

TRANSFERRING YOUR COMPANY TO KEY EMPLOYEES

Owners wishing to sell their businesses to management (key employees) face one unpleasant fact: their employees have no money. Nor can they borrow any—at least not in sufficient quantity to cash out the owner. As a result, each transfer method described in this White Paper uses either a long-term installment buyout of the owner or uses someone else's money to affect the buyout. The last method discussed—the Modified Buyout—uses both an installment buyout and someone else's money.

LONG TERM INSTALLMENT SALE

A long-term installment sale typically follows this course:

1. A value for the company is agreed upon.
2. At least one employee agrees to buy the company by promising to pay the agreed upon value to the owner.
3. The former owner holds a promissory note with installment payments over a seven to ten year period with a reasonable interest rate, signed by the buyers. The note is secured by the assets and stock of the business and the personal guarantee and collateral (usually residences) of the buyers.
4. Little or no money is paid at closing.

Owners wishing to sell the business to key employees must understand that they are transferring the business and receiving nothing in return other than a promise to receive the purchase price from the future cash flow of the business. There is no other source of cash available to the employee/buyer. If the new ownership cannot at least maintain the business, you will not receive your purchase price. There are several planning steps that can reduce the significant risk of nonpayment.

The first step is to pay the owner what he or she wants in the form of Non-Qualified Deferred Compensation payments, severance payments, lease payments or some similar means of making tax-deductible payments directly from the company to the owner. This technique minimizes the net tax cost of the buyout and thereby makes more cash available to the owner. It is discussed in a separate White Paper, "Exit Planning Primer," as well as in Chapter Seven of *The Completely Revised How To Run Your Business So You Can Leave It In Style*.

As a second step, the owner should transfer any excess cash out of the company well before she sells it.

Third, the owner can enhance security through:

- Securing personal guarantees (collateral, both business and personal);
- Postponing the sale of the controlling interest;
- Staying involved until satisfied that cash flow will continue;
- Obtaining partial outside financing; and
- Selling part of the business to an outside party.

These techniques reduce but do not eliminate risk. For that reason, owners typically undertake this type of sale only if no alternative exists,

if they don't need the money, or if they have complete confidence in their employees and in the economy to support the company's prosperity. The most common reason, however, for exiting using the long term installment sale is that the owner has failed to create a less risky exit plan.

LEVERAGED MANAGEMENT BUYOUT

This transaction structure draws upon the company's management resources, outside equity or seller equity, and significant debt financing. This structure can be an ideal way to reward your key employees, position the company for growth, and minimize or eliminate your ongoing financial risk.

To effectively execute a leveraged management buyout, your business should possess the following characteristics.

- A management team that is capable of operating and growing the business without your involvement.
- Stable and predictable cash flow.
- Good prospects for future prosperity and growth. The growth of the company should be described in detail in a management-prepared business plan.
- A solid tangible asset base, such as accounts receivable, inventory, machinery and equipment. Hard assets make it easier to finance the acquisition through the use of debt, but service companies without significant tangible assets can obtain debt financing, albeit at higher cost.
- Have a fair market value of at least \$5 million (probably \$10 million in order to attract the interest of private equity investors).

The prerequisite for a management-led leveraged buyout is that you, as the seller, and the management team agree on a fair value for the company. The parties then execute a letter of intent giving management the exclusive right to buy the company at the agreed price for a specified period of time (typically 90 to 120 days). The management team and its advisors subsequently arrange the senior bank debt to fund a portion of the transaction. This bank debt usually requires management to arrange to make an equity investment prior to closing. It is at this point that the management team and its advisors seek an equity investor. They offer the equity investor a complete package of price, terms, debt financing, and management talent. The equity investor need only weigh the reasonableness of the projected return on his investment.

There are many professionally managed private equity investment funds that actively seek management leveraged buyouts as a preferred investment. These private equity funds control billions of dollars of capital for investment which they may structure as senior debt, subordinated debt, equity or some combination thereof. This investment flexibility enables the private equity investment firms to be much more nimble than your local commercial banker. The investment

philosophy of these private equity investors is captured in the slogan of a successful buyout group: “We partner with management to create value for shareholders.”

