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Corporate Structure for a New Business

In this article I explain how to structure a new business venture. I focus on small businesses that have only a few shareholders or partners. I discuss four important issues for the structure of the business: share ownership, compensation, control rights, and lastly the shareholders' exit from the business.

Negotiate

You must negotiate the business structure with your partners. Discuss everything upfront – by this I mean put everything on the table and be petty. Don't be embarrassed to talk money and negotiate for what you need. If you don't resolve these issues now, you're planting a timebomb in your business.

Start negotiations with a term sheet that fully discusses each of the four items below. Once you've agreed at term-sheet level, you can draft final documents. A Shareholders (Buy-Sell) Agreement most likely will be the document that covers the issues in your term sheet.

Word to the Wise: Don't commit yourself or your resources to the business until the contracts are signed. There is no deal until the documents are done. Each commitment of resources weakens your position in the negotiations. This is especially true if you give up your current gig for the new venture, because you have nothing to go back to (hence no bargaining leverage).

Four Things to Negotiate

1. **Contributions & Shares**. All contributions made by the partners should correlate directly into ownership. That is, ownership of the business should correlate 1:1 with the partners' contributions of cash, assumed liabilities, equipment, real estate, intellectual property etc.

- For example, assume there are two partners, and the first contributes $600,000 in assets while the second contributes $400,000. Shareholder #1 should get 600 shares while shareholder #2 gets 400 shares, for a 60/40 split.

If a shareholder will receive shares based on future labor to be performed, then the shares should be subject to vesting. It's common (and OK) for a shareholder to get his shares up-front based on the

promise of future labor, but the shares must vest so that if the shareholder fails to perform the services, he loses the unvested shares. To the extent possible, match the value of the services with the value of the shares, to maintain the 1:1 correlation between contributions and ownership.

2. **Compensation**. A business is only worth the money it puts in the owners' pockets. For most small businesses, this means the business is only worth the salary and dividends it pays to the owners. A business first pays salary, then pays the remainder of net profits to the shareholders as dividends and distributions based on their share ownership. A business must maintain a balance between the two forms of compensation (salary and dividends) so that both active and passive shareholders receive a fair return.

A business should pay salary based on work actually performed. It's fair for partners who work more to get paid more. In fact, it's healthy for a business to reward those who do the work, otherwise no one will do the work.

3. **Control**. I prefer that share ownership percentages determine control within a corporation, because it's simple and transparent. Many businesses use a one-man one-vote system, however, and that's OK. Determine who has the number of shares needed to elect directors and how this power is distributed among the shareholders. This tells you who can control the board of directors. Then be careful to understand the nuances of your board of directors and the natural coalitions that exist among them.

4. **Exit**. All businesses need an exit plan. When disputes among the owners put the business in danger, they need a structure that ensures a fair resolution without having to go to court. I call this the economic divorce – if the business cannot survive a particular shareholder or partner, the buy-sell agreement gets you a divorce on terms that are fair to everyone. Usually you have buy-back provisions that cover the 4 D's – a shareholder's death, disability, divorce and disputes. The result of buy-back is that one or more shareholders keep the business, and the exiting shareholder gets a payoff.

The buy-out price is crucial. A high buy-out price gives the exiting owner a windfall. A low buy-out price is unfair and leads to litigation. The trick is finding a procedure that ensures a fair price – for example, using a neutral appraisal process to fix a price. A business also can use an accounting formula to fix the buy-out price.

Call me if you want to talk more.

The Cruelty of Critics

Bernard Shaw has no enemies but is intensely disliked by his friends. – *Oscar Wilde*

I fell asleep reading a dull book, and I dreamed that I was reading on, so I awoke from sheer boredom. – *Heinrich Heine*

Very nice, but there are dull stretches.
– *Criticism of a two line poem*

"The phrase you're groping for is 'Thank you.'"