, if any. Related fees and costs are recorded net of any amounts reimbursed. Interest is accreted or accrued to "Interest revenue" using the interest method. When and if supplemental royalties are received from certain of these notes and other long-term receivables, an adjustment to the estimated effective interest rate is affected prospectively.

Royalty Rights - At Fair Value

We have elected to account for our investments in royalty rights at fair value with changes in fair value presented in earnings. The fair value of the investments in royalty rights is determined by using a discounted cash flow analysis related to the expected future cash flows to be received. These assets are classified as Level 3 assets within the fair value hierarchy as our valuation estimates utilize significant unobservable inputs, including estimates as to the probability and timing of future sales of the related products. Transaction related fees and costs are expensed as incurred.

Realized and unrealized gains and losses from investments in royalty rights are presented together on the statements of income as a component of revenue under the caption, “Royalty rights - change in fair value.”

Correction of Immaterial Error

As disclosed in our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2014, PDL was engaged in ongoing discussions with the SEC staff after receiving a comment letter regarding the Company's consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. The comment letter requested additional information about the Company’s accounting for the Depomed Royalty Agreement. The Company was asked to support its position and explain why the transaction was accounted for as the acquisition of intangible assets as opposed to that of financial assets. While significant judgment is required to account for this transaction, as either the acquisition of intangible assets or financial assets, we have concluded that it is most appropriate to account for the asset as a

Level 3 financial asset, which is a change to the previously reported accounting for this transaction. PDL has elected to measure this asset at fair value each reporting period. The change in the estimated fair value of this asset at each reporting period will be shown on a single caption, “Royalty rights - change in fair value” in our condensed consolidated statements of income. The purchase of this asset will be reported as an investing activity in our consolidated statements of cash flows. The revenue recognized each period related to this asset will be reported as an adjustment to net income in order to determine net cash provided by (used in) operating activities in our consolidated statements of cash flows. Actual cash received will be reported as an investing cash inflow in our consolidated statements of cash flows, separate from cash used in investing activities to purchase the asset in 2013. The Company reviewed the impact of this change in accounting on prior annual and interim periods in accordance with SAB no. 99, Materiality and SAB No. 108, Considering the Effects of Prior year Misstatements when Quantifying Misstatements in Current Year Financial Statements and determined that the changes were not material for the period from October 18, 2013 (acquisition date), through March 31, 2014, and did not represent a material impact to our consolidated financial statements in either our previously filed Annual Report on Form 10-K for the fiscal year ended December 31, 2013, or our previously filed Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2014.

For the year ended December 31, 2013 (in thousands)

Amounts in 000's	As Filed	Reclassification	Correction of Error	As Corrected	% Error Change
Total Revenues	$442,921	$18,976	$190	$462,087	— %
Operating Income	$407,529	$18,976	$5,013	$431,518	1.2 %
Pre-tax Income	$401,876	$—	$5,013	$406,889	1.2 %
Net Income	$264,530	$—	$3,184	$267,714	1.2 %
EPS:					
Basic	$1.89	$—	$0.02	$1.91	1.1 %
Diluted	$1.66	$—	$0.02	$1.68	1.2 %

For the three months ended March 31, 2014 (in thousands)

Amounts in 000's	As Filed	Reclassification	Correction of Error[1]	As Corrected	% Error Change
Total Revenues	$139,664	$9,071	$1,669	$150,404	1.2 %
Operating Income	$123,151	$9,071	$12,786	$145,008	10.4 %
Pre-tax Income	$115,604	$—	$12,786	$128,390	11.1 %
Net Income	$72,883	$—	$8,121	$81,004	11.1 %
EPS:					
Basic	$0.48	$—	$0.05	$0.53	10.4 %
Diluted	$0.44	$—	$0.05	$0.49	11.4 %

[1] Includes cumulative impact of 2013 corrections

We evaluated the materiality of correcting the cumulative error in the period ended June 30, 2014. Based on such evaluation, we concluded that the correction is not material to this period. Accordingly, we corrected the cumulative error in our condensed consolidated statement of income for the quarter ended June 30, 2014 as follows: (i) $1.7 million increase in total revenues, (ii) $12.8 million increase pre-tax income, (iii) $8.1 million increase in net income. The impacts to our condensed consolidated balance sheet and statements of cash flows were not material.

We determined that a retrospective revision due to the correction of an error was not required. The prospective change is reflected in the current period as a component of “Royalty rights - change in fair value” in our condensed consolidated statements of income. Intangible assets that were presented in historical periods have been reclassified to "Royalty rights - at fair value" for all periods presented. Such reclassifications did not have an impact on our results of

operations, cash flows or financial position.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Interest income recognized from financial assets that were previously reported as a component of "Interest and other income, net" in the condensed consolidated statements of income has been reclassified to "Interest revenue" as a component of revenue in the condensed consolidated statements of income.

Customer Concentration

The percentage of total revenue recognized, which individually accounted for ten percent or more of our total revenues, was as follows:

		Three Months Ended June 30,				Six Months Ended June 30,			
Licensee	Product Name	2014		2013		2014		2013	
Genentech	Avastin®	24	%	31	%	27	%	33	%
	Herceptin®	24	%	32	%	25	%	32	%
	Lucentis®	10	%	20	%	11	%	17	%
Biogen Idec[1]	Tysabri®	8	%	9	%	9	%	11	%
Depomed	Glumetza®	16	%	0	%	13	%	0	%

[1] In April 2013, Biogen Idec completed its purchase of Elan's interest in Tysabri. Prior to this our licensee for Tysabri was identified as Elan.

Foreign Currency Hedging

We enter into foreign currency hedges to manage exposures arising in the normal course of business and not for speculative purposes.

