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UTILIZATION OF ONE-WAY BUY-SELL AGREEMENTS TO EFFECT A SALE OF YOUR BUSINESS TO EMPLOYEES (INCLUDING FAMILY MEMBERS)

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More and more business owners are discovering that their children are becoming less interested in taking over the family business, whether they obtain the business by sale or inheritance. As a result, Business Owners looking for an Exit Strategy will have to look to third parties or long-term employees to purchase their businesses.

Many economists believe that over the next decade or so, the ratio of third-party buyers will shrink dramatically, resulting in many more sellers than buyers of businesses, especially closely-held businesses. One way or the other, the baby boomer business owners will want to exit their businesses and may be better served by selling their businesses to their employees rather than to third party purchasers in order to realize their targeted sales price or to leave their businesses as legacies.

Potential Advantages of Selling to Employees:

(1) Owners are able to identify potential buyers of their businesses.

(2) Employees have experience and familiarity with the businesses.

(3) Owners have direct experience with the talents and abilities of their potential purchasing employees and can groom those employees in taking over the business.

(4) The opportunity to plan for transition to purchasing employees can be effected over an extended period of time.

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Suggested Reading:

The Testament

By John Grisham

(Enjoyable read of an interesting Estate Plan with plenty of intrigue and twists)

Potential Disadvantages of Selling to Employees:

(1) Purchasing employees are likely to have little available cash and limited borrowing ability.

(2) The targeted purchasing employees can be lost by death or disability over the extended purchasing time period.

(3) Difficulty in selecting certain key employees and excluding others which could result in loss of employee morale.

When Does the Owner Give Up Control

The owner must properly balance the timing of giving up control, particularly if a significant portion of the purchase price is owner-financed, with the purchasing employee(s)' desire to take over operational control.

Just like parenting children, the owners must be careful when transferring to their employees the responsibilities of operating the business as well as the risk of ownership. Keep in mind that very few non-owner employees have experienced the anxiety of making payroll, guaranteeing business debt and mortgaging their homes and other assets to secure financing for the business.

One-Way Buy-Sell Agreements

Once the owner decides to sell the business to his or her selected employees, an excellent way to start the discussion with the purchasing employees is to enter into a One-Way Buy-Sell Plan with the employees to outline an agreement and timetable for transitioning business responsibilities and ownership. Beginning with the end in mind, the owner might suggest that the purchasing employees pay for all or at least a portion of life insurance and permanent disability coverage on the owner to facilitate the sale of the business if the sale is triggered by the owner's death or disability. Having the employees pay for this coverage allows the employees "to put some skin in the game."

If one or more of the employees squawk about sharing the cost of the insurance coverage to protect the business and their own careers, this puts into question such employee(s)' ability to purchase the business successfully and to make prudent financial decisions once they own the business; this is of particular concern for owners who owner-finance the purchase price.

Toggle Switch of Control

As part of the One-Way Buy-Sell Plan, the owner should evaluate the strengths and weaknesses of the selected purchasing employees to determine who are the best candidates to fill the business' CEO and other key positions. The plan should include key benchmarks or control checkpoints that trigger a transfer of ownership in stages when certain benchmarks are met and transfer of control when all of the benchmarks are met. Transitioning ownership and control over time is healthy for the owner and purchasing employees and more likely will convince the business' other employees, customers/clients, suppliers and lenders to embrace the transition.

Timing, Terms and Taxes

The owner must first determine his minimum exit amount and make sure that his advisors (possibly with the help of a business appraisal) match the net after tax amount to be realized by the owner to his or her minimum exit amount.

Only a fixed amount of cash flow is available from the business to accommodate the owner(s)' ability to receive the purchase price and the employee(s)' ability to pay the purchase price.

Multiple compensation and benefit plans, employee/consulting arrangements and asset leasing by the owner (if available) should be considered to help the parties structure the plan as tax efficiently as possible.

Many of these issues are addressed in Patrick Ungashick's excellent book "Dance in the End Zone" and on the Navix website. These resources should be considered in addition to bringing in the business owner's advisors (including CPA, Banker, Financial Consultant and Tax Attorney) to assist in developing and carrying out a successful exit plan.

CONCLUSION

Keep in mind that One-Way Buy-Sell arrangements also are an excellent way to effect a part gift/part sale of a business to the owner(s)' children working in the business, and at the same time to help equalize inheritances of children not involved in the business when a closely-held family business comprises a substantial part of an owner's net worth.

Since preparing a business for a successful and organized transition of ownership and control takes significant time, owners of businesses should begin preparing their businesses years in advance of their desired trigger date. Owners should open up discussions with their employees (including purchasing children) well in advance to ascertain if: (1) the selected employees are willing to accept the risk and responsibilities of ownership and have been sufficiently trained to operate the business successfully and (2) to establish a targeted purchase price, structure, time table and tax analysis for the transition with the assistance of professional advisors. You can contact our firm if you have questions regarding Business Exit Plans and Buy-Sell Plans.

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