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Howdy Partner: A Trail Guide for Promoting an Employee to Co-Owner

It is a particularly thorny question – one faced by owners of businesses both large and small: Is it time to promote this employee to co-owner?

Panelists at our 2019 Closely Held Business Summit recently noted the benefits: Expanding the pool of ownership can be a valuable tool for both employee retention and business succession planning. But – like starting any long journey – this is not a decision that should be entered into lightly. In fact, many advisors analogize new business partnerships to new marriages. A marriage proposal prompts all kinds of questions and self-reflection: *Are they the one? Do we both want the same things? Can I deal with their crazy family? Are we rushing into this?* Why, then, do some business owners seem to ignore these same questions when considering the promotion of an employee to a business partner?

Make no mistake, there are pit-falls in this tricky terrain. But asking hard questions along the way can help alleviate those dangers and illuminate the right path forward.

The first question is often the toughest: *Why am I really considering this change?*

Any number of circumstances might lead to a new partnership: You have a particularly stellar employee that you don't want to lose. You begin to realize that you can't do it all on your own forever. You see an opportunity to expand.

There are many "right" reasons to bring on a partner, but be wary of a "wrong" reason tipping the balance or influencing your decision here. Nailing down one or two core motivations can be important not only to solidify your broader business succession plan, but also to help identify potential alternatives. If employee retention is the real motivation, performance-based bonuses or phantom ownership plans can serve just as effectively to ensure employees are in it for the long haul and invested in your company's success.

The next question is introspective: *Can I really let go of some control?*

It is as American-Dream (the cowboy version) as it comes: The 'lone ranger' business owner strikes out on their own to make their fortune wherever they decide to roam. They may acquire a side-kick or even a caravan along the way, but they are still holding the reins. As a society and individually, we place an extremely high value on our independence and autonomy. But when co-ownership is considered, the lone ranger is bound to lose some level of control. Owners often downplay that potential loss of control: "*Oh no, I'm not selling the business – They're just getting a small stake... and I'll retain all the decision-making powers.*"

But when a partner (even a small one) is brought on, at the very least, someone else has *access* to the reins in a manner they did not before. Depending on the type of entity and the negotiated voting rights, there may be certain decisions that just cannot be autonomous anymore. Fiduciary duties also might apply between a majority owner and a minority stakeholder, depending on the entity type and negotiated contract terms. It may seem like an obvious step, but any owner considering this change should first spend some significant time deciding if they are truly ready to give up that total control, and if so, if they are ready to cede some of it to this particular employee.

Next: *How will this impact our respective wallets?*

(Hint: It may not be as straight-forward as it seems for the new prospective owner!)

The subtext of this question can be somewhat uncomfortable (*Wait, we have to talk about our wallets?*). Family law attorneys will tell you, as will business ones: The financial disclosures (and perspectives) matter.

For an employee who is used to receiving an hourly wage or yearly salary, the receipt of new ownership interests can sometimes result in surprising consequences. These consequences often take the form of taxes. Especially if the interests carry only discretionary distribution rights (perhaps still at the mercy of the original majority owner), the employee-turned-part-owner may be asking a few questions of their own – about whether they have enough income from other sources to pay the new taxes, or whether they are losing the income their family has grown to depend on. When dealing with a pass-through entity, the new ownership (and profits) interests may also complicate their individual tax returns or impact other financial plans.

Employees may also balk at certain financial aspects of ownership that an original owner would consider old-hat: The realization can sometimes come as a shock that, as a part-owner, the new owner might be required to serve as a personal guarantor of business debts.

Things can also get prickly when a "buy-in" is proposed, especially when personal financials have not been discussed openly in the past. The subject requires a certain delicacy – otherwise cordial and high-functioning employer-employee relationships can be irreparably changed or strained to a breaking point if expectations are not lining up or assumptions are being made on either side. The owner's and the employee's marital status, other business endeavors, and family support needs cannot be ignored – and these considerations require some delicate information-sharing.

A sure-footed business owner will consider the employee's financial perspective from the outset and try, as often as possible, to put themselves into their employee's shoes: Yes, the employee might be receiving a great opportunity, but they are also being asked to take on new and significant liabilities.

Finally, one last hard question: *Am I prepared to deal with (or effectively avoid) their crazy family?*

The term "crazy family" is used very broadly here, to encompass not only a quirky brother or wicked stepmother, but also the myriad of "what-ifs" that arise whenever family, friends, and relationships are involved. Despite our valiant efforts to keep our home and work lives separate, any new business partnership will join not only the new partners and their individual personalities, histories, and skills, but also their respective families and social circles. Personal relationships and dramas can and often do impact our supposedly separate "work lives."

Starting a partnership without preparing for these personal contingencies may lead to an uncomfortable and unanticipated co-ownership role with a former partner's ex-spouse, or their children, or both. Divorces, bankruptcies, deaths, and "crazy families" are unfortunate constants – and business owners and prospective new partners ignore them at their peril. The importance of preparing for these what-ifs in writing ahead of time cannot be overstated. Buy-sell agreements, voting rights provisions, and financial covenants can help protect both partners, but they are infinitely more effective if they are in place before the "what-ifs" become realities. Even the lucky-in-love can admit the benefits of a premarital agreement in the event of divorce – and unfortunately there are business divorces too.

In summary, promoting an employee to co-owner without asking these hard questions may lead to some untenable, expensive, or just plain unpleasant trails ahead.   If you are considering expanding your ownership pool, our business succession team would be happy to guide you through this legal terrain or help you come up with some alternative strategies to keep your business thriving.

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