We hedge certain Euro-denominated currency exposures related to royalties associated with our licensees' product sales with Euro forward contracts. In general, these contracts are intended to offset the underlying Euro market risk in our royalty revenues. These contracts currently extend through the fourth quarter of 2014. We designate foreign currency exchange contracts used to hedge royalty revenues based on underlying Euro-denominated licensee product sales as cash flow hedges.

At the inception of each hedging relationship and on a quarterly basis, we assess hedge effectiveness. The fair value of the Euro contracts is estimated using pricing models with readily observable inputs from actively quoted markets and is disclosed on a gross basis. The aggregate unrealized gain or loss, net of tax, on the effective component of the hedge is recorded in stockholders' equity as accumulated other comprehensive income (loss). Gains or losses on cash flow hedges are recognized as an adjustment to royalty revenue in the same period that the hedged transaction impacts earnings as royalty revenue. Any gain or loss on the ineffective portion of our hedge contracts is reported in interests and other income, net in the period the ineffectiveness occurs.

Recent Accounting Pronouncements

In May 2014, the FASB issued new revenue recognition guidance which amended the existing accounting standards for revenue recognition. The new guidance establishes principles for recognizing revenue upon the transfer of

promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. It is effective for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently in the process of evaluating the impact of adoption of the new standard on its consolidated financial statements, but does not expect the impact to be material.

2. Net Income per Share

Net Income per Basic and Diluted Share: (in thousands except per share amounts)	Three Months Ended June 30, 2014	2013	Six Months Ended June 30, 2014	2013
Numerator				
Net income used to compute net income per basic share	$92,055	$93,742	$164,938	$147,213
Add back interest expense for convertible notes, net of estimated tax of approximately $0 and $3 for the three months ended June 30, 2014 and 2013, respectively, and $0 and $7 for the six months ended June 30, 2014 and 2013, respectively.	—	6	—	13
Net income used to compute net income per diluted share	$92,055	$93,748	$164,938	$147,226
Denominator				
Weighted-average shares used to compute net income per basic share	160,256	139,825	155,752	139,821
Restricted stock outstanding	115	75	90	71
Effect of dilutive stock options	22	19	21	19
Assumed conversion of February 2018 Notes	1,872	—	1,484	—
Assumed conversion of Series 2012 Notes	4,487	8,304	7,570	8,693
Assumed conversion of May 2015 Notes	10,476	3,825	10,894	4,004
Assumed conversion of February 2015 Notes	—	176	—	176
Weighted-average shares used to compute net income per diluted share	177,228	152,224	175,811	152,784
Net income per share - basic	$0.57	$0.67	$1.06	$1.05
Net income per share - diluted	$0.52	$0.62	$0.94	$0.96

We compute diluted net income per share using the sum of the weighted-average number of common and common equivalents shares outstanding. Common equivalent shares used in the computation of diluted net income per share include shares that may be issued under our stock options and restricted stock awards, our February 2018 Notes, our Series 2012 Notes and our May 2015 Notes on a weighted average basis for the period that the notes were outstanding, including the effect of adding back interest expense and the underlying shares using the if converted method. In the first quarter of 2012, $179.0 million aggregate principal of our February 2015 Notes was exchanged for our Series 2012 Notes, in the third quarter of 2013, $1.0 million aggregate principal of our February 2015 Notes was exchanged for our Series 2012 Notes, and the February 2015 Notes were retired, and in the first quarter of 2014, $131.7 million aggregate principal of our Series 2012 Notes was retired in a privately negotiated exchange and purchase agreements.

In May 2011, we issued our May 2015 Notes, in January and February 2012, we issued our Series 2012 Notes, and in February 2014, we issued our February 2018 Notes. The February 2018 Notes, Series 2012 Notes and May 2015 Notes are net share settled, with the principal amount settled in cash and the excess settled in our common stock. The weighted average share adjustments related to our February 2018 Notes, Series 2012 Notes and May 2015 Notes, shown in the table above, include the shares issuable in respect of such excess.

May 2015 Notes Purchase Call Option and Warrant Potential Dilution

We excluded from our calculations of diluted net income per share 21.8 million and 20.4 million shares for the three months ended June 30, 2014 and 2013, respectively, and 21.8 million and 20.4 million shares for the six months ended June 30, 2014, and 2013, for warrants issued in 2011, because conversion of the underlying May 2015 Notes is not assumed. These securities could be dilutive in future periods. Our purchased call options, issued in 2011, will always be anti-dilutive and therefore 25.7 million and 24.0 million shares were excluded from our calculations of net income per diluted share for the three months ended June 30, 2014 and 2013, respectively, and 25.7 million and 24.0 million shares were excluded from our calculation of diluted net income per share for the six months ended June 30, 2014, and 2013, respectively, because they have no effect on diluted net income per share. For information related to the conversion rates on our convertible debt, see Note 9.

February 2018 Notes Purchase Call Option and Warrant Potential Dilution

We excluded from our calculation of net income per diluted share 29.0 million shares for the three months ended June 30, 2014, 29.0 million shares for the six months ended June 30, 2014, for warrants issued in February 2014, because the exercise price of the warrants exceeded the VWAP of our common stock and conversion of the underlying February 2018 Notes is not assumed, no stock would be issuable upon conversion. These securities could be dilutive in future periods. Our purchased call options, issued in February 2014, will always be anti-dilutive and therefore 32.7 million shares were excluded from our calculation of net income per diluted share for the three months ended June 30, 2014, and 32.7 million shares were excluded from our calculation of net income per diluted share for the six months ended June 30, 2014, because they have no effect on diluted net income per share. For information related to the conversion rates on our convertible debt, see Note 9.

