Business Ownership White Paper

Small Business Legal Formation

A GUIDE TO STRUCTURE AND GOVERNANCE ISSUES

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Why a White Paper?

A white paper is an authoritative report to educate and assist people in making decisions. I issue white papers when the subject matter is important to business owners, but it is too technical or complex to address in the length of an article or blog posting.

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SMALL BUSINESS LEGAL FORMATION

A guide to structure and governance issues

I. Structural Roles

Any business organization requires decisions to be made on three levels; ownership, governance and management. Although some or all of the individuals involved may be present at all three levels, their duties and responsibilities change depending on which of the three "hats" they are wearing at a given time.

The three roles exist regardless of the legal structure chosen. For the sake of simplicity, we will use the terminology applicable to a "normal" "C" corporation. In a corporate structure, the three roles are stockholder, director (board member), and officer.

II. Ownership

A. Valuing Shares

Most stock is initially issued with a low (e.g. $.01 per share) or no par value. The founding stockholders may pay only a few hundred or a few thousand dollars for their shares.

Unless all of the stockholders are exiting simultaneously, the question of share value can be very contentious. There are three common methods of valuing shares:

- *Book value* – This is the lowest value, and usually consists of the net of depreciated assets over liabilities on the balance sheet.
- *Appraised value* – This is usually determined by an outside professional but may be reached by having an outside appraisal and then applying the methodology at a future point in time.
- *Agreed value* – This can range from a formula (e.g. multiple of sales, multiple of EBITDA, operating profit plus current assets, etc., etc.) to a simple agreement by stockholders ("We hereby vote the value of the company to be $1,000,000.").

You do <u>not</u> have to apply the same value to the shares under all circumstances. For example, a new partner may buy in at appraised value and then sell at retirement for the appraised value at that time. In the case of an employment termination for dishonesty, however, the repurchase price may be far lower.

Ownership Questions:

1. What is the purpose of your share ownership?
   a. To divide profits according to a formula
   b. To cash in when we sell the company
   c. To allow the orderly entrance and exit of partners
   d. To recognize sweat equity via low cost participation in equity growth

   e. To reward founders with periodic compensation as new partners enter
   f. Other
2. Should share purchase prices be higher or lower under different circumstances?
3. Should share sale prices be higher or lower under different circumstances?
4. Under what "forced-sale" circumstances should the price received be reduced?
5. How will you determine "value" for purchasing shares?
6. How will you determine "value" for selling shares?

B. Selling shares

Most successful organizations continue well beyond the willingness of 100% of the founders to participate. Sooner or later, it is likely that an owner will want to, or have to, sell his or her shares. Determining exactly when and how that should happen, up front, can prevent having to deal with issues, or even litigation, later.

Sale of shares may be voluntary or involuntary. If the stockholder is also an employee of the business, employment might be a requirement for holding shares. How those shares are repurchased could differ depending on whether the employment relationship is terminated voluntarily or involuntarily.

Shares may need to be repurchased upon death, disability, or if the stockholder's financial status affects the business (e.g. personal bankruptcy).

A repurchase may be required if the stockholder files for divorce or is convicted of a crime. In multiple owner scenarios, it is usually be prudent to make sure that there is the ability to buy out a stockholder just because all of the other stockholders want him gone.

The shares are the stockholder's personal property. You cannot deny him or her right to sell them, but you can agree in advance to make such a sale difficult or unprofitable.

Many companies do this by requiring the stockholder to have a written, third-party offer for the shares, and then submit to a series of refusal rights. Such rights of refusal to purchase can include the company itself, the other stockholders, or a single stockholder, or all three options successively, each with a window of time to make a decision.

Ownership Questions:

7. Under what circumstance can a stockholder be required to sell his or her shares?
8. Under what circumstances can a stockholder require that his or her shares be purchased?
9. Must a stockholder be currently employed by the company?
10. If a stockholder wishes to sell to a third party, what rights do the other stockholders have and what is the policy/procedure for doing so?

C. Voting Shares

Stockholders own the company. They are entitled to the profits of the business, either at the decision of the Directors ("C" Corp), or in a direct proportion to their ownership ("S" Corp, partnerships) or, in some cases, by prior agreement. Except in the case of a partnership, stockholders elect directors who have fiduciary responsibility for the running of the company.

Stockholders elect directors but do not typically make company decisions. It is common to hear someone say "I'm the majority stockholder. What I say goes." Be aware that direct voting of shares to make decisions can void your "corporate veil". If a judge determines you ran the business as an owner, rather than as an elected director, he may determine that your personal assets and those of the company are one and the same.

Ownership can take on a myriad of appearances; shares do not need to be equal and can be defined differently one from another. Some may have greater authority to elect directors, priority claims on profits, or even veto power over the other stockholders. These are called "classes" of stock.

