Business Equity for Services Rendered

I got an email from a reader of this column two weeks ago that said “I am in the processing of starting my new business but haven’t been able to come up with sufficient capital to do some of the important startup items that I need. I have had meetings with an accountant and a website developer. Their services are very important to me and I am convinced that they can do what I need. What do you think about my offering them a piece of ownership of my new business in lieu of payment to them for their services?”

OK, you think about this. What would you say to this inquiry?

The really strange thing about this request is that I had just met with a couple in early December who are starting their new business and they had a similar question. I have responded to both with a very big caution. I know that in today’s economy it is difficult to raise startup funds, but there are some good ways and there are some bad ways to do it. I told them that I would not do it if I were you.

I remembered a question that Tim Berry (CEO of Palo Alto Software) used and I asked them “would you marry someone whom you had never met? This business question is a very similar situation.

Never use shares of ownership to pay for services. This equity swap is really a bad idea. Sharing a company is an intimate partnership for the rest of that business’ life. It’s like marrying somebody you’ve never met. It’s the business equivalent of a mail-order bride. Minority shareholders end up with some serious rights regarding second-guessing your strategy, your decisions. Having an incompatible partner in business is a really bad situation.

There are exceptions to this rule, of course: For example, if you have somebody you know well, trust, would be happy to work with forever and ever, who also provides a service. That can be ideal. But you already have the relationship. This is somebody you’d be pleased to partner with.

However, finding a way to trade money now for money later, the underlying idea, is not so bad. But do it right. How about finding an entrepreneurial web developer that will work for a percent of future revenues? You might develop some innovative formula like “I’ll pay you three times more if I make it, so you share the risk.”
Tim Berry went on to say that “I have real experience with this, with my own company. In the early days of Palo Alto Software I found programmers for hire who agreed to work for a small minimum fee plus a percent of future revenues. It was win-win. They made good money eventually, way more than they would have if they hadn’t agreed to take a risk. And I found a way to get started without having any capital. It was really a good deal for all.”

He summed it up this way, “they never had a share in the ownership of the company. We owed them money. Not shares.”

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