Anti-Dilutive Effect of Stock Options and Restricted Stock Awards

For the three and six months ended June 30, 2014, we excluded approximately 24,000 and 69,000 shares underlying outstanding stock options, respectively, calculated on a weighted average basis, from our net income per diluted share calculations because their effect was anti-dilutive.

For the three months ended June 30, 2013, we excluded approximately 139,000 and 28,000 shares underlying outstanding stock options and restricted stock awards, respectively, calculated on a weighted average basis, from our net income per diluted share calculations because their effect was anti-dilutive. For the six months ended June 30, 2013, we excluded approximately 139,000 and 8,000 shares underlying outstanding stock options and restricted stock awards, respectively, calculated on a weighted average basis, from our net income per diluted share calculations because their effect was anti-dilutive.

3. Fair Value Measurements

The fair value of our financial instruments are estimates of the amounts that would be received if we were to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date or exit price. The assets and liabilities are categorized and disclosed in one of the following three categories:

Level 1 – based on quoted market prices in active markets for identical assets and liabilities;

Level 2 – based on quoted market prices for similar assets and liabilities, using observable market based inputs or unobservable market based inputs corroborated by market data; and

Level 3 – based on unobservable inputs using management’s best estimate and assumptions when inputs are unavailable.

The following tables present the fair value of our financial instruments measured at fair value on a recurring basis by level within the valuation hierarchy.

	June 30, 2014				December 31, 2013			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
(In thousands)								
Financial assets:								
Money market funds	$155,107	$—	$—	$155,107	$85,970	$—	$—	$85,970
Corporate securities	—	3,243	—	3,243	—	5,238	—	5,238
Royalty rights - at fair value	—	—	247,116	247,116	—	—	235,677	235,677

Total	$155,107	$3,243	$247,116	$405,466	$85,970	$5,238	$235,677	$326,885
Financial liabilities:								
Foreign currency hedge contracts	$—	$4,199	$—	$4,199	$—	$8,871	$—	$8,871

There have been no transfers between levels during the three months ended June 30, 2014, and December 31, 2013. The Company recognizes transfers between levels on the date of the event or change in circumstances that caused the transfer.

Corporate Securities

Corporate securities consist primarily of U.S. corporate equity holdings. The fair value of corporate securities is estimated using recently executed transactions or market quoted prices, where observable. Independent pricing sources are also used for valuation.

Royalty Rights - At Fair Value

Depomed Royalty Agreement

On October 18, 2013, PDL entered into the Depomed Royalty Agreement, whereby the Company acquired the rights to receive royalties and milestones payable on sales of Type 2 diabetes products licensed by Depomed in exchange for a $240.5 million cash payment. Total arrangement consideration was $241.3 million, which was comprised of the $240.5 million cash payment to Depomed and $0.8 million in transaction costs.

The rights acquired include Depomed’s royalty and milestone payments accruing from and after October 1, 2013: (a) from Santarus with respect to sales of Glumetza® (metformin HCL extended-release tablets) in the United States; (b) from Merck with respect to sales of Janumet® XR (sitagliptin and metformin HCL extended-release); (c) from Janssen Pharmaceutica with respect to potential future development milestones and sales of its investigational fixed-dose combination of Invokana® (canagliflozin) and extended-release metformin; (d) from Boehringer Ingelheim with respect to potential future development milestones and sales of the investigational fixed-dose combinations of drugs and extended-release metformin subject to Depomed’s license agreement with Boehringer Ingelheim; and (e) from LG Life Sciences and Valeant Pharmaceuticals for sales of extended-release metformin in Korea and Canada, respectively.

Under the terms of the Royalty Purchase and Sale Agreement, the Company will receive all royalty and milestone payments due under license agreements between Depomed and its licensees until the Company has received payments equal to two times the cash payment it made to Depomed, after which all net payments received by Depomed will be shared evenly between the Company and Depomed.

The Royalty Purchase and Sale Agreement terminates on the third anniversary following the date upon which the later of the following occurs: (a) October 25, 2021, or (b) at such time as no royalty payments remain payable under any license agreement and each of the license agreements has expired by its terms.

As of June 30, 2014, and December 31, 2013, the Company determined that its royalty purchase interest in Depo DR Sub represented a variable interest in a variable interest entity since the equity in Depo DR Sub was not sufficient to finance its operations without additional financing. However, the Company does not have the power to direct the activities of Depo DR Sub that most significantly impact Depo DR Sub's economic performance and is not the primary beneficiary of Depo DR Sub; therefore, Depo DR Sub is not subject to consolidation by the Company.

The asset acquired represents a single unit of accounting. The fair value of the asset acquired was determined by using a discounted cash flow analysis related to the expected future cash flows to be generated by each licensed product. This asset is classified as a Level 3 asset within the fair value hierarchy, as our valuation utilized significant unobservable inputs, including estimates as to the probability and timing of future commercialization for products not yet approved by the FDA or other regulatory agencies. The discounted cash flow was based upon expected royalties from sales of licensed products over a nine year period. The discount rates utilized ranged from approximately 21% to 25%. Significant judgment is required in selecting appropriate discount rates. Should these discount rates increase or decrease by 5%, the fair value of the asset could decrease by $22.3 million or increase by $28.2 million, respectively. A third-party expert was engaged to assist management with the development of its estimate of the expected future

cash flows. The fair value of the asset is subject to variation should cash flows vary significantly from our estimates. An evaluation of those estimates, discount rates utilized and general market conditions effecting fair market value will be performed in each reporting period.

As of June 30, 2014, and December 31, 2013, the carrying value of the asset acquired and reported in our consolidated balance sheets was approximately $231.6 million and $235.7 million, respectively. As of June 30, 2014, the maximum loss exposure was $231.6 million.

