How to sell *shares to employees.*

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Business succession planning: how to sell shares to employees.

When the owner of a privately held business is looking to move on, one option is to sell just some of the shares in the company to an existing, usually senior employee, and for the owner to retain the majority of the shares in the company.

Over time the remainder of shares can be transferred to the buyer. The right to buy further shares can be based on financial or other targets being achieved by the purchaser, or the company as a whole.

An advantage of selling to an employee is bringing in someone, generally younger, with enthusiasm to run the business. Owners often build up a business over many years and genuinely care about their customers, staff and others that they have a business relationship with. The owner will most likely know the buyer well and have confidence in their knowledge of these parties and their ability to nurture and develop these existing relationships. If the purchaser is able to increase the value of the business with new ideas and hard work then the existing owner benefits because they still hold the majority of the company's shares.

Process – overview.

It is very important that these types of succession planning transactions are structured correctly to protect the owner's interests. When working with owners in relation to selling to employees, a typical process for your business lawyer to follow would be:

Discussions With Current Owner

- Learn company and family background.
- Understand owner's plans for the company, and personal goals.
- Learn about proposed new owner.
- Discuss plans for staged exit of existing owner.

Communication Between Advisors

The owner's business lawyer would typically communicate with the following advisors during the transaction:

Bank

- Confirm proposed arrangement is within banking parameters.
- Consider finance structure for part or all of purchase price and security requirements.

Accountant

- Prepare company valuation.
- Advice on dealing with owner's current account and payment of retained earnings.
- Consider tax efficiency.

Insurance Broker

- Arrange insurance to protect against death or permanent disability of a shareholder.

Prepare Legal Documentation

This will usually include some or all of:

- Heads of Agreement.
- Sale and Purchase Agreement.
- Loan and Security Documents.
- Shareholders Agreement.
- Compulsory Share Purchase Agreement.

CASE STUDY – OVERVIEW: *Darrel started his manufacturing business 30 years ago. He runs the business through a company of which he is the only director and his trust is the only shareholder. The company has grown over time and returns good profits every year. Darrel would now like to reduce his hours and start handing over some of the management responsibilities. Fortunately, he has a very competent employee, Scott, who has worked with him for the last five years and has shown an interest in taking some ownership in the company. Scott lives in Auckland and has a big mortgage and a young family.*

Process – finance.

Structuring the transaction to protect the owner's interests –

Financing The Purchase

It is possible for the owner to let the purchaser pay off the shares they have purchased over a period of time. This is referred to as "vendor finance" because the seller of the shares (the vendor) is effectively providing finance to the purchaser until the shares have been paid for in full. An advantage of vendor finance is that it can enable a purchaser who otherwise may not be able to afford to buy shares in the company (e.g., because they have recently financed a house purchase) to participate in the transaction.

Vendor finance is often provided in conjunction with some bank funding which enables the owner to receive a portion of the purchase price (the bank funded part) immediately at the time of the share sale.

When vendor finance is provided it is usual for the owner of the shares to take security over those shares until they have been fully paid for. This means if the purchaser of the shares were to default on their payments, the owner will have the ability to take back the shares. The security can then be registered on the Personal Property Securities Register to give the owner priority over subsequent secured parties.

CASE STUDY – FINANCE: *Darrel engages the company's accountant to provide a valuation for the company. The valuation comes back at $3M. It is agreed that Scott will buy 20% of the company from Darrel's trust immediately, and another 10% in a year's time. Because Scott recently purchased his house he already has a large loan to the bank. The bank will lend him another $300,000, which will be secured against his house, but no more. So Darrel agrees that his trust will lend Scott the remaining $300,000 needed to purchase the first 20% of the shares in the company. And further funds in a year's time when it is time to purchase the next 10%. Scott must use his share of company dividends to repay those loans. Documents are drawn up to record the loan and the security that Darrel's trust will take over the shares until they are paid off.*

Process – documentation.

Shareholders' Agreement

When shares are sold to an employee and the owner is retaining an interest, it is very important that a Shareholders' Agreement is prepared to record the rights and obligations of both parties. This will usually include things such as:

- Recording that some decisions require approval of all shareholders.
- What will happen if a shareholder gets a long-term illness and can no longer work.
- The process to follow if a shareholder wants to sell their shares.
- How the shares are to be valued in the event of a sale.
- Details of any restraints of trade on a party who has sold their shares.
- Where the original owner is still a majority shareholder – that the employee will have to sell their shares back to the original owner if they leave the company within a certain period of time (if this is the agreed process).
- The process to follow in the event of a dispute.

Dispute Resolution

Dispute resolution is dealt with in the shareholders agreement but requires special consideration. Parties almost always go into business thinking they will get on well forever, but unfortunately this isn't always the case. So clear procedures to follow in the event of a dispute should be specified.

Usually the first step is to require the parties to negotiate. If that doesn't resolve the issue then there are a number of other options. One of them is for the parties to have to mediate the dispute. Mediation has a good chance of resolving the issue. The downsides of mediation is that both parties have to agree to the process, there is no guarantee of a resolution and although cheaper than court, it can still get costly. If no resolution is reached at mediation then the parties would be free to go to court to litigate the issue.

Another option, is that one party will have the right to buy out the other. In the context of an employee buying in to the company, it usually makes sense for the original owner to be able to buy back the employee's shares. A mediation or similar process would usually have to be followed first. The advantages of this approach is that it best protects the original owner's interests and means there is a definite way of ending the relationship if the parties can no longer work together.

