SHOULD BILL GATES HAVE LET PAUL ALLEN KEEP PAUL'S MICROSOFT SHARES WHEN PAUL LEFT IN 1983?

Paul Allen and Bill Gates owned the Microsoft partnership 40%/60% until 1977, then 36%/64%. Current CEO Steve Ballmer joined the company in 1980. The Microsoft partnership reorganized as a corporation in June, 1981, with 96% of the stock owned by Bill (53%), Paul (35%) and Steve (8%).

The IBM personal computer came out in August, 1981 -- with a Microsoft operating system and Microsoft software. In January, 1983 Time Magazine named the personal computer the "Person of the Year" for 1982. The IBM XT, with a 10MB hard drive, 128kb RAM and an 8-bit bus, debuted in March, 1983. Zork, a popular computer game then ("Pick up axe", "There is no axe here"), was all text, with no audio or graphics.

Paul was diagnosed with Hodgkin's disease, a form of cancer, and treated successfully in 1982. Just before Paul Allen left his Microsoft job in February, 1983, Bill Gates offered to buy Paul's Microsoft shares at **$5** each. Paul said he would not even discuss less than **$10** per share. Bill said "No way." So Paul kept his Microsoft shares and his seat on the board of directors.

Paul said "If he'd been willing to offer something close to my asking price, I would have sold way too soon."[1]

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[1] Paul Allen, *Microsoft's Odd Couple*, Vanity Fair, May, 2011, http://www.vanityfair.com/business/features/2011/05/paul-allen-201105, adapted from IDEA MAN, by Paul Allen, to be published in May, 2011 by Portfolio, a member of the Penguin Group (USA) Inc. "When Vern Raburn, the president of our consumer products division, left to go to Lotus Development, the Microsoft board had voted to buy back his stock for three dollars a share,

Later in 1983 Microsoft introduced its first mouse and its first version of Word. In November 1983 it announced (but did not ship until 1985) its first version of Windows. Microsoft went public in March 1986 at **$21** a share.

Adjusted for splits, the shares Paul kept in 1983 are now worth **$7,376** each. Because Paul kept those shares, he was eventually worth **$13 billion**, ranking 57th on the most recent Forbes magazine list of billionaires. Paul has given over $900M to charities. Bill Gates is worth $56B and is the second richest person in the world, after 17 years at No. 1.[2] Bill has given $28B to charity, including to his foundation. Bill and Paul have pledged to leave their wealth to charity. Steve Ballmer is worth $14.5B and is the 46th richest person in the world. Steve made his fortune in Microsoft stock options.[3]

The viewpoints. One view is "They are all filthy rich, who cares if one got more that the other?" So let's take it down five decimal places and assume all their wealth is Microsoft ("MS") shares. In this hypothetical world, Bill has $5.6 million after giving away $2.8M. Steve has $1.4M and Paul has $1.3M. In other words, Paul has participated in MS profits about the same as Steve.

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which ultimately cost him billions of dollars. I knew that Bill hoped to pressure me to sell mine the same way. But I was in a different position from Vern, who'd jumped to Lotus in apparent violation of his employment agreement. I was a co-founder, and I wasn't leaving to join a competitor."

[2] Carlos Slim of Mexico is currently No. 1.

[3] *Microsoft Co-Founder Hits Out at Gates*, Wall St. Journal 3-30-11; Fredrick E. Allen, *Bill Gates Tried to Screw Paul Allen? What's the Surprise?,* blog on www.Forbes.com 3-30-11; *Key Events in Microsoft History,* www.microsoft.com/downloads; www.billgatesmicrosoft.com; *Steve Ballmer* at www.ReferencesforBusiness.com; http://www.forbes.com/profile/bill-gates; http://www.forbes.com/profile/steve-ballmer; *Billion-Dollar Donors*, www.Forbes.com, 8-24-09; *Allen Steps Up to Buffett and Gates' Billionaire Challenge*, Forbes.com, 7-15-10; *Steve Ballmer* at www.wikipedia.com (stating without citation that Steve made his fortune in MS stock options).

Should Paul have participated to this extent in the profits from Windows, MS Office, Internet Explorer, mice, keyboards, Xbox and other hardware -- all projects started after Paul left as an officer? Paul was there when MS took over the operating system and programming language of IBM personal computers. Steve was there when MS took over a much bigger computing world. Steve shepherded MS through antitrust battles with both the USA and the EU -- and MS survived. Steve took the reins as CEO when Bill retired. Of course, Steve also received a salary from MS in the years after 1983 when Paul did not. But if Steve's salary was commensurate with the value of his services, shouldn't Steve have earned more than Paul from the shares?

Paul would probably say (a) that he deserves his share of the MS profits because he was there for the formative years of 1975 to 1983, and (b) that he put his valuable stamp on the company then. Also, he contributed as a director to the company's success after 1983.[4] MS went public in 1986, so since then Paul has participated just as any other investor.[5]

Bill and Steve might now wish that most of Paul's shares were bought back by MS, Bill or Steve in 1983, when Paul left as an employee. By keeping his shares, Paul was able to elect himself to the Board of Directors.[6]

Cash flow and white-hot growth. If Paul had a 35% interest in MS in 1983 and MS bought it back, the share ownership would become Bill (83%, from 53%), Steve (12%, from 8%), others (6%, from 4%). To buy Paul's shares, MS would have needed to redirect scarce after-tax cash away from new projects to paying Paul. MS would probably have paid for Paul's shares mostly with a prom-

4 "[After resigning as an officer in 1983,] I retained my seat on the board and was subsequently voted vice-chairman -- as

(footnote continued from preceding column)

a tribute to my contributions, and in the hope that I would continue to add value to the company I'd helped create," said Paul in the Vanity Fair excerpt from his book.