VB Royalty Agreement

On June 26, 2014, PDL entered into the VB Royalty Agreement, whereby VB conveyed to the Company the right to receive royalties payable on sales of a PMA-approved spinal implant in exchange for a $15.5 million cash payment, less fees.

The royalty acquired includes royalties accruing from and after April 1, 2014. Under the terms of the VB Royalty Agreement, the Company will receive all royalty payments due to VB pursuant to certain technology transfer agreements between VB and Paradigm Spine until the Company has received payments equal to two and three tenths times the cash payment made to VB, after which all rights to receive royalties will be returned to VB. VB may repurchase the royalty right at any time on or before June 26, 2018, for a specified amount. The acting chief executive officer of Paradigm Spine is one of the owners of VB. The Paradigm Spine Credit Agreement and the VB Royalty Agreement where negotiated separately.

The fair value of the royalty right at June 30, 2014, was determined by using a discounted cash flow analysis related to the expected future cash flows to be received. This asset is classified as a Level 3 asset, as our valuation utilized significant unobservable inputs, including estimates as to the probability and timing of future sales of the licensed product. The discounted cash flow was based upon expected royalties from sales of licensed product over a nine year period. The discount rate utilized was approximately 17.5%. Significant judgment is required in selecting the appropriate discount rate. Should this discount rate increase or decrease by 2.5%, the fair value of this asset could decrease by $1.4 million or increase by $1.7 million, respectively. A third-party expert was engaged to assist management with the development of its estimate of the expected future cash flows. The fair value of the asset is subject to variation should those cash flows vary significantly from our estimates. An evaluation of those estimates, discount rates utilized and general market conditions effecting fair market value will be performed in each reporting period.

As of June 30, 2014, the carrying value of the asset acquired as reported in our consolidated balance sheets was $15.5 million. As of June 30, 2014, the maximum loss exposure was $15.5 million.

The following tables summarize the changes in Level 3 assets and the gains and losses included in earnings for the six months ending June 30, 2014:

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

(in thousands)	Royalty Rights - At Fair Value
Beginning Balance at December 31, 2013	—
Transfer into Level 3	235,677
Total change in fair value for the period Included in earnings	(4,061)
Purchases, issues, sales, and settlements Purchases	15,500
Ending Balance at June 30, 2014	$247,116

The correction of the immaterial error as described in Note 1 resulted in accounting for the Depomed Royalty Agreement as a Level 3 financial asset. That correction has been identified above as a transfer into Level 3.

Gains and losses included in earnings for each period are presented in "Royalty rights - change in fair value" as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2014	2013	2014	2013

Total change in fair value for the period included in earnings for assets held at the end of the reporting period	$(4,061)	$—	$(4,061)	$—

Foreign Currency Hedge Contracts

The fair value of the foreign currency hedge contracts is estimated based on pricing models using readily observable inputs from actively quoted markets and are disclosed on a gross basis.

The following tables present the fair value of assets and liabilities not subject to fair value recognition by level within the valuation hierarchy:

	June 30, 2014			December 31, 2013		
	Carrying Value	Fair Value Level 2	Fair Value Level 3	Carrying Value	Fair Value Level 2	Fair Value Level 3
(In thousands)						
Assets:						
Wellstat Diagnostics note receivable	$50,191	$—	$50,191	$47,694	$—	$46,042
Hyperion	1,200	—	1,200	1,194	—	1,195
AxoGen note receivable and embedded derivative	28,942	—	27,160	26,544	—	25,785
Avinger note receivable	20,422	—	19,336	20,250	—	19,061
LENSAR note receivable	39,591	—	40,842	39,572	—	39,572
Durata note receivable	40,000	—	39,402	24,995	—	24,995
Direct Flow Medical note receivable	35,049	—	34,723	34,799	—	34,799
Paradigm Spine note receivable	49,517	—	51,165	—	—	—
kaléo note receivable	155,407	—	155,407	—	—	—
Total	$420,319	$—	$419,426	$195,048	$—	$191,449
Liabilities:						
Series 2012 Notes	$47,160	$88,523	$—	$172,630	$277,650	$—
May 2015 Notes	150,797	248,889	—	148,253	212,304	—
February 2018 Notes	272,824	341,955	—	—	—	—
Term loan	37,364	37,500	—	74,397	75,000	—
Total	$508,145	$716,867	$—	$395,280	$564,954	$—

As of June 30, 2014, the estimated fair value of our Paradigm Spine note receivable and kaléo note receivable, as of June 30, 2014 and December 31, 2013, the estimated fair values of our Wellstat Diagnostics note receivable, Hyperion note receivable, AxoGen note receivable and derivative, Avinger note receivable, LENSAR note receivable, Durata note receivable and Direct Flow Medical note receivable, were determined using one or more discounted cash flow models, incorporating expected payments and the interest rate extended on the notes receivable with fixed interest rates and incorporating expected payments for notes receivable with a variable rate of return. In some instances the carrying values of certain notes receivable exceed their estimated fair market values. This is generally the result of discount rates used when performing a discounted cash flow for fair value valuation purposes. In all cases, the undiscounted expected future cash flows exceed the related carrying value.

When deemed necessary we engage a third party valuation expert to assist in evaluating our investments and the related inputs needed for us to estimate the fair value of certain investments. We determined our notes receivable assets are Level 3 assets as our valuations utilized significant unobservable inputs, including estimates of future revenues, discount rates, expectations about settlement, terminal values and required yield. To provide support for the estimated fair value measurements, we considered forward looking performance related to the investment and current

measures associated with high yield indices, and reviewed the terms and yields of notes placed by specialty finance and venture firms both across industries and in similar sectors.