From management’s perspective, a significant advantage to working with a private equity firm is that most will continue to invest in the company after the acquisition to fuel the company’s growth. These private equity firms will also allow management to receive a “promoted interest in the deal.” This means that management can earn greater ownership in the company than it actually pays for.

To help you better understand the mechanics of this process, let’s look at one highly-profitable medical device manufacturing business with revenues of approximately \$5 million. The owner wanted out of the business and was willing to sell it to management under the condition that the transaction be completed within 60 days. The agreed upon sale price was \$8 million, payable in cash to the owner at closing. The management team’s biggest and only problem was that it had only \$750,000 collectively from second mortgages on their homes. Consequently, they hired an investment banking firm to help them arrange financing to close the transaction. With the clock ticking on their exclusivity period, management was motivated to make the deal.

The transaction was ultimately structured as follows:

In this transaction, management owned 20 percent of the equity ownership, despite investing only nine percent of the equity funds needed to close the transaction. Six years later, all of the debt that had been used to buy the company had been repaid. The outside equity investors received five times their initial investment and the management team reaped their initial investment ten-fold.

Another advantage of the management leveraged buyout is its flexibility. If an outside private equity investor cannot be located under acceptable terms, the seller can elect to maintain an equity position in the company, or subordinate a term note to the bank.

As you can see, a management leveraged buyout may enable a business owner to accomplish the majority of his original objectives.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

An ESOP is a tax-qualified retirement plan (profit sharing and/or money purchase pension plan) that must invest primarily in the stock of the company. In operation, it works just like a profit sharing plan: the company’s contributions to the ESOP are tax-deductible to the company and tax-free to the ESOP and its participants (who are essentially all of the company’s employees).

In the context of selling at least part of the business to the key employees, the ESOP is used to accumulate cash as well as to borrow money from a financial institution. It uses this money to buy the business owner’s stock. Provided certain additional requirements are met, the owner can take the cash from this sale, reinvest it in “qualifying securities”—publicly traded stock and bonds—and pay no tax until he sells those securities.

The participants in the ESOP then own, indirectly, the stock purchased by the plan. Key employees will likely own a significant part of that stock because ESOP allocations to participants are based on compensation.

Typically, however, key employees will want more than indirect ownership. They will want to control the company and have the

possibility of owning a disproportionate amount of the company by purchasing stock directly from the owner before the owner sells the balance of this stock to the ESOP. By owning all of the stock not owned by the ESOP, the key employees can effectively control the company. The net result is an ownership structure not unlike the management LBO. An ESOP, rather than an outside investor, owns and pays cash for a majority interest in the company. The existing management operates the business and has significant ownership. The owner is largely cashed out of the business, perhaps having to carry only a portion of the purchase price of the stock sold to management.

There are substantial financial and other costs associated with an ESOP; after all, there is a reason that there are fewer than 25,000 active ESOPs. The benefits and limitations of ESOPs are described in our ESOP White Paper. For now, consider it a method worthy of exploration with your legal, tax and financial advisors.

MODIFIED BUYOUT

Despite its catchy title, this method really is the workhorse of the group. It is the one that works best for most owners who want to:

- Transfer their businesses to key employees;
- Motivate and retain key employees; and
- Receive full value for their businesses

The difficulties and opportunities presented to owners as they transfer their businesses to key employees using the Modified Buyout are summarized on the last page.

Dan Hudson was the owner of an electronic parts distribution company, “EPD.” His was a 45- employee company with revenues of over \$6 million per year and a fair market value of \$5 million. At age 52, Dan planned to stay with the company for at least five more years.

EPD employed a half dozen experienced senior managers and salesmen. Dan was interested in both “handcuffing” these employees to the company (making it economically rewarding to stay with the company) and, at the same time, exploring an exit strategy for himself. He thought he could achieve both goals by beginning to sell the company to his key employees.

