

**Larry and Barry, As Business Owners,  
Discuss A Bad Idea Proposed By  
Royalty Investors For The  
Terms Of A Royalty**

**Arthur Lipper**

**Larry:** Now the royalty investors want to make the royalty convertible into equity, or allow the royalty holder some other means, related to reported profits, of becoming a partner in our business.

**Barry:** That would defeat the reason we found the whole royalty idea appealing, since we didn't have to optimize reported profits.

**Larry:** How so? All we really want is the use of their money to grow the revenues of our business.

**Barry:** You seem to forget that we are overpaying our "public relations" person; do you really want to cut off her income?

**Larry:** Ok. I will find another way for the business to take advantage of her talents. She is important to me.

**Barry:** What about your travel and entertainment expenses?

**Larry:** So I like to travel first class and the business can afford it. It's like the hot BMW the company leases for me.

**Barry:** Yes, the business can afford it -- and the all-in health insurance and retirement plan arrangement we have, reflecting your success in marketing and mine in running the business.

**Larry:** Sure, there are a lot of perks. But we own the business, so these are all for our benefit. Couldn't we throw the

investors a bone and give them a car to use or some bonus based on reported profits?

**Barry:** That wouldn't work, as they are not actually involved in the business. And it would give them a right and reason to look into how we have been able to increase revenues without a corresponding increase in our reported corporate profits.

**Larry:** You make it sound like we have a fiduciary responsibility to maximize our reported profits just so they can sell their stock in our company at a big profit. Why would we do that, as then we wouldn't have the benefit of the taxes we are not required to pay?

**Barry:** But once we sell even one share of stock, let alone the significant minority holding these investors would own, we do become fiduciaries and all expenditures have to be for the direct and sole benefit of the company. And remember where the extra money came from, which we needed and still need, to build this business.

**Larry:** Sure, to a large extent we built the business on the income taxes we didn't have to pay, by reducing our actual profits.

**Barry:** Yes, and it doesn't mean, just because we passed the IRS audit without too much of a problem, that the investors might not question expenses, special deals we have with some customers, or deals the company has made with both of us. Minority shareholders in privately owned companies have the right to review all of the company's books and may well question some of the perks we believe help the business grow.

**Larry:** And probably the equity holders would want us to repay some of those low-interest loans the company made to us.

- Barry:** Yes, and their royalty will still give them the benefit of a share of our revenue growth, and a great return on their investment.
- Larry:** If we wanted to sell this company, we'd have made different profit recognition decisions.
- Barry:** Thanks for remembering that which we want to forget.
- Larry:** I am sure that investors want all the benefits they can negotiate and we want to retain all the perks, possible.
- Barry:** That's the whole point of financing the business with non-equity dilutive royalties. The royalty investors benefit from our success in making the company bigger, and we get to keep the prerogatives of ownership.
- Larry:** Yes, and I would be very suspicious of any business owner willing to sell me ownership in his company at a fraction of what he says it will be worth in the future.
- Barry:** Also, negotiating a financing which does not require a valuation of the business means that it is a lot easier for us to provide comfort to the investor that revenues will increase, as opposed to substantiating how much profit will be earned.
- Larry:** Ok, then we wavoid the sale of anything which is profit-related -- that's off the table.
- Barry:** Absolutely. I am happy with you as my partner and I don't need more partners. The royalty in itself gives them a great deal.