When Does It Make Sense to Sell Stock to an Employee?
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Some of the most challenging and complex decisions a business owner can make involve when and how to sell a part of their business to an employee. The decision to sell a portion of your business to an employee may be motivated by the desire to raise capital or as an effort to retain a key employee or as a part of succession plan to begin transitioning out of a business. Whatever the motivation, as an owner you should make sure you consider whether bringing in a partner is the best choice and whether it is consistent with the long-term goals of you and your company.

The sale of stock (or a membership interest) is not to be taken lightly. As a securities sale, this type of transaction imposes fiduciary duties on you as seller to act openly, honestly and in good faith. Full disclosure of all aspects of your business is a key requirement so that the employee is fully aware of all of the parts of your business, warts and all. You do not want to be accused somewhere down the road of having misled the employee as to what he or she is buying. You will want to document everything that you reveal so that the employee is not in a position to say they "didn't know" about any material aspects of your business.

Also, when you make an employee a shareholder, under Minnesota law, you turn that employee from an "at-will" employee into an employee you may only be able to discharge "for cause." You can and should address this issue in an employment agreement as part of the overall sale documents. In addition, that employee, as a shareholder now, has the right to access certain information as a shareholder that you might not have provided them as an employee.

So when does it make sense to think about selling stock to an employee?

1. **Raising capital.** If your motivation for selling a portion of your business is to raise capital for your business, make sure you consider all other options first. The issues that arise when an employee becomes a shareholder may very well not be worth the amount of capital that they can contribute. Investment capital of loans from non-employee sources such as banks, outside investors, the SBA and other forms of lenders will often pose fewer operational challenges and should ordinarily be your first choice. Convincing an employee to invest if they are not a sophisticated investor can open you up to security claims that could have a very large price-tag. If your only option is employee capital, be sure to build in all of the necessary protections to ensure that you can still treat them as an employee when you need to.
2. **Keeping a key employee.** Sometimes an employee is just too valuable to lose because of the production they bring to your company. However, a great employee does not necessarily make for a great partner. In particular, the high-performing, high-maintenance type of employee could be a nightmare if they buy in and assuming that means they have a right to "contribute" their opinions on all aspects of your business. Consider the compatibility of your key employee as a decision-maker in your business. If the employee is not someone you would trust to make good decisions in operating your business,

consider alternate compensation plans instead of selling them stock. Phantom stock plans, performance bonuses based upon profitability or simple salary increases can serve to keep a key employee happy and in your employ, particularly if you tie the additional compensation with a well-drafted non-compete agreement.

3. **Finding your successor.** This is probably the most common reason people consider selling stock to an employee. For many small business owners, the best exit strategy may be an employee sitting just down the hall. If you are considering offering stock to an employee who you view as a potential successor, keep in mind several factors. First, can they afford to buy the company? At the end of the day you want to be cashed out and the best purchaser is one you don't have to finance. Oftentimes a sale to an outsider is a bank or SBA financed. What type of resources does the employee have? If they aren't going to be able to cash you out, it is possible they can buy you out over time based upon the future performance of the company. If you see that as the likely path to a sale, then you should consider whether the employee has the management capacity to run the business successfully enough to pay for the purchase after you have left the company. If you need the company to operate successfully after you are gone to get paid, make sure that your successor has the type of business sense necessary to be successful. Finally, if you have a team of employees who collectively may become your successor, identify who you see as the leader of the team and build around that person. Odds are not all of the team members will stay in it for the long haul, so don't create a plan that requires the entire team to stay together to be successful.

If you are considering bringing in an employee as a partner, please take advantage of this month's offer of a free one hour consultation on whether and how to sell part of your business to an employee.