A preliminary Exit Plan was prepared, listing the three principal exit objectives:

- To establish a plan for the eventual buyout of all of Dan’s ownership in the company;
- To begin the buyout of a portion of his interest in the company by selling to two existing key employees, Brian Banbury and Lisa Derbes. Dan would select additional key employees at a later date;
- To have the plan in place and effective as of March 1 of the following year.

The Exit Plan recommended that Brian and Lisa purchase up to a total of 10 percent of the ownership of EPD (represented by nonvoting stock). In the future, other key employees (as yet unidentified, and probably not yet hired) would participate in the stock plan.

The plan also included a two-phase sale of the business.

Phase I—Sale of Initial Minority Interest

Dan will make available a pool of 40 percent of EPD’s total outstanding stock (converted to non-voting stock) for current and future purchases

by key employees. Initially, five percent of the outstanding stock (non-voting) will be co-owned by Lisa and five percent (non-voting) by Brian.

For purposes of the initial buy-in (and any future repurchases of that stock), the value of EPD is based on a valuation (with minority and other discounts) provided by a Certified Valuation Specialist. In EPD's case, those discounts totaled half of the true fair market value. A lower initial value is necessary in order to make the purchase affordable by the employees as well as to provide them an incentive to remain with the company.

The initial purchase price will be paid in cash. If either key employee needs to borrow funds to secure the necessary cash, EPD will be willing to guarantee the key employee's promissory note to a bank.

Even though the key employees will not receive voting stock, there will be significant benefits to them in purchasing non-voting stock. Namely, employees would:

- Enjoy actual stock ownership in EPD, and the ability to receive any appreciation in the stock;
- Participate (pro rata) based on their stock ownership in any "S" distributions made by EPD;
- Receive fair market value paid by a third party for their percentage of stock (if EPD were to be sold to a third party);
- Participate more directly in day-to-day operating decisions;
- Initially be appointed as directors to serve
- under the terms of the bylaws (such positions not being guaranteed); and
- Participate in determining which additional key employees will be offered stock out of the 40 percent pool. This determination will be based on written criteria developed by all three shareholders.

Each key employee purchasing stock will enter into a Stock Purchase Agreement with the company that provides for the repurchase of their stock in the event of death, long-term disability, or termination of employment.

Phase II — Sale of Balance of Ownership Interests

At the end of Phase I (three to seven years), Dan will choose one of the following courses of action:

- Sell the balance of the company to the key employees, at true fair market value, by requiring the employees to finance an all-cash purchase; or
- Finance the buyout by means of a long-term, installment sale to the employees at true fair market value

Alternatively, Dan may decide to sell to an outside third party. In either a sale to employees or to an outside third party, his intention is to retire from the company; or continue to maintain ownership in the company and continue his management and operational involvement.

Dan's Exit Plan recommended that Dan base his decision on whether to sell the balance of his stock to the key employees upon the following criteria:

- Dan's analysis of the key employees' abilities to continue to move the company forward while paying him full fair market value for his remaining 60 percent ownership interest. In other words, how much risk is there in allowing the key employees to move forward without Dan's supervision, management, or control? How much risk is there in depleting the company of the cash flow needed to pay the departing

- owner for ownership? How much risk is there that business, economic or financing climates may sour, thereby jeopardizing the buyout? If Dan is unwilling to assume these risks, he must require a cash buyout by the employees at the end of Phase I or sell to an outside third party.
- The ability of the key employees and the company to obtain financing to pay the remaining purchase price in cash to Dan. If employees own 30 to 40 percent of the company, it is likely (at least in today's economic climate) that financing could be obtained in an amount sufficient to cash Dan out.
- The marketability of the company should Dan decide to sell the company at any future point in this process.