The carrying value and estimated fair value of the AxoGen note include the value of a change of control embedded derivative valued at $1.2 million and $1.1 million at June 30, 2014, and December 31, 2013, respectively. We utilized discounted cash flows and probability analysis to estimate the fair value of the embedded derivative.

The Wellstat Diagnostics note is collateralized by all assets and equity interest in Wellstat Diagnostics. The estimated fair value of the collateral was determined by using a discounted cash flow analysis related to the underlying technology included in the collateral. On June 30, 2014, the discounted cash flow was based upon expected income from estimated sales over a period of 15 years. The terminal value was estimated using selected market multiples based on sales and EBITDA. On December 31, 2013, the estimated fair value of Wellstat Diagnostics Note Receivable and Credit Agreement was determined by using a discounted cash flow that was based upon expected income from estimated sales through December 31, 2016.

On June 30, 2014, the carrying value of the Avinger note exceeds its fair value. This is the result of discount rates used when performing a discounted cash flow for fair value valuation purposes. We determined this note to be a Level 3 asset, as our valuation utilized significant unobservable inputs, including a discount rate of 22.5%, estimates of Avinger's future revenues, expectations about settlement and required yield. To provide support for the fair value measurement, we considered forward looking performance related to Avinger, current measures associated with high yield and Standard & Poor's Leveraged Commentary & Data indices, and reviewed the terms and yields of notes placed by specialty finance and venture firms both across industries and in a similar sector.

The fair values of our convertible notes were determined using quoted market pricing or dealer quotes.

4. Cash Equivalents and Investments

As of June 30, 2014, and December 31, 2013, we had invested our excess cash balances primarily in money market funds, and a corporate security. Our securities are classified as available-for-sale and are carried at estimated fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss) in stockholders' equity, net of estimated taxes. See Note 3 for fair value measurement information. The cost of securities sold is based on the specific identification method. To date, we have not experienced credit losses on investments in these instruments and we do not require collateral for our investment activities.

Summary of Cash and Available-For-Sale Securities	Adjusted Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	Cash and Cash Equivalents	Short-Term Investments
(In thousands)						
June 30, 2014						
Cash	$59,418	$—	$—	$59,418	$59,418	$—
Money market funds	155,107	—	—	155,107	155,107	—
Corporate security	3,500	—	(257)	3,243	—	3,243
Total	$218,025	$—	$(257)	$217,768	$214,525	$3,243
December 31, 2013						
Cash	$8,332	$—	$—	$8,332	$8,332	$—
Money market funds	85,970	—	—	85,970	85,970	—
Corporate security	3,500	1,738	—	5,238	—	5,238
Total	$97,802	$1,738	$—	$99,540	$94,302	$5,238

No gains or losses on sales of available-for-sale securities were recognized for the three and six months ended June 30, 2014 and 2013.

The unrealized gain (loss) on investments included in other comprehensive income (loss), net of estimated taxes, was approximately ($167,000) and $1,129,000 as of June 30, 2014, and December 31, 2013, respectively. No significant facts or circumstances have arisen to indicate that there has been any deterioration in the creditworthiness of the issuers of these securities. Based on our review of these securities, we believe we had no other-than-temporary impairments on these securities as of June 30, 2014, and December 31, 2013.

5. Foreign Currency Hedging

We designate the foreign currency exchange contracts used to hedge our royalty revenues based on underlying Euro-denominated sales as cash flow hedges. Euro forward contracts are presented on a net basis on our Condensed Consolidated Balance Sheets as we have entered into a netting arrangement with the counterparty. As of June 30, 2014, and December 31, 2013, all outstanding Euro forward contracts were classified as cash flow hedges.

In January 2012, we modified our existing Euro forward and option contracts related to our licensees' sales through December 2012 into Euro forward contracts with more favorable rates. Additionally, we entered into a series of Euro forward contracts covering the quarters in which our licensees' sales occur through December 2014.

The notional amounts, Euro exchange rates and fair values of our Euro forward contracts designated as cash flow hedges were as follows:

Euro Forward Contracts			June 30, 2014 (In thousands)		December 31, 2013 (In thousands)	
Currency	Settlement Price ($ per Euro)	Type	Notional Amount	Fair Value	Notional Amount	Fair Value
Euro	1.240	Sell Euro	$—	$—	$10,850	$(1,207)
Euro	1.270	Sell Euro	27,940	(2,126)	44,450	(3,760)
Euro	1.281	Sell Euro	30,732	(2,073)	36,814	(2,785)
Euro	1.300	Sell Euro	—	—	19,500	(1,119)
Total			$58,672	$(4,199)	$111,614	$(8,871)

The location and fair values of our Euro contracts in our Condensed Consolidated Balance Sheets were as follows:

Cash Flow Hedge	Location	June 30, 2014	December 31, 2013
(In thousands)			
Euro contracts	Accrued liabilities	$4,199	$7,355
Euro contracts	Other long-term liabilities	$—	$1,516

The effect of our derivative instruments in our Condensed Consolidated Statements of Income and our Condensed Consolidated Statements of Comprehensive Income was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
(In thousands)				
Net gain (loss) recognized in OCI, net of tax [1]	$264	$(1,265)	$331	$2,303
Gain (loss) reclassified from accumulated OCI into royalty revenue, net of tax [2]	$(2,027)	$268	$(2,755)	$(979)
Net gain (loss) recognized in interest and other income, net -- cash flow hedges [3]	$1	$2	$3	$5

(1) Net change in the fair value of the effective portion of cash flow hedges classified in OCI.
(2) Effective portion classified as royalty revenue.

(3) Ineffectiveness from excess hedge was approximately ($1) and ($2) for the three months ended June 30, 2014 and 2013, respectively, and $(3) and ($5) for the six months ended June 30, 2014, and 2013, respectively.

