Considerations for the Seller of a Royalty ©

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Business owners frequently need additional capital to accelerate the growth of the company's revenue. Business owners may not wish to incur personally guaranteed debt for the company or share in the ownership of the business.

Once a business owner transfers shares of his company to others, he becomes a fiduciary and is therefore obliged to make all business decisions in the best interest of all of the shareholders of the company. Will his taking a large year end bonus or the company leasing an expensive car for his use, or buying art for his office or acquiring a company in which he has an interest, or making deals which are overly favorable to the other party, be in the best interests of all of the shareholders?

If the company has sold securities based on projections of earnings or market valuation and fails to achieve the anticipated levels of profit or valuations, will the investors have any legal remedy such as a rescission action? Will the non-affiliated investors always be friendly to management or will they want a change in control?

Is it always in the best interest of all the shareholders of a company for the controlling shareholder to decide to take actions which legally reduce the amount reportable as profit and therefore reduce the company's income tax liability?

Isn't it usually the desire of those owning businesses to be able to make the decisions they believe to be in their best interest? Is it not reasonable and usual that decisions are made which benefit the owner of the business at the expense of the business? Who checks for reasonableness the expense account of the owner, acting as CEO? Who decides who should be hired and on what terms, if not the business owner?

The sale of equity-related securities is the traditional way businesses have been financed and sometimes the investors do just fine.

However, in private company financing royalties, an agreed share of gross revenues is a better way for both investing in and financing of privately owned companies.

The royalty owner is only interested in the survival of the company and the growth of a company's revenues. The investor is not interested in reported profits or market valuation.

As long as there is a contractual right of redemption in the royalty agreement the business owner can terminate the royalty if the payments become burdensome or a transaction such as a merger of sale of the company becomes an option.

Following is from "Tools and Considerations for Royalty Investment" written earlier today and which I recommend reading.

"The redemption right of the issuer is important so the issuer knows the worst case for terminating all royalty payments. The issuer is the most logical buyer of royalties from the investors as each dollar paid in royalties is a dollar of pre-tax profit.

**The issuer can contact directly all or any of the royalty investors and attempt to negotiate an acquisition of the royalty. Cash, debt and/or some other asset may be offered in exchange for the royalty.
The issuer can also offer through a tender, perhaps on a Dutch-auction basis of establishing the maximum amount to be paid for the desired amount of royalties to be acquired thus assuring the lowest price offerings to be accepted. Finally, the royalty issuer can exercise the redemption right for whatever royalties are still outstanding.**

In most cases of a 20-year royalty I suggest a fair redemption value, assuming exercise is within 10 years is 10 times the cost of the royalty, less any royalty payments made. This would result in at least an IRR of 25% per annum for the investor."

Only businesses which have or project a substantial profit margin, should consider the sale of royalties. Investors should consider the likely sustainability of a company before buying a royalty from the company.

Royalties, by their very nature, are a conservative way of participating in the growth of a company's revenues without the conflicts inherent in owning equity in privately owned companies.

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