After receiving his preliminary Exit Plan, Dan thought long and hard about the consequences of selling stock to his employees. In fact, it often takes two or three meetings before owners are comfortable with their objectives. Take a few minutes to study the chart on the final page. The technique recommended to EPD requires:

- Key employees who eventually will be capable of running and managing the company without the former owner's presence.
- Time. Total buyout time is typically three to seven years.
- Owner's willingness to take less than true fair market value for the initial portion of stock sold to the key employees (30-40 percent of total ownership), assuming the stock is saleable to an outside third party for cash.

SUMMARY OF SALE TO KEY EMPLOYEES

The advantages and disadvantages of each exit method are:

Installment Sale:

Advantages

- Rewards and motivates employee/buyer because the business can be acquired with little or no money and can be paid for using future cash flow of the business.
- Key employees receive the entire business.

Disadvantages

- Owner receives little or no money at time of closing.
- Owner is at significant risk of receiving less than the entire purchase price.

Employee Stock Ownership Plan (combined with Key Employee Buy-In):

Advantages

- Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
- Key employee receives operating control of the business.
- Owner receives cash at closing (which can be immediate).
- Company may gain additional financial resources from equity investors.
- Significant tax advantages associated with ESOP purchase.

Disadvantages

- Key employees may want all or most of the company.
- Initial funding of plan usually needs to be made with company money otherwise payable to owner.
- Business must continue to pay off bank loan after owner leaves. Because key employees will be responsible for running the company they will likely prefer such debt to benefit them

- directly.
- Cost of maintaining ESOP.

Management Leveraged Buyout:

Advantages

- Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
- Key employee receives operating control of the business.
- Owner receives cash at closing (which can be immediate).
- Company may gain additional financial resources from equity investors.

Disadvantages

- Requires the use of debt and private equity investment which many businesses may not be able to attract.
- Key employees may want all (or most) of the company, and not be satisfied with a minority sale.
- Burdens the company with significant debt.

Modified Buyout:

Advantages

- Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
- Key employee receives entire business.
- Owner receives at least 75 percent of fair market value of the business (and usually more).
- Owner can stay in control of business until full purchase price is received.
- Flexibility after initial key employee buy in (of 30-40 percent ownership) is completed. Majority owner can sell balance to key employees for cash, sell all of company, sell shares to third party, or sell the owner’s interest to ESOP.

Disadvantages

- Owner does not receive entire purchase price for several years.
- Owner generally remains active in business until initial employee buy in is completed.

The information contained in this article is general in nature and is not legal, tax or financial advice. For information regarding your particular situation, contact an attorney or a tax or financial advisor. The information in this newsletter is provided with the understanding that it does not render legal, accounting, tax or financial advice. In specific cases, clients should consult their legal, accounting, tax or financial advisor. This article is not intended to give advice or to represent our firm as being qualified to give advice in all areas of professional services. Exit Planning is a discipline that typically requires the collaboration of multiple professional advisors. To the extent that our firm does not have the expertise required on a particular matter, we will always work closely with you to help you gain access to the resources and professional advice that you need.

Any examples provided are hypothetical and for illustrative purposes only. Examples include fictitious names and do not represent any particular person or entity.

Fair Market Value - \$5,000,000		Cash Flow = \$800,000/year	
Phase I Value \$2,500,000 – using minority discount Employee A: 5% Employee B: 5% Remaining Stock in Pool: 30%	Phase II – Sale of Balance of Company		
	<u>Option A</u> Require employees to secure outside financing; sell balance of company for fair market value, for cash (60% of \$5 million = \$3 million – perhaps more, if premium is desired).	<u>Option B</u> Sell all remaining stock for true fair market value (assumed to be \$3 million) to key employees on installment basis or in increments of 5%-10% for cash.	<u>Option C</u> Sell stock at low value (perhaps \$1.5 million); receive tax-deductible (to company) money directly from business, in form of non-qualified deferred compensation, rental income or similar deductible types of income.
Sell 40% of company for total \$1 million (40% of \$2,500,000)	*Total A and B will equal 60% of company fair market value, net of taxes to you. *Adopt "Wait and See" provisions and either keep company or sell company for true fair market value to outside Third Party or ESOP.		