Buying Out Your Partner

MMS, Inc., a computer service business, had survived recent industry turbulence through the persistent efforts of its owners, Ralph McMillan and Janet Shaw. In fact, MMS had enjoyed good cash flow for the past three years and its future looked rosy. Successfully meeting these challenges made Ralph (age 59) more anxious than ever to leave the business and Janet (age 48) more than ready for Ralph to leave. But neither owner had a clear idea of how to proceed, who to ask for guidance or even how to take the first step.

Janet and Ralph had to find the starting line before they could run the course to the successful dissolution of their partnership.

Ralph's Tasks

First, Ralph must assess his income needs and timing of his exit. He must determine how much of the purchase price he needs (or wants) on the day he leaves and how much he is willing to receive after he leaves (a Retirement Needs analysis). This is a very different question from how much his interest is worth yet the questions are related because the cash Ralph needs must be attainable from the sale of his interest.

Second, Ralph must obtain an *independent* valuation of his ownership interest.

Note: Ralph is unwilling to leave unless he exits with full value for his ownership interest (hence the need for the valuation) and unless that value is enough to meet his retirement needs (hence the need for a retirement income needs analysis).

Janet's Tasks

Janet wants to balance the risk/liability she and the business will assume in Ralph's buy-out with the opportunity for continued growth in the value of business interest. Since Janet is likely to be unwilling to buy Ralph's interest—if doing so puts her (or the business) at too great a financial risk—she must secure a professional's projection of the company's future cash flow.

This cash flow projection will enable Janet to determine if the business will likely have enough cash flow (after Ralph leaves) to finance the purchase of Ralph's interest without stifling the growth and prosperity of the business.

Ralph's Exit Plan Design

Ralph's Exit Plan should be designed to:

- Use the available cash flow in the most tax-efficient manner possible.
- Plan the long-term ownership structure of the company.

For example, after Ralph is gone, what does Janet (the remaining owner) intend to do with the business? Does it not make sense to consider her future exit when Ralph's exit is being designed and implemented?

Ralph's Alternatives

As Ralph contemplates his exit, perhaps Janet should consider:

1. Selling all of the ownership to an outside party. To do so, the business must be marketable and Janet (and perhaps even Ralph) may need to remain for a year or more after the sale. In this scenario, Ralph has a better chance of receiving at least the bulk of the purchase price.
2. Selling Ralph's interest to key (or all) employees. This strategy depends on the existence of motivated management willing to assume ownership. Often, a partial sale to a younger management group (keeping control firmly in the hands of the remaining principal owner) makes great sense. This strategy starts to pave the way for the eventual sale of the remaining owner's interest to this group, can be a great motivation tool and handcuffs this management team to business.
3. Selling all (or just Ralph's interest) to an Employee Stock Ownership Plan (ESOP). This design can potentially offer tax and cash flow savings for both Ralph and the buyers.

These are just a few of the many ways to design the exit of a co-owner.

Before any group of co-owners can create a successful Exit Plan they must employ professionals to:

1. Assess the departing owner's needs (a retirement income needs analysis);
2. Secure an independent valuation of ownership interests; and
3. Assess the remaining owner's risk tolerance (dependent on a cash flow projection).

If you are a co-owner and are thinking about how to maximize the chances for a successful exit of either you or your co-owner, please give us a call. We can help you to create a buy-out plan that helps you to achieve your buy-out goals.

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