How Startups Can Avoid the Pitfalls of a Bad Breakup

Partnerships: A shareholder agreement can help remove a problem partner.

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By Matt Crowley

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As we discussed last month, having partners help you carry the load in starting your new business can be extremely valuable. If you have done your homework on your partners, you can be relatively sure that you can build a great team.

But what happens if you guessed wrong and your partner is a disaster?

A serial entrepreneur -- someone who has started, run and sold several businesses -- would tell you that if you had a shareholder agreement you could safely remove your problem partner without killing your business.

A shareholder agreement is a document that covers how the shareholders will deal with basic scenarios where a partner is going to leave the company, either voluntarily or involuntarily. Sometimes these agreements are also called “buy-sell” agreements.

This column will describe some of the key elements of a good shareholder agreement.

Repurchase Rights

The easiest points to deal with in a shareholder agreement are a partner’s death, retirement or resignation. Typically, a good agreement will give the company the ability to repurchase the withdrawing partner’s equity in the business. A repurchase right will use a formula to decide how much the partner’s equity is worth. There are many variants on the formula used, but typically, book value established by the company’s accountant is the cheapest, most efficient way to set the repurchase amount until the company actually starts making money.

When a company becomes profitable, I usually recommend that a company avoid using complicated formulas to value the company, and just replace the book value mechanism with a provision calling for the hiring of an independent valuation firm. The danger in using formulas is

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DineEquity Board Approves Share Repurchase the formula you pick to use in 2010 may create an awful result in 2011, depending on changes in accounting, the state of the business and the shareholders' individual financial situations. Also, given that the company is now profitable, there will be money to pay for the valuation.

Many repurchase arrangements allow a company to pay the repurchase amount over time to avoid gutting the company's bank account on the day of the repurchase. Sometimes installment payments are coupled with interest if the payments need to be stretched over a particularly long period.

As a final note on repurchase rights, frequently shareholder agreements will set up exceptions where the company is not allowed to repurchase the partner's equity if the partner's family inherits the equity and also agrees to be subject to the same repurchase right down the road.

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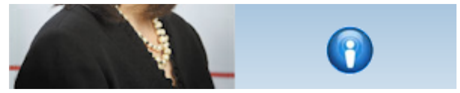

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