Picking Business Partners

THE FIRST COMMANDMENT

> LIMIT THE NUMBER OF PRIMARY PARTICIPANTS TO PEOPLE WHO CAN CONSCIOUSLY AGREE UPON AND CONTRIBUTE DIRECTLY TO THAT WHICH THE ENTERPRISE IS TO ACCOMPLISH, FOR WHOM, AND BY WHEN.

There are many reasons people become involved in young, growing companies as owners, investors, or key employees. The broad range of satisfactions sought runs from an opportunity for personal expression on one end of the spectrum to capital gains on the other. Unless there is compatibility between what the primary participants want out of the business, debilitating conflict is likely to ensue. The process of trying to reach conscious agreement on the purpose of the enterprise is often difficult and revealing.

The primary participants in a young enterprise are those people who share the initial ownership and/or management decision-making processes. The early months and years in the life of a company are critical ones in which the tone and shape of the venture are determined. If the character formed during the early days is convoluted by too much compromise or scarred by too much acrimonious debate, the foundation upon which the business is to be built will be less sturdy than it could and, ideally, should be.

Here is a list of six common mistakes that would-be entrepreneurs often make in piecing together participants at the start of a new venture:

- The founding group is formed spontaneously.
- Personal or family lawyers, insurance agents, CPAs, and bankers are automatically used as advisers.
- Harmony is sought at the expense of creative conflict.
- Needed support people are given stock or stock options before the people have validated their long-term value.
- The board of directors consists solely or primarily of insiders—company officers, their spouses, and friends or relatives.
- People with widely varying motives are mixed together in the same financial lifeboat.

Let's consider these six common mistakes in a bit more depth.

The founding group is formed spontaneously. It happens in real life and in novels. Visualize a buzzing weekend cocktail party or an animated, after-work conversation in a car or café. Out of the blue a new product or service or distribution idea materializes and takes shape. It's a euphoric moment, and the two, three, or more souls present are each caught up in the conception. Too often, they are also included willy-nilly as investors or key employees in the new venture.

This spontaneous combination of souls may be just what the venture needs; then again, it may not be. Experience suggests it is best if the choice of investors (if any) and staff flow from a thorough understanding of the requirements for success for the prospective business. Essentially random collections of folks seldom make the right bedfellows for business building even if they are coworkers, classmates, or professional cousins.

How does an entrepreneur go about exploring an idea and triggering enthusiasm and interest, while at the same time reaching the ideal of limiting the number of primary participants to those who can consciously agree upon and contribute directly to that which the enterprise is to accomplish? The answer is: *Cautiously*. The proper mindset is one that says that the eventual blueprint for building the business—the Business Plan—will dictate the desired specifications for investors and staff alike (see Commandment Four). If a small, qualified group can be organized to create the blueprint with a clear understanding from the start that everyone may not be on the actual construction team if construction is started, then the spontaneity risk is at least addressed.

Here is an illustration of how Commandment One was violated via an incompatibility of interests in the founding group.

CASE A. A bright, energetic high school dropout conceived a new athletic shoe for the jogger market. He sold his uncle, an accountant, on the concept. Together they raised close to $100,000 from individual outside investors, mostly friends who were avid joggers.

The $100,000 represented essentially all the capital put into the company. The shoe was introduced to the local market and sold very well. The company became a regional success story. The outside investors wanted to keep the earnings in the business and expand it. The founder/president wanted to play with new shoe designs, do research and de-

(case continued on next page)

velopment, and give speeches on entrepreneurship at luncheon-club meetings. The uncle/general manager was happy taking home $50,000 a year (his salary), and he didn't want to travel very far to build the business. The company quickly stagnated and eventually faltered. No one won. The founder lost his hero status; the uncle, his interesting job; the investors, their money. Each participant had his or her eye on a different star: *...that which the enterprise was to accomplish, for whom.*

Common mistake number two has to do with guidance on administrative matters.

Personal or family lawyers, insurance agents, CPAs, and bankers are automatically used as advisers. Growth companies don't just happen. There is a lot of administrative expertise needed to glue the pieces together and keep the enterprise on a peaceful course among the snags and shoals of government requirements and the law. Any average attorney, CPA, or insurance agent can speak the language, give you advice, mail you something to sign, and send a bill. Not many have the professional interest and proven experience to help you build a business. It's a relatively narrow spectrum of practice. An entrepreneur has enough to do without investing time and money to educate his or her advisers.

In any metropolitan area there are CPAs, attorneys, and insurance people who have developed or are developing a reputation with embryonic companies. Seek them out. Interview them. Discuss fees. Check their references. Then select who you want and listen to what he or she has to say. Your job as a modern entrepreneur is not to have all the answers, but to know where to get them. Of course it helps to know what questions to ask, too. This book offers a condensation of the experiences of others, to help you ask (and get answers to) solid questions.

How about bankers? In general, most of them do not have particular, in-depth expertise in business building. However, with the march of deregulation, some are learning out of necessity. Good bankers know about money, particularly debt money. And in Commandment Eight you will be advised to cultivate *all* your potential money sources on a continuing basis. So developing a working relationship with a reputable banker is a smart thing to do. But don't confuse doing so with developing a workable financial plan for your new enterprise. For a comprehensive financial plan you may need assistance from one or more people skilled in corporate finance—particularly start-up and small business financing. For example, investment bankers, venture capitalists, and occasionally business school professors of finance or accounting may be helpful. Someone who has worked with numbers and lived through a start-up or two in the same or nearly the same industry as your own is probably the best single source of guidance.

