Using Royalties to Rescue a Failed Equity Offering ©

Arthur Lipper

Frequently in the case of early stage companies, when attempting to raise capital through the sale of equity, an impasse is reached, with less than the necessary number of investors agreeing to the terms offered.

There is a difference in the investors' minds as to the relative attraction of the company in terms of its potential and the conditions of the deal, which can appear to be assuming a success that has yet to be achieved.

In most cases the entrepreneur either abandons the project, or makes the mistake of going forward with less capital than had been sought, which significantly increases the risk to the investors and therefore should improve the terms for the original deal accepting investors.

Those who were offered the opportunity to participate and declined, frequently are rejecting the deal terms even though they may be enthusiastic regarding the potential of the company.

It all comes down to valuation. What was the valuation of the company based on the terms of the offering and what level of success was assumed to justify the offering valuation?

In many cases, using the revenues assumed in the equity offering as the basis for a royalty offering, either the entire amount can be raised or the difference between that agreed by the equity investors and the company's requirement can be raised by using an intelligently structured royalty.

Of course, there are many ways the company seeking funding can make deals more attractive if the deal offered is not accepted. The valuation can be reduced so the amount invested buys a greater percentage of the company. The offering can be changed to a

convertible preferred or note. A guarantee that the equity will produce an agreed minimum level of return can be reached.

However, the best way for both the company and investors is to use royalties to finance the company. This will, at first, reduce the profitability of the company but it will allow the present owners to retain their ownership positions and thereby benefit from the progress anticipated to be made by the company.

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