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How to Bring a New Partner into your Business

This is a brief summary of how to bring a new partner into your business.

Culture & Compensation. When bringing in the new partner, your primary risk is that the existing group and the new partner might not fit well together. For example, you and the new partner might differ on the group's guiding principles or work ethic, or the new partner's skills might not be a good fit. After you're confident that the new guy will fit in, set a level of compensation for the new partner that is fair to him and to the existing partners.

Buy-in. After culture & compensation, think ownership. Frequently a business asks a high-level employee to wait a period of time (e.g. one year) before they discuss the buy-in. This ensures that the new person fits-in before buying-in. It's smart to be patient, because the unwinding of a bad partnership is painful and expensive.

Employment agreements sometimes have clauses for the purchase of ownership in the business. Usually the clauses are vague and non-binding, and only express the parties' expectations on the subject. If the buy-in is a material part of the deal, however, specify these deal terms:

- The ownership percentage that the employee will obtain
- The purchase price
- The period over which the employee will pay for and receive the ownership (i.e. vesting)
- The extent of the employee's participation in control decisions for the business, e.g. is he or she on the board of directors?

Ownership percentage is a matter of control. It's dangerous to give control to a new person, and even a minority owner can get control if she aligns with other shareholders. Existing owners must think carefully about the effect of admitting the new owner on existing and future voting blocs among the shareholders and on the board of directors.

Group Liabilities. If the existing owners are liable for business debts (most likely the office lease and bank loans), state clearly the liabilities for which the new partner will become responsible. Will the new partner guarantee existing loans or leases, and must he guaranty future ones? Will the new partner step into a capital call?

Exit Strategy. Now that you've structured the entry of the new partner, structure the exit. The existing owners and the incoming owner all need an exit strategy. The most common exit is the termination of the partner's employment plus the buy-back of his or her equity.

This is where a buy/sell agreement comes in. A buy/sell agreement is essentially an agreement for exiting a business. A buy/sell agreement works like this –

First, the agreement names certain trigger events for buy-back (e.g. termination of employment, death, disability, bankruptcy);

Second, the agreement permits the buy-back of the partner's equity on the occurrence of a trigger event;

Third, the agreement sets a price for the buy-back.

Termination of employment is the most important of the trigger events, because that's how the existing owners get rid of the new (soon to be ex-) partner. The control group on the board of directors can fire the problem partner as an officer of the company; and the control group among the shareholders can remove the problem partner as a director. If the buy/sell agreement permits the buy-back of shares on termination of employment, the control group can take the final step to completely remove the partner from the business – repurchase of shares.

Buy-Back Price. The buy-back price is all-important, clearly, because a low price may cause the ex-partner to sue the business, while a high price gives the ex-partner an undeserved windfall. Various methods exist for setting a buy-back price, including appraisal procedures and earnings-based formulas. The payment terms are important too, because payment up-front is a lot different than payment over 3, 4 or more years. I talk about these topics a lot on my website.

No-Competes. The last item to keep in mind is whether the company will lock up the departing partner with a non-competition covenant. A company that buys back shares can prohibit the departing partner's competition in a limited geographic area for a limited time.

Call me if you want to talk more.

Dogs

- Outside of a dog, a book is man's best friend. Inside of a dog it's too dark to read.
— *Groucho Marx*
- If you pick up a starving dog and make him prosperous he will not bite you. This is the principal difference between a dog and man. — *Mark Twain*
- If there are no dogs in Heaven, then when I die I want to go where they went.
— *Will Rogers*