5 But buyers at the IPO invested much more cash in MS than Paul.

6 If Paul had been bought out, whether he served on the Board would have been up to Bill and Steve.

issory note, making monthly payments for 3 to 6 years.

If Bill bought Paul's shares, Bill would then have owned 88% of the company. If Steve bought all of Paul's shares, Steve would then have owned 43% of the company. Either of them would have planned on paying for Paul's shares with dividends from MS. With MS in a white-hot growth mode, it probably was not attractive to take scarce after-tax cash from the corporation, distribute it to the shareholders who would pay tax again on the dividend, so that one shareholder could use the after-tax cash to pay for Paul's shares. Which probably explains why Bill did not offer more than a low-ball price for the shares. In a nutshell, buying Paul's shares might have made MS less likely to meet its commitments to IBM – it might have killed the goose that laid the golden eggs.

Bill should have kept talking. Bill still had several alternatives. He could have accepted Paul's $10 per share price, but paid it over 7 to 10 years, to lower the payments. If MS bought Paul's shares, Bill and Steve could have pledged some of their shares to secure the MS debt to Paul. If Paul balked at this offer, MS could have provided a 3-year note amortized over 7 or 10 years with a balloon. That would give Bill and Steve time to raise debt or equity to fund the balloon payment to Paul.

Bill could have considered having MS set up an Employee Stock Ownership Plan. The ESOP would borrow from a bank to buy all of Paul's shares for cash. Paul would pay no tax if he reinvested in stock or bonds of US companies. Paul could access the sale proceeds with margin loans. MS would make deductible plan contributions to the ESOP to enable the ESOP to pay its bank debt. Bottom line: Paul might take a lower per-share price for a tax-free sale *and* MS would pay for the shares with pretax dollars. The ESOP does not fit every situation. But when it does, the tax benefits are amazing.

Bill could have suggested that Paul use a charitable remainder trust to sell some of the shares, generating a charitable contribution deduction in 1983 that might have saved Paul enough in taxes to induce him to accept a lower price per share.

The **key point** is that Bill could have tentatively accepted Paul's price and **continued to negotiate** a deal that would leave MS with cash to operate and grow. However, no matter how the deal was structured, it would cause MS to grow at a somewhat slower rate, because cash would be diverted from growing MS to paying Paul.

Planning in advance for a stock transaction. In 1981 when MS incorporated, Bill and Paul should have considered a "buy-sell agreement." (Did you know I was going to get to this?) The agreement would have said that if either Bill or Paul died, became eligible for disability insurance or walked away from the business, MS would have an option to buy all of their shares. If MS did not buy all of the shares, the remaining shareholder could buy them. A method of pricing the shares would be set: probably by appraisal. The agreement would give each of them a right of first refusal to buy if the other wanted to sell to anyone else. If MS was an S corporation, the agreement could have protected that status. Paul could have asked for close corporation status for MS and a provision in the agreement that would name him Executive VP while he held shares and retained his mental abilities.[7]

Paul's 1982 cancer scare shows that it would have been smart for MS to buy life insurance on Bill and Paul, if the buy-sell agreement had been in place in 1981. If Paul's treatment had not been successful, MS could have bought Paul's shares for the cost of a few years of life insurance premiums. The life insurance might not have been very expensive, since Bill and Paul were both young men.[8]

Another key point: **If Bill and Paul had put a buy-sell agreement in place in 1981, they would not have needed to argue about the purchase price in 1983**. (More accurately, they would *have already had* that argument when they were negotiating the buy-sell agreement). When Paul got sick, Bill and Stave would not have to anguish over whether they should fire Paul and try to buy his shares. If Paul was sick enough to collect disability insurance, his shares could be bought (at the option of MS and Bill), his employment and salary

[7] Otherwise, Bill could name two out of three directors and Bill's directors could terminate Paul's employment and/or remove Paul as an officer. (As long as Paul kept his big block of shares, he could elect at least one director on a three-seat board.)

[8] It's better tax-wise if Bill and Paul each owned a policy on the life of the other – a "cross-purchase" arrangement. But if Paul had died, an "entity-purchase" arrangement -- with MS buying Paul's shares -- would have been far better than no life insurance and no buy-sell agreement.

payments would end and the disability insurance payments would begin.

With 8% of the shares, Steve probably would not be in this agreement between Bill and Paul. Steve and each employee in the 4% block of shares would have his or her own "buy-back agreement" with MS. As an example, if Steve ceased to be employed by MS, MS (and no one else) would have an option to buy his shares back, probably for one cash payment.

With agreements like these in place in 1981, Bill still might not have wanted to use scarce after-tax cash to buy Paul's shares in 1983. But he would have had the option to do so, and there would have been a mechanism to set the price. Of course, Bill could have said to Paul "The agreement calls for a price of $10 per share, but we can't afford that right now. Would you take $5 per share and we will shorten the payment period from the 60 months in the agreement to 36 months?" They could still negotiate, but the agreement would be the new default.

Your own "Paul Allen" situation. Although I did not speak with Bill, Paul or Steve, I have worked with many business owners in their positions. The best time to get serious about a buy-sell agreement for the principal shareholders is the first week that they think "OK, this might actually work. Our ideas and hard work are now generating real cash flow." When one shareholder gets back bad lab tests, it's too late. It's also unlikely that a buy-sell agreement will get signed when one of the principal shareholders has a difficult marriage.

The minute that an employee or family member receives shares is the right time for his or her buy-back agreement. Any delay will disadvantage the company.

I would be pleased to discuss with you ways to protect the shares of your business (or your client's business) from a "Paul Allen" situation.

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