Harmony is sought at the expense of creative conflict. Entrepreneurs by nature tend to listen most attentively to themselves, but this surely restricts the input they receive. Business builders are wise to regularly seek counsel from others, including people who may well raise contrarian points of view. With these people participating, meetings can become downright uncomfortable. But managed well, such sessions can also be quite productive. Friction produces heat and, ideally, light. There are many experiments that show that groups made up of people with complementary skills usually produce more valuable solutions to problems than experts working alone.

The primary participants in a new enterprise need to provide balanced, qualified input to the decision-making process. Harmony is not the measuring stick.

CASE B. A group of three prominent, academic scientists spotted a major opportunity in the emerging bio-medical industry. Technically it was within their combined spheres of expertise. They mulled over the opportunity for nearly a year and then latched onto a young MBA student with no bio-med experience. The student was seeking a field project for one of her classes. With the scientists guideance the MBA developed an elaborate business plan with computer generated projections covering every conceivable scenario. The four people got along well together in both business and social settings. The projections looked good. Four months later seed financing was obtained from an overseas venture capital firm and the MBA was hired as the general manager of the newly formed company. Everyone was giddy.

Now ask yourself: How reliable are the projections and the business plan developed for the scientists by a busy student in need of a job after graduation? How well qualified is the new general manager to build a competitive, bio-med company? What is the probability of business success for this cozy quartet? How could a modicum of creative conflict been woven into the formative period of this potential growth company?

Needed support people are given stock options before the people have validated their long-term value. Cash is almost always tight in the early days of a new enterprise. Among other things, cash is needed to attract and hire key employees—experienced people who can boost performance quickly. Often such people are relatively expensive to hire, compared to rookies. A practical question then arises: How can you entice desired people aboard with a minimum salary outlay? Often the answer is to grant them company stock options in lieu of part of their salaries. In general, this is a bad answer. Here are four reasons why:

1. Some options will end up in the hands of people you later have to release. Such people can become disagreeable shareholders. 2. Certain option holders may be people who professional investors consider unacceptable equity partners. This could make it difficult for you to raise needed outside money for your company. 3. Options may be converted to shares that could be offered to back to the company via a repurchase option at a point in time when the company can least afford to buy shares. 4. Employees with options can become shareholders who end up working for a competitor, which could create some difficulties for you and your enterprise.

Does this mean you should never use stock options for key support people involved in a start-up? The best answer is a qualified yes. Restrict the ownership risks and potential rewards to just the primary participants who, by definition, are making a unique, direct contribution. Then, once your enterprise has graduated into positive cash flow and reached a point of relative stability, consider options for secondary company builders only after giving the matter deep, detailed, long-term thought. Options can rise and fall in value. In addition, they can distort the true, balance-sheet value of enterprise. Options are a form of compensation. Handle with care.

CASE C. A young entrepreneur had an idea: Build a bungee-jump tower at a ski area so skiers could add to their winter fun. He sold the idea and forty percent of the new company to an investor who put up the money to build the tower. He also sold a significant amount of stock at the founder's price to a buddy who agreed to help operate the tower. Two years later, bungee sales were good but below projections. The investor wanted his money back and the buddy wanted to leave the snow country for good. The entrepreneur now had two unhappy shareholders who, together, owned over half of "his" company, and he was short on cash to buy either one of them out. He had a problem. The business died.

The board of directors consists solely or primarily of insiders—company officers, their spouses, and friends or relatives. Legal questions aside, the operating purpose of a board is to aid, challenge, and replace, as necessary, the chief executive officer (CEO) in the service of the stockholders' interests. Those interests usually revolve around the financial health of the enterprise, so a board ideally concentrates on helping the CEO optimize the financial performance of the company over some finite period of time. If the CEO/entrepreneur is open to seasoned advice (via creative conflict), he or she is unlikely to get it—at least anything very unsettling—from insiders, spouses, friends, or relatives. A properly constituted board can inexpensively double the width of a young company-management's point of view. One or two directors with relevant experience can be equivalent to another key person on the payroll. A strong board can be the single best source of right questions as the enterprise learns first to stand, and then to walk...and run.

People with widely varying motives are mixed together in the same financial lifeboat. A huge spectrum of people participate in small, growing companies. Some of them are seeking long-term capital gains; they understand that stock ownership is a prime way to build one's own net worth. Other people are happy with a comfortable annual income. Still others are interested in technical challenge and its tributaries, including problem solving and personal expression. Other people relish the prospect of fame. A smart entrepreneur will illuminate the driving force in each of his or her potential colleagues and think hard about whether there is compatibility across the members of the basic team.

It is completely honorable for a group of talented people to join together to build a company with the in-

tention to give each participant a chance to do his or her own thing and, incidentally, make a buck in the process. Problems arise, however, if responsible outside investors are brought into the very same company under the false pretense that management intends to vigorously grow the enterprise and make everyone, including the investors, rich in a certain number of years.

In summary, Commandment One is important because a new company is fragile. It needs a well-developed internal system of supports and braces to withstand the pressures of entering and competing successfully in a marketplace. Appropriate supports and braces can be conceived and squeezed into place by dedicated people with qualifications especially suited to the configuration of the particular enterprise. An entrepreneur faces the task of gathering just the right number of right people. Too few result in weakness; too many create chaos; and a collection of wrong ones can produce debilitating, and perhaps fatal, dissension. Probably as many potential growth companies fail because of internal weaknesses as they do due to wounds inflicted by competitors.