TRANSFERRING YOUR COMPANY TO KEY EMPLOYEES

WHITE PAPER

GUYTON GROUP

Strategies for Your Wealth

Joseph H. Guyton, AEP®, CLU®, RICP®
The Guyton Group
One New Hampshire Avenue
Portsmouth, NH 03801
Phone: 603-766-9200
The Guyton Group

Introduction

Owners wishing to sell their businesses to management—specifically, key employees—face two unpleasant facts: Their employees have no money (most likely) and they cannot borrow any, at least not in sufficient quantities to cash out the owner. Thus, each transfer method described in this white paper uses either a long-term installment buyout of the owner or someone else's money to complete 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. The owner and buyers agree on the company's value.
2. At least one employee agrees to buy the company by promising to pay the agreed-on value to the owner.
3. The former owner holds a promissory note with installment payments over a 7–10-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 their businesses to key employees must understand that they are transferring their businesses and receiving nothing in return other than a promise to receive the purchase price from the future cash flow of the business, since there is no other source of cash available to the employee/buyer. If the new ownership cannot at least maintain the business, the former owner will not receive his or her purchase price. Fortunately, there are several planning steps that owners can take to reduce the significant risk of nonpayment.

The first step is to have the buyers 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.

In the second step, the owner should transfer any excess cash out of the company well before he or she sells it.

Third, the owner can enhance security through the following:

- 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.
- Selling part of the business to an outside party.

These techniques reduce risk but do not eliminate it. Thus, owners typically undertake long-term installment sales only if no alternative exists, they don't need the money, or they have complete confidence in their employees and the economy to support the company's prosperity. However, the most

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common reason for exiting using the long-term installment sale is that the owner has failed to create a less-risky Exit Plan.

Leveraged Management Buyout

A leveraged management buyout draws on 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 a higher cost.
- Have a fair market value of at least $5 million (preferably $10 million 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, 90–120 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. At this point, 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 needs only to weigh the reasonableness of the projected return on his or her investment.

There are many professionally managed private-equity investment funds that actively seek leveraged management 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 nimbler than a 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 of 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.

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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.

Maribel Sanchez wanted out of her business and was willing to sell it to management under the condition that the transaction be completed within 60 days. The agreed-on sale price was $8 million, payable in cash to Maribel at closing. The management team's biggest and only problem was that it only had $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:

Management owned 20% of the equity ownership, despite investing only 9% 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 tenfold.

Another advantage of the leveraged management 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.

In short, a leveraged management buyout may enable a business owner to accomplish the majority of his or her 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 and 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 or she sells those securities. The participants in the ESOP then indirectly own 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.

However, key employees typically 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

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not owned by the ESOP, the key employees can effectively control the company. The net result is an ownership structure similar to the leveraged management buyout: 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.

Modified Buyout

The modified buyout is the workhorse of the group. It is the method that works best for most owners who want to do the following:

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

Let's look at a brief case study regarding the concept of modified buyouts.

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

EPD employed six experienced senior managers and salespeople. He was interested in both handcuffing these employees to the company (making it economically rewarding for them 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 three principal Exit Objectives:

- Establish a plan for the eventual buyout of all of Jacob's ownership in the company.
- Begin the buyout of a portion of his interest in the company by selling to two existing key employees, Michael Brooks and Alice Patton. Jacob would select additional key employees at a later date.
- Have the plan in place and effective as of March 1 of the following year.

The Exit Plan recommended that Michael and Alice purchase up to a total of 10% of the ownership of EPD (represented by non-voting 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. Jacob will make a pool of 40% of EPD's total outstanding stock (converted to non-voting stock) available for current and future purchases by key employees. Initially, 5% of the outstanding stock (non-voting) will be co-owned by Alice and 5% (non-voting) by Michael.

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

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value. A lower initial value is necessary to make the purchase affordable for the employees and 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, they will be able to do the following:

- 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).
- Participate in determining which additional key employees will be offered stock out of the 40% pool. This determination will be based on written criteria developed by all three shareholders.

Each key employee who purchases 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), Jacob 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.
- Finance the buyout by means of a long-term installment sale to the employees at true fair market value.

Alternatively, Jacob 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.

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

- Jacob'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% ownership interest. In other words, how much risk is there in allowing the key employees to move forward without Jacob'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

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ownership? How much risk is there that business, economic, or financing climates may sour, thereby jeopardizing the buyout? If Jacob 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 to Jacob in cash. If employees own 30–40% of the company, it is likely (in certain economic climates) that financing could be obtained in an amount sufficient to cash Jacob out.
- The marketability of the company should Jacob decide to sell the company at any future point in this process.

After receiving his preliminary Exit Plan, Jacob thought 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.

The technique recommended to EPD required the following:

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

Summary of Sale to Key Employees

The advantages and disadvantages of each exit method are as follows:

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 business cash flow.
- 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.

ESOP (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

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- Key employees may want all or most of the company.
- Initial funding of the plan usually needs to be made with company money otherwise payable to owner.
- Business must continue to pay off bank loans after the 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.

Leveraged Management 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 may 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% 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% ownership) is completed. Majority owner can sell balance to key employees for cash, sell all of the company, sell shares to third party, or sell the owner's interest to an 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.

Conclusion

This white paper described a few of the many possible paths you can take when selling your business to management. The goal of this paper was to expose you to some of the alternatives to selling your business for a promissory note and losing control before receiving full value. Risk management is just as important when exiting as it is when operating a business, and the aforementioned options may help you manage the risk inherent to selling to management. However, it is important for you to evaluate each possible path in terms of risk until you have received full payment or, if full payment will span over time, how you can maintain control during the

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buyout period to assure that you are paid the full value for your business. For more information, contact us today.

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