A few variations on standard or "common" stock include"

- Preferred stock – often used to give a party(ies) a priority claim on profits. This claim may be cumulative, that is, guaranteed to be paid in full from inception to the current date before any other distributions are made. Preferred stock may vote the same as common shares, be convertible to common shares, or not vote at all. Preferred stock is usually a financial, not a control, mechanism.
- Weighted or "super" stock – This is the conceptual reverse of preferred stock in that it represents a control, but not a financial, mechanism. Super stock has equal profit rights with common shares but has the voting power of multiple shares.
- Veto stock – (sometimes called "founders" stock) These shares must vote affirmatively for the election of Director or passage of any stockholder resolution.

Ownership Questions:

11. Who will control the election of directors?
12. How many shares will be authorized? (Consider:)
    - Initial Issuance
    - Future potential partners or stockholders
    - Will stock be needed for future acquisitions?
    - Will there be a stock option plan?
13. If additional shares are issued in the future:
    - Will all stockholders be equally diluted?
    - Is there a control level below which any stockholder will refuse to dilute?
    - Will future stockholders have lesser power or rights?
14. Does any stockholder(s) have a priority claim on profits?

15. Are there any decisions for which a specific stockholder(s) demands a right of approval?

III. Governance

The Board of Directors, or its equivale nt, is responsible for protecting the interest of the stockholders. The directors are elected by the stockholders and appoint the management of the business.

Directors have fiduciary duty to the stockholders. That means that they can be held liable for decisions that are not in the interests of the stockholders.

The directors are regulated by the bylaws of the company. The bylaws describe when director meetings are held, under what circumstances meetings may be called, the number of board seats, what decisions require a vote of the board, and whether certain decisions require a minimum number of votes (a "supermajority").

Directors may be elected by stockholder voting for each seat, or by "cumulative" voting. In cumulative voting, each stockholder receives votes equal to the number of shares held times the number of directors to be elected. The votes may be concentrated or distributed as the stockholder wishes.

Election by seat strengthens the influence of large stockholders. Cumulative voting strengthens the influence of smaller stockholders. Some states allow either method, some require cumulative voting, and some forbid it.

When forming your board (and bylaws) there are some important questions to consider:

Governance Questions:

16. How many directors will sit on the board?
17. How will they be elected?
18. How many directors are required to hold a valid meeting?
19. Who may call meetings, and under what circumstances (notice? lead-time?) may meetings be called?
20. How often are the regular meetings of the directors to be scheduled?
21. What decisions (if any) require more than a simple majority vote? (E.g. issuing new stock, sale of major assets, tender offer to buy out a stockholder)

IV. Management

The officers or managers of the company are responsible for the day to day details of running the business. They serve at the pleasure of the directors.

Unless the managers have employment agreements, their roles are usually flexible. There are no legal requirements assigning specific duties to specific officers.

The directors continue to hold responsibility for oversight of the officers, and should have certain guidelines. Directors can remove the officers, and a Board meeting is usually required to terminate an officer of change officer compensation.

Management Questions:

22. Which officer or manager has final authority on operating decisions?
23. Is there a monetary limit to disbursements by one officer?
24. What is the chain of command? In the event of absence or disability of an officer(s), who is in charge?
25. May officers commit to capital expenditures or debt without board approval? Is there a limit?
26. Under what circumstances may the Board terminate an officer?

V. Summary and Disclaimer

This paper is intended to assist a small or first-time business owner in developing a company structure. It is a brief summary of the major areas and decisions that should be made at formation.

Many business owners let the "details" of their companies, especially the buy/sell agreement for stockholders and governance, become defined only when there is an issue to deal with. The time to discuss potential disagreements among owners is at the outset, when enthusiasm is high and the dollars involved are relatively low. Deciding how to solve a problem after the problem exists is painful and costly.

Finally, this document discusses concepts of business. It is not intended to be comprehensive regarding legal, financial or tax issues. The decisions you make in setting up your company will have long term implications on your liability and income tax rates. Always consult appropriate professionals before forming or modifying a business entity.

AUTHOR'S BIO

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Business Ownership Expert

John F. Dini is widely recognized as one of the nation's leading experts on small business ownership. He is a consultant and coach to hundreds of business owners, CEOs and Presidents of companies. John is an outlier in coaching business owners, having achieved the rare feat of delivering over 10,000 hours of face-to-face, personal advice to entrepreneurs.

Mr. Dini is the author of *11 Things You Absolutely Need to Know About Selling Your Business*, now in its second edition. He is a serial entrepreneur currently operating his 9th company, and has conducted business in all 50 United States, Canada, South America, Europe and Asia.

John founded and operates the most successful peer group franchise in North America, overseeing 15 monthly meetings of business owners' groups under the auspices of The Alternative Board®. He holds a Bachelor of Science in Accounting from Rutgers University, a Master of Business Administration from Pepperdine University, is a Certified MBA, and holds six additional certifications in exit planning, business brokerage, behavioral analysis, medical practice management, facilitation and coaching.

Mr. Dini writes numerous articles on business topics for newspapers and magazines, in addition to his weekly column on business ownership on this website Awake at 2 o'clock in the morning? and his opinion blog at Awake at 3 o'clock. He speaks frequently to business groups and national associations, and is a 10-year member of Jim Blasingame's "Braintrust" appearing regularly on "The Small Business Advocate" nationally syndicated radio program as an expert in the issues of business ownership.

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