There are many options when it comes to selecting a dispute resolution process, and it pays to give the matter some serious consideration rather than simply accepting a standard procedure, which is unlikely to be right for every circumstance.

Compulsory Share Sale On Death Or Permanent Injury

It is important to consider what will happen to the business, and the shares in the company, in the event that one of the shareholders suffers from death, disablement or another illness or injury (a "critical event") that prevents them from returning to the business.

Currently, if one of the parties suffer from a critical event and do not have an agreement with the other shareholders about what will happen to their shares, it is possible that:

1. The shareholder will be left with their shares in the company but unable to work in the business. In the event they want to sell their shares, the other shareholders may not have sufficient funding to buy them; or
2. In the event that a shareholder dies, their shares may be dealt with in accordance with the terms of their will and left to their estate and the beneficiaries of their estate. Accordingly the remaining shareholders may be left in business with the deceased's spouse.

These scenarios can be potentially damaging to the business. It can also leave the other shareholders with an arrangement that they did not intend when they joined the business.

A way to protect against the above scenarios is to take out insurance protection and for the shareholders to enter into a **"Compulsory Share Sale Agreement"** (sometimes also called a **"Buy/Sell Agreement**").

Insurance

Generally, there are two main types of insurance that should be considered:

1. **Key Person (or "Key Man") Insurance**
   This type of insurance allows the business to cover its costs in the event that a person who is fundamental to the business suffers a critical event. It can cover costs such as staff replacement costs, training costs and loss of profits; and
2. **Life, Trauma and Disability Insurance**
   These types of insurances are usually triggered when a shareholder suffers from a critical event and has to leave the business. The insurance will usually pay a lump sum to the remaining shareholders of the company, allowing them to buy out the shareholder and may in some cases, pay out the current account of that existing shareholder.

We always suggest consulting with a specialist insurance broker about what insurance arrangements will be best for your business.

Compulsory Share Sale Agreement

A Compulsory Share Sale Agreement outlines the process to be followed in the event that a shareholder suffers from a critical event. It specifies that the insurance proceeds ***must be used*** to purchase the exiting shareholder's shares in the company.

The Compulsory Share Sale Agreement will usually cover points such as:

- **Ownership of Insurance Policies:**
  Shareholders usually arrange for the insurance policies to be held on trust for the shareholders by an independent third party. Having an independent person involved to receive and pay out the insurance proceeds can relieve some of this stress and help ensure the process runs smoothly.
- **Payment of Insurance Premiums:**
  The insurance premiums may be paid by the shareholders of the company, or the shareholders could require the company to pay the insurance premiums.
- **When a Share Sale Will be Required:**
  What events will trigger a share sale under the agreement will depend on what type of insurance has been taken out by the shareholders. A pay out under an insurance policy may be triggered by events such as the death of a shareholder, the total and permanent disablement of a shareholder or when a shareholder suffers a critical injury or illness preventing them from returning to the business.
- **The Share Sale Process:**
  The agreement will outline how the shares are to be sold to remaining shareholders, including when settlement will take place, and what documents and conditions are required to complete the share sale.
- **The Sale Price for the Shares:**
  The agreement will also outline the price to be paid for the shares. It could be based on a fair valuation, formula or on the value of the insurance proceeds that are to be paid out. It is best to seek accounting advice on this point before making a decision.

Compulsory Share Sale Agreements can be relatively technical documents, but are important for protecting the business from an unexpected event to one of the shareholders.

CASE STUDY – DOCUMENTATION: *Scott has purchased 30% of the company and repaid his loans to Darrel's trust using his share of company dividend. The company has continued to grow and the sale of shares to Scott has been beneficial to both parties. Insurance policies have been taken out over the lives of Scott and Darrel and a Compulsory Share Purchase Agreement has been signed. Six years after selling the first shares to Scott, Darrel suffers a health condition and cannot return to work. Fortunately, an insurance policy is held that protects the parties in this eventuality. The insurance company pays out and the funds are initially held in trust by a company set up for that particular purpose. After consultation with advisers, the parties follow the process recorded in the Compulsory Share Purchase Agreement and the funds are utilised by Scott to purchase the remainder of Darrel's shares in the company. Scott becomes the sole director and shareholder.*

Process – summary.

Below are some questions to consider if you are considering selling shares to one or more employees.

Selling Shares

- Will the shares be sold all at once or in stages?
- If in stages, will targets have to be met before further sales proceed?
- How will the shares be valued?
- Will the full purchase price be paid by the purchaser upfront, or will the owner lend some of the purchase price to the purchaser (called a vendor loan)?
- If a vendor loan, how will it be repaid? From dividends?
- Will the vendor's current account be repaid prior to settlement?
- Are there any dividends to pay prior to settlement?

Operating

- Will the purchaser be providing guarantees to landlords, banks or other parties?
- What will each party's salary be?
- Will salaries change over time?
- What hours will each party be required to work? Will this change over time?
- Should any decisions require approval by all shareholders?
- How will company operations be funded? (e.g. company profits, then bank funding and lastly from shareholders?)

Exit

- What if the parties have a dispute? If it can't be resolved should the vendor be able to buy back the shares?
- How will the shares be valued when a party wants to sell?
- Will insurance be taken out over the lives of the shareholders to enable purchase of their shares in the event of death or disability?

Getting Started

If you would like to talk about selling shares to one or more of your employees feel free to get in touch. We'd be happy to discuss your particular situation, what you're looking to achieve and how you might go about getting there.

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