6. Notes Receivable and Other Long-term Receivables

Notes receivable and other long-term receivables included the following significant agreements:

Wellstat Diagnostics Note Receivable and Credit Agreement

In March 2012, the Company executed a $7.5 million two-year senior secured note receivable with the holders of the equity interests in Wellstat Diagnostics. In addition to bearing interest at 10% per annum, the note gave PDL certain rights to negotiate for certain future financing transactions. In August 2012, PDL and Wellstat Diagnostics amended the note receivable, providing a senior secured note receivable of $10.0 million, bearing interest at 12% per annum, to replace the original $7.5 million note. This $10.0 million note was repaid on November 2, 2012, using the proceeds of the $40.0 million credit facility entered into with the Company on the same date.

On November 2, 2012, the Company and Wellstat Diagnostics entered into a $40.0 million credit agreement pursuant to which the Company is to accrue quarterly interest payments at the rate of 5% per annum (payable in cash or in kind). In addition, PDL will receive quarterly royalty payments based on a low double digit royalty rate of Wellstat Diagnostics' net revenues, generated by the sale, distribution or other use of Wellstat Diagnostics' products, if any, commencing upon the commercialization of its products.

In January 2013, the Company was informed that, as of December 31, 2012, Wellstat Diagnostics had used funds contrary to the terms of the credit agreement and breached Sections 2.1.2 and 7 of the credit agreement. PDL sent Wellstat Diagnostics a notice of default on January 22, 2013, and accelerated the amounts owed under the credit agreement. In connection with the notice of default, PDL exercised one of its available remedies and transferred approximately $8.1 million of available cash from a bank account of Wellstat Diagnostics to PDL and applied the funds to amounts due under the credit agreement. On February 28, 2013, the parties entered into a forbearance agreement whereby PDL agreed to refrain from exercising additional remedies for 120 days while Wellstat Diagnostics raised funds to capitalize the business and the parties attempted to negotiate a revised credit agreement. PDL agreed to provide up to $7.9 million to Wellstat Diagnostics to fund the business for the 120-day forbearance period under the terms of the forbearance agreement. Following the conclusion of the forbearance period that ended on June 28, 2013, the Company agreed to forbear its exercise of remedies for additional periods of time to allow the owners and affiliates of Wellstat Diagnostics to complete a pending financing transaction. During such forbearance period, the Company provided approximately $1.3 million to Wellstat Diagnostics to fund ongoing operations of the business. During the year ended December 31, 2013, approximately $8.7 million was advanced pursuant to the forbearance agreement, and no further advances have been provided by the Company to Wellstat Diagnostics during the six months ended June 30, 2014.

On August 15, 2013, the owners and affiliates of Wellstat Diagnostics completed a financing transaction to fulfill its obligations under the forbearance agreement. On August 15, 2013, the Company entered into an amended and restated credit agreement with Wellstat Diagnostics. The Company determined that the new agreement should be accounted for as a modification of the existing agreement.

Except as otherwise described here, the material terms of the amended and restated credit agreement are substantially the same as those of the original credit agreement, including quarterly interest payments at the rate of 5% per annum (payable in cash or in kind). In addition, PDL will continue to receive quarterly royalty payments based on a low double digit royalty rate of Wellstat Diagnostics' net revenues. However, pursuant to the amended and restated credit agreement: (i) the principal amount was reset to approximately $44.1 million which was comprised of approximately $33.7 million original loan principal and interest, $1.3 million term loan principal and interest and $9.1 million forbearance principal and interest; (ii) the specified internal rates of return increased; (iii) the default interest rate was increased; (iv) Wellstat Diagnostics' obligation to provide certain financial information increased in frequency to

monthly; (v) internal financial controls were strengthened by requiring Wellstat Diagnostics to maintain an independent, third-party financial professional with control over fund disbursements; (vi) the Company waived the existing events of default; and (vii) the owners and affiliates of Wellstat Diagnostics are required to contribute additional capital to Wellstat Diagnostics upon the sale of an affiliate entity. The amended and restated credit agreement continues to have an ultimate maturity date of December 31, 2021 (but may mature earlier upon certain specified events).

When the principal amount was reset, a $2.5 million reduction of the carrying value was recorded as a financing cost as a component of interest and other income, net. The new carrying value is lower as a function of the variable nature of the internal rate of return to be realized by the Company based on when the note is repaid. The internal rate of return calculation, although increased, was reset when the credit agreement was amended and restated.

In June of 2014, the Company received information from Wellstat Diagnostics that showed that it was generally unable to pay its debts as they became due. This constitutes an Event of Default under the amended and restated credit agreement. Wellstat Diagnostics entered into a transaction involving another lender, pursuant to which Wellstat Diagnostics obtained additional short term funding for its operations. At the same time, the Company entered into the First Amendment to Amended and Restated Credit Agreement with Wellstat Diagnostics. The material terms of the amendment include the following: (1) Wellstat Diagnostics acknowledged that an Event of Default had occurred, (2) the Company agreed to forbear from immediately enforcing its rights for up to sixty (60) days, so long as the other lender provided agreed levels of interim funding to Wellstat Diagnostics; and (3) the Company obtained specified additional information rights with regard to Wellstat Diagnostics' financial matters and investment banking activities.

