Crediting Royalties Paid for Redemption Right Calculation ©

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The negotiation of a redemption right as a means of terminating the royalty payment obligation is fair and necessary to attract business owners to use royalties as a means of financing that does not dilute existing equity holders.

The redemption right should recognize the amount of royalty payments made prior to exercise of the right, as the terms of the redemption right require an overall payment of a multiple of the cost paid by the investor for the royalty.

The reality of the arithmetic is that each royalty payment made, up until the amount invested equals the original cost of the royalty, reduces the investor's risk. Once the cost of the royalty has been recaptured, all payments are profit.

As there is a time value for money it seems fair to me that the earlier royalty payments should be more highly valued than the later payments, when crediting those payments against the redemption right amount. Therefore, I suggest the following crediting formula, reducing the credit amount for each year by 10%:

1st year 100%
2nd year 90%
3rd year 80%
4th year 70%
5th year 60%
6th year 50%
7th year 40%
8th year 30%
9th year 20%
10th year 10%

The effect of such a progression would be to encourage the business owner to pay royalties sufficient to return their original capital to royalty investors as soon as possible.

Of course, the business owner or royalty issuing company can attempt to adjust these terms with the royalty investors at any time, and the terms will be as agreed by the parties. Royalty issuing companies will also be able to offer a range of tenders to the royalty investors at terms less than those agreed in the initial redemption right.

In all cases, successful companies will be willing buyers of royalties they have issued, since royalties which do not have to be paid are immediately profit.

It should also be remembered that we suggest that the royalty issuer will have issued a 60-month Continental Put contract to the investors, exercisable at the full price of the royalty, less royalty payments made. The Put is only exercisable by investors at the maturity of the contract. It is highly unlikely that investors will exercise the Put and its purpose has to do with the U.S. tax treatment of the proceeds of the sale of the royalty by the issuer.

As I believe that 20-year royalties should be structured to provide a recapture of investment in 4 to 6 years, there will be many years of presumably increasing royalty generating royalties in which profits may be realized, thus the unlikely exercise of the Put.

I believe that most royalties will be redeemed well prior to maturity, so the Internal Rate of Return achieved by investors should be highly satisfactory.

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