

# THE UNIVERSITY OF NEW MEXICO

## PATENT ADMINISTRATION OFFICE

### Protocol on Stock in Lieu of Royalties

#### Background

STC from time to time acquires stock from small start-ups in lieu of cash royalties, because these start-ups often have no liquid cash. Such stock holdings are subject to the usual 40/40/20 distribution between STC/inventors/ UNM. The question arises how and when to allocate those shares.

UNM's interest in this is both as STC's quasi-parent company, and as a beneficial owner of the stocks (because of its rights to 20% of the royalty proceeds). Inventors also have interests as beneficial owners of 40% of the stock.

#### Rationale

STC's historic practice has been not to distribute immediately all shares received, for the following reasons:

- STC withholds money from its royalty distributions. It withholds reimbursement costs for certain commercialization expenses, such as patent fees and litigation expenses (reimbursement to be made to STC and UNM under the IPP, based upon their outlays). Start-up stock has no well defined value, so STC cannot simply set aside and withhold some number of shares to satisfy the reimbursement obligation -- it has no way to determine the number of shares to withhold.
- Immediate distribution of the stock would increase the total number of shareholders of the start-up. This is disadvantageous for at least two reasons. If the number of shareholders of a New Mexico company increases beyond 25, the start-up is then required by state law to issue a prospectus; this is a burden without much compensating advantage. Moreover, certain transactions, such as issuing new stock to enable further infusions of capital to the company, require shareholder approval; increasing the number of shareholders complicates such approval.

This practice of postponing distribution is entirely consistent with the Intellectual Property Policy. Section 2.6.5 provides that:

In any case where royalties shall be represented by shares of stock or other intangible assets, these assets shall be held in the name of the University or the STC and managed by them. At the discretion of the managing unit (the University or the STC), such stock or other intangible assets may be divided prior to liquidation and distributed ....

On the other hand, for STC to hold the stock creates disadvantages to the inventors, and, to a lesser extent, to UNM, as follows:

- Since the inventors have a beneficial interest in the stock, due to STC's obligation to distribute 40% of proceeds to them, receipt of the stock by STC is a taxable event to the investors, according to tax advice obtained by STC. They incur the tax liability without actual receipt. This is not an issue for UNM because UNM is tax-exempt.
- Without title to the stock, inventors and UNM do not have voting rights. Voting rights are to likely to be especially important at the formative stages of a start-up, both because those early decisions can dramatically impact the company's direction, and because inventors' and UNM's shares at the early stages may be a large enough fraction to have real influence in voting.

## **Protocol**

In an attempt to balance these conflicting concerns, STC holds start-up stock until such time as it is publicly tradable or is purchased for cash as part of the acquisition of the startup. Tradability would typically be triggered by an initial public offering (subject to any lock-up agreement), or a buy-out by a company with publicly traded stock. Upon either event STC would value its holdings at market value, withhold enough shares to cover reimbursement costs, and distribute the remaining shares to the inventors, UNM, and itself, according to the 40/40/20 formula.

Additionally, if there is a private offering, STC will, upon request, sell all of an inventor's or UNM's shares and distribute the proceeds. A portion of any such sale proceeds would be allocated to expense reimbursement, as follows. STC would calculate the share of stocks sold as a percentage of the total STC shares held on behalf of STC, UNM, and the inventors. It would then apply that percentage to the total accumulated expenses to date, deduct the resulting amount from the proceeds of any sale, and apply it to reimbursement. STC would most likely not participate in such a private sale, but it did not take a firm position on that issue in 1999.

Prior to any distribution, STC would be willing to enter into a voting trust with the inventors or UNM, by which STC would agree to notify the inventors of decisions coming up for a vote with reasonable advanced notice, and would vote the portion of the shares corresponding to the inventors' or UNM's percentage beneficial interest according to the inventors' or UNM's wishes. If the inventors or UNM did not communicate their desired vote to STC by a pre-defined time prior to the voting, then STC would vote those shares at its discretion.