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Legal Structure for a Business with 50/50 Shareholders

In this article, I explain the legal structure of a business with 50/50 shareholders. The key to the structure is this: The two partners can either work together, or they can breakup.

In a business that is 50/50 owned, all decisions require the consent of the two owners. Both shareholders must agree, or deadlock. If they deadlock, no action can be taken, which most likely leads to the breakup of the venture.

The company's legal structure should track this reality. You don't need elaborate provisions for how the two shareholders will get along. Fancy rules for making decisions and controlling the business mean nothing when the two control people can't work together. If your partner wants to deadlock, a simple "no" will suffice, no matter how long and complex you wrote the corporate bylaws. Think about a marriage – no matter how much marriage counseling you suffer through, and no matter how many agreements you make for dividing the chores, one spouse's "no" will stop everything.

Instead, you need a structure to split up the shareholders in case of deadlock. The structure should focus on the shareholders' exit, not the details of their day-to-day relationship. Sometimes a clear exit, a.k.a. mutually assured destruction, gives shareholders more incentive to get along better. Cooperation is easier when the alternative costs more.

The Shareholders Agreement for the business should be simple. Anything over 7 pages / 12 font is too complex. The basic legal structure in the Shareholders Agreement should have the following:

Resolve Deadlock with Russian Roulette

With two 50/50 shareholders, one shareholder likely won't have the power to unilaterally remove the other. You can use a Russian Roulette (a.k.a. shotgun) provision to break the deadlock, and remove one of the two shareholders on fair terms. In brief, as between the two warring shareholders, the first shareholder offers to buy out the second shareholder, and the second shareholder has the choice, either be bought out or turn around and buy out the first shareholder on identical terms (i.e. I cut, you choose). Either way, a fair price is fixed for the buy-out, and one of the warring shareholders leaves the business.

Maintain the 50/50 Relationship

During the life of the venture, you should maintain the equal 50/50 relationship, because once one shareholder gets majority control, the other one is at risk. This means that you should require that both shareholders agree to any change in the ownership percentages. No shareholder should be permitted to contribute money or assets to the business and in return, have the corporation issue new shares to that shareholder. A shareholder receiving even one additional share will change the 50/50 ownership split, hence the nature of the relationship.

Restrict the Entry of New Shareholders

For like reasons, you should require that both shareholders agree to the bringing in of a third shareholder, whether by the issue of new shares to the third person, or by a shareholder selling some or all of his shares to the third party. A third shareholder will create a 2 to 1 vote, which is great if you control the third shareholder, but not so great otherwise. You want an approval right over the new shareholder, because running a small business is like a marriage. You should choose your partners, instead of having them chosen for you.

Share Liabilities Evenly

A 50/50 company can become unbalanced if one shareholder has greater liability for corporate debts than the other shareholder. For example, one shareholder might have guarantied the office lease, but the other has not. Imbalance causes bad incentives: The guarantying shareholder has more risk than the other shareholder, which might give the other shareholder extra bargaining leverage when the dispute starts. It's best to keep the 50/50 relationship as equal as possible, although I admit that if one shareholder has little personal net worth, his guaranty will be worth less no matter how we structure things.

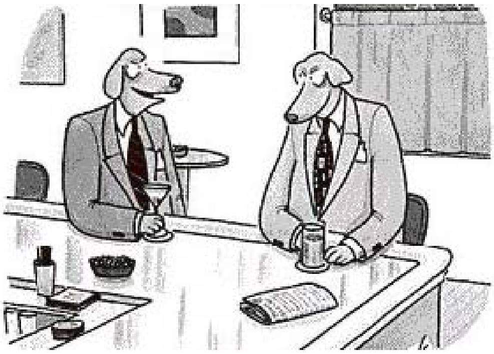
Traditional Buy-Sell

All legal structures need a traditional Shareholders Buy-Sell Agreement. Traditional buy-sell involves what I call the 4 D's– death, disability, divorce and dispute. I add a couple B's to the mix – bankruptcy and bad transfers of shares. I talk about dispute resolution above. I talk about the other D's and the 2 B's on my website.

Non-Competition Clauses

Lastly, think whether, after a breakup, the two shareholders might compete against one another for customers or patients. It's not fair to involve customers or patients in a nasty breakup (we'll save that joy for the children). Any breakup must divide up the customers and patients too, for example, one shareholder might get a non-competition clause against the other as part of the buyout of shares. Or for a health care practice, you can create a mechanism whereby patients choose one of the two doctors for continuing care.

Let the jokes begin.



"*It's not enough that we succeed. Cats must also fail.*"

The Simpsons

- It takes two to lie: one to lie and one to listen.
- Lisa, you have the brains and talent to go as far as you want, and when you do I'll be right there to borrow money.
- Son, if you really want something in this life, you have to work for it. Now quiet! They're about to announce the lottery numbers.
- My dreams have been shattered into shards of a broken dream.
- I just wish once someone would call me "Sir" without adding, "You're making a scene."
- You don't like your job, you don't strike. You go in every day and do it really half-assed. That's the American way.