Royalty investors financing early stage companies are frequently concerned by their lack of ability to influence management. ©

Arthur Lipper

The royalty investor in an early stage company is pleased when the company generates the revenues projected at the time of investment. However, when the projected revenues fail to be achieved, during an agreed period, the investor wants to have greater control of the royalty issuing company than is the case with a traditional royalty.

When things are not as projected the investor wants an ability to significantly influence the management of the company, for security of capital concerns, not to increase their economic benefit.

The Royalties Contingently Convertible Into Participating Preferred Stock (RCC-IPPS) meets the needs of the investor without damaging the ownership benefit of the business owner.

If the revenues are as projected during an agreed period, say a specified year, then the royalty terms are as originally agreed. However, if the revenues are less than an agreed percentage of those projected, say a deficiency of 40% or more, then the royalty automatically converts to preferred stock in the issuing company. The par value of the preferred would be the net amount paid for the royalty, less royalty payments received by the investor.

The terms of the preferred stock require the quarterly payment of the same percentage of revenues as in the royalty if the payments can be made without creating a loss for the company. In the event the distributions cannot be made the royalty payment obligation accrues at an agreed interest rate until it can be paid.

At the time of the original sale of the royalty the controlling shareholders place in a trust their shares in the company and appoint a trustee satisfactory to the royalty investor. The trustee attends all Board of Director meetings and is required to block any corporate action deemed by the trustee to not be in the best interest of the shareholders. Said corporate actions to include all executive appointments and compensation arrangements.

The preferred stock is callable, if the amounts accrued have been paid, on terms reflecting the redemption clause of the royalty. Of course, it is natural for the business owner to always prefer not to be obligated to make royalty payments and for an investor to be pleased for the royalty to continue to maturity. The wishes of both parties are addressed by the terms of royalty redemption.

Therefore, both the investor and business owner have the same economic benefit as originally agreed, but the investor also has, in the event of a risk increasing failure to achieve the projected level of revenues, effective negative control of the business.

As with any contract, the parties have an ability to modify the contract and it is possible the preferred shareholders would agree to an exchange resulting in a reversion to the original royalty relationship, especially as they would have the same economic benefit without the administrative burden of the trustee monitoring.

The benefit to the business owner is that many investors will be moved to accept the risk of investing in a royalty based upon projected revenues only if they have an ability to influence management in the event the projections are not achieved.

The benefit to investors is that the described mechanism allows a participation in the growth of an early stage company with greater comfort than that of investing in a royalty, which has no vote, and no ability to influence management once the royalty has been sold.

Though new, different and seemingly complex the result is a win/win for those directly concerned and the society as a business having great potential gets financed.

Arthur Lipper, chairman
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February 10, 2016