On August 5, 2014, the Company received notice that the short term funding being provided pursuant to the agreement with the other lender entered into during June 2014, was being terminated. Wellstat Diagnostics remained in default because it was still unable to pay its debts as they became due. Accordingly, the Company delivered a notice of default to Wellstat Diagnostics, due to, inter alia, its on-going failure to pay its debts as they become due and Wellstat Diagnostics' failure to comply with certain covenants included in the First Amendment to Amended and Restated Credit Agreement by the deadlines to which the parties had agreed (the Borrower Notice). The Borrower Notice accelerates all obligations under the amended and restated credit agreement and demands immediate payment in full in an amount equal to $53,939,820, (which amount, in accordance with the terms of the amended and restated credit agreement, includes an amount that, together with interest and royalty payments already made to the Company, would generate a specified internal rate of return to the Company), plus accruing fees, costs and interest, and demands that Wellstat Diagnostics protect and preserve all collateral securing its obligations. On August 7, 2014, the Company delivered a notice to each of the guarantors of Wellstat Diagnostics' obligations to the Company under the credit agreement (the Guarantor Notice). The Guarantor Notice includes a demand that the guarantors remit payment to the Company in the amount of the outstanding obligations. The guarantors include certain affiliates and related companies of Wellstat Diagnostics, as well as Wellstat Diagnostics' shareholders. The Company is evaluating the remedies available to it at this time.

The amended and restated credit agreement is secured by a pledge of all of the assets of Wellstat Diagnostics, a pledge of all of Wellstat Diagnostics' equity interests by the holders thereof, and a second lien on the assets of the affiliates of Wellstat Diagnostics.

At June 30, 2014, and December 31, 2013, the carrying value of the note was included in non-current assets.

As of June 30, 2014, the Company determined that its interest in Wellstat Diagnostics represented a variable interest in a Variable Interest Entity since Wellstat Diagnostics' equity was not sufficient to finance its operations without amounts advanced to it under the Company's note and forbearance agreement. However, the Company does not have the power to direct the activities of Wellstat Diagnostics that most significantly impacts Wellstat Diagnostic's economic performance and is not the primary beneficiary of Wellstat Diagnostics; therefore, Wellstat Diagnostics is not subject to consolidation.

As of June 30, 2014, the carrying value of all amounts advanced to Wellstat Diagnostics including accrued interest through March 31, 2014, was $50.2 million, which was recorded in notes receivable. As of June 30, 2014, the maximum loss exposure was $50.2 million. As a result of the event of default, we ceased to accrued interest for the current period presented.

We believe that Wellstat Diagnostics does not currently have sufficient capital to execute its business plan over the long term. Wellstat Diagnostics recently raised $2.5 million and has informed the Company that Wellstat Diagnostics is continuing to consider other sources of financing and strategic alternatives.

The estimated fair value of the collateral is approximately $50.2 million. The estimated fair value of the collateral was determined by using a discounted cash flow analysis related to the underlying technology included in the collateral. The discounted cash flow was based upon expected income from sales of planned products over a period of 15 years. The terminal value was estimated using selected market multiples based on sales and EBITDA.

Hyperion Agreement

On January 27, 2012, PDL and Hyperion entered into an agreement whereby Hyperion sold to PDL the royalty streams due from SDK related to a certain patent license agreement between Hyperion and SDK dated December 31, 2008. The agreement assigned the patent license agreement royalty stream accruing from January 1, 2012 through December 31, 2013 to PDL in exchange for the lump sum payment to Hyperion of $2.3 million. In exchange for the lump sum payment, PDL was to receive two equal payments of $1.2 million on both March 5, 2013 and March 5, 2014. The first payment of $1.2 million was paid on March 5, 2013. The second and final payment of $1.2 million was due on March 5, 2014. Hyperion has not made the payment due on March 5, 2014. The inability to make this payment constitutes a breach of the purchase agreement. The Company

completed an impairment analysis as of June 30, 2014. The estimated fair value of the collateral was determined to be in excess of that of the carrying value. Hyperion is considering other sources of financing and strategic alternatives, including selling the company. Depending on the outcome of its efforts and PDL's assessment of Hyperion's financial viability, we may recognize an impairment in a future period.

Merus Labs Note Receivable and Credit Agreement

In July 2012, PDL loaned $35.0 million to Merus Labs in connection with its acquisition of a commercial-stage pharmaceutical product and related assets. In addition, PDL agreed to provide a $20.0 million letter of credit on behalf of Merus Labs for the seller of the assets to draw upon to satisfy the remaining $20.0 million purchase price obligation. The seller made this draw on the letter of credit in July 2013 and an additional loan to Merus Labs for $20.0 million was recorded for an aggregate of $55.0 million in total borrowings.

Outstanding borrowings under the July 2012 loan bore interest at the rate of 13.5% per annum and outstanding borrowings as a result of the draw on the letter of credit bore interest at the rate of 14.0% per annum. Merus Labs was required to make four periodic principal payments in respect of the July 2012 loan, with repayment of the remaining principal balance of all loans due on March 31, 2015. The borrowings were subject to mandatory prepayments upon certain asset dispositions or debt issuances as set forth in the credit agreement. Merus Labs made the first of these payments in December 2012 in the amount of $5.0 million, and made the second payment in June 2013 in the amount of $7.5 million.

In September 2013, Merus Labs prepaid in full its obligations under the credit agreement, including accrued interest through the payment date and a prepayment fee of 1% of the aggregate principal amount outstanding at the time of repayment. There was no outstanding balance owed as of June 30, 2014.

AxoGen Note Receivable and AxoGen Royalty Agreement

In October 2012, PDL entered into the AxoGen Royalty Agreement with AxoGen pursuant to which the Company will receive specified royalties on AxoGen’s net revenues (as defined in the AxoGen Royalty Agreement) generated by the sale, distribution or other use of AxoGen’s products. The AxoGen Royalty Agreement has an eight year term and provides PDL with royalties of 9.95% based on AxoGen's net revenues, subject to agreed-upon guaranteed quarterly minimum payments of approximately $1.3 to $2.5 million beginning in the fourth quarter of 2014, and the right to require AxoGen to repurchase the AxoGen Royalty Agreement at the end of the fourth year. AxoGen has been granted certain rights to call the contract in years five through eight. The total consideration PDL paid to AxoGen for the royalty rights was $20.8 million, including an interim funding of $1.8 million in August 2012. AxoGen was required to use a portion of the proceeds from the AxoGen Royalty Agreement to pay the outstanding balance under its existing credit facility. AxoGen plans to use the remainder of the proceeds to support the business plan for its products. The royalty rights are secured by the cash and accounts receivable of AxoGen.

Under the AxoGen Royalty Agreement, beginning on October 1, 2016, or in the event of the occurrence of a material adverse event, AxoGen's bankruptcy or material breach of the AxoGen Royalty Agreement, the Company may require AxoGen to repurchase the royalty rights at a price that, together with payments already made by AxoGen, would generate a specified internal rate of return to the Company. The Company has concluded that the repurchase option is an embedded derivative which should be bifurcated and separately accounted for at fair value.

In the event of a change of control, AxoGen must repurchase the assigned interests from the Company for a repurchase price equal to an amount that, together with payments already made by AxoGen, would generate a 32.5% internal rate of return to the Company. The Company has concluded that the change of control provision is an embedded derivative that should be bifurcated and separately recorded at its estimated fair value. The estimated fair

value of the change of control provision was approximately $1.2 million and $1.1 million as of June 30, 2014, and December 31, 2013, respectively. The estimated fair value of this embedded derivative is included in the carrying value of the AxoGen note receivable. The Company recognized gains of approximately $0.1 million and $0.4 million related to the change in the estimated fair value of embedded derivative during the three month periods ended June 30, 2014 and 2013, respectively. The Company recognized gains of approximately $0.1 million and $0.4 million related to the change in the estimated fair value of embedded derivative during the six month periods ended June 30, 2014 and 2013, respectively.

At any time after September 30, 2016, AxoGen, at its option, can repurchase the assigned interests under the AxoGen Royalty Agreement for a price applicable in a change of control.

During the term of the AxoGen Royalty Agreement, the Company is entitled to designate an individual to be a member of AxoGen's board of directors. The Company has exercised this right and on October 5, 2012, upon the close of the transaction, the Company's President and Chief Executive Officer was elected to AxoGen's board of directors.

On August 14, 2013, PDL purchased 1,166,666 shares of AXGN at $3.00 per share, totaling $3.5 million. The shares are classified as available for sale and recorded as short term investments on the balance sheet. As of June 30, 2014, the shares were valued at $3.2 million, which resulted in an unrealized loss of $0.3 million and is recorded in other comprehensive loss.

Avinger Note Receivable and Royalty Agreement

On April 18, 2013, PDL entered into a credit agreement with Avinger, under which we made available to Avinger up to $40.0 million to be used by Avinger in connection with the commercialization of its lumivascular catheter devices and the development of Avinger's lumivascular atherectomy device. Of the $40.0 million initially available to Avinger, we funded an initial $20.0 million, net of fees, at the close of the transaction. The additional $20.0 million in the form of a second tranche is no longer available to Avinger. Outstanding borrowings under the initial loan bear interest at a stated rate of 12% per annum.

Avinger is required to make quarterly interest and principal payments. Principal repayment will commence on: (i) the eleventh interest payment date if the revenue milestone is not achieved or (ii) the thirteenth interest payment date if the revenue milestone is achieved. The principal amount outstanding at commencement of repayment, after taking into account any payment-in-kind, will be repaid in equal installments until final maturity of the loan. The loan will mature in April 2018.

In connection with entering into the credit agreement, the Company will receive a low, single-digit royalty on Avinger's net revenues through April 2018. Avinger may prepay the outstanding principal and accrued interest on the note receivable at any time. If Avinger repays the note receivable prior to April 2018, the royalty on Avinger's net revenues will be reduced by 50% and will be subject to certain minimum payments from the prepayment date through April 2018.

The obligations under the credit agreement are secured by a pledge of substantially all of the assets of Avinger and any of its subsidiaries (other than controlled foreign corporations, if any). The credit agreement provides for a number of standard events of default, including payment, bankruptcy, covenant, representation and warranty and judgment defaults.

LENSAR Credit Agreement

On October 1, 2013, PDL entered into a credit agreement with LENSAR, under which PDL made available to LENSAR up to $60 million to be used by LENSAR in connection with the commercialization of its currently marketed LENSAR™ Laser System. Of the $60 million available to LENSAR, an initial $40 million, net of fees, was funded by the Company at the close of the transaction. Upon attainment by LENSAR of a specified sales milestone to be accomplished no later than September 30, 2014, PDL will fund LENSAR an additional $20 million. Outstanding borrowings under the loans bear interest at the rate of 15.5% per annum, payable quarterly in arrears.

Principal repayment will commence on the thirteenth interest payment date or December 31, 2016. The principal amount outstanding at the commencement of repayment will be repaid in equal installments until final maturity of the loans. The loans will mature on October 1, 2018. LENSAR may elect to prepay the loans at any time, subject to a prepayment penalty that decreases over the life of the loans. The loans are secured by all of the assets of LENSAR.

Durata Credit Agreement

On October 31, 2013, PDL entered into a credit agreement with Durata, under which the Company made available to Durata up to $70.0 million. Of the $70.0 million available to Durata, an initial $25.0 million (tranche one), net of fees, was funded by the Company at the close of the transaction. On May 27, 2014, the Company funded Durata an additional $15 million (tranche two) as a result of Durata's marketing approval of dalbavancin in the United States, which occurre