

The

EXIT

Planner

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## WHAT'S INSIDE

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→ JOHN H. BROWN

# SELLING OUT TO MANAGEMENT

**A**t first glance, many business owners see selling a business to key employees to be the ideal exit strategy. Ideal because they believe that this type of exit not only *rewards* key employees for years of loyal and effective service, but that it also *motivates* them to make the company more profitable and *stay* with the company long-term as owners of the company. The icing on the cake is the *financial security and independence* that the owner expects to achieve from the sale of his ownership interest.

In this issue of **The Exit Planner** we outline four methods business owners use to sell a business to employees. These methods are:

- Long term installment sale to employees
- Leveraged Management Buyout
- Employee Stock Ownership Plan
- Modified installment/cash sale

This article discusses all of these methods, but will pay particular attention to the one that can, in fact, achieve most of the owner's goals. That said, however, owners must understand that no matter which method they choose, all have significant limitations. No method can fully achieve all three of the owner's objectives. Again, these are:

- Rewarding key employees for past effort
  - Motivating key employees toward future effort
  - Attaining financial security for the owner.
- A word (or two) of warning. All methods:
- Fail to put the maximum number of dollars in your pocket;
  - Take several years to complete;
  - Are substantially riskier than other types of ownership transfers (both from the standpoint of receiving payment for your ownership interest, and successfully completing the transfer itself);
  - *Give away*, at least in part, your business to your employees.

By far, the best exit strategy for maximizing dollars in your pocket as well as your chance of getting paid is selling your business to an outside third party for cash.

No matter. Most business owners at least investigate the possibility of selling their businesses to their key employees or children. Ergo, this article.



# SELLING A BUSINESS TO KEY EMPLOYEES

by John H. Brown

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 method described in this issue uses either a long-term installment buyout of the owner or uses someone else's money to effect the buyout. The last method described—the Modified Buyout—uses both an installment buyout and someone else's money.

## EP LONG TERM INSTALLMENT SALE

A long term installment sale typically follows this course:

1. A value for the company is agreed upon.
2. One or more employees 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 preventive steps that can reduce the significant risk of non-payment.

The first step is to pay the owner what she wants in the form of a reduced purchase price plus direct payments from the company to her. These payments usually take the form of Non-Qualified Deferred Compensation payments, severance payments, lease payments or some similar means of getting 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 *The Exit Planner* titled "Inevitabilities" as well as in Chapter Seven of my book *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 must maximize her security through:

- EP Securing personal guarantees (collateral, both business and personal)
- EP Postponing the sale of the controlling interest
- EP Staying involved until satisfied that cash flow will continue

EP Obtaining partial outside financing

EP Selling part of the business to an outside party.

These techniques reduce but do not eliminate risk. For that reason, owners 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.

## EP LEVERAGED MANAGEMENT BUYOUT

This transaction structure draws upon management resources, outside equity or seller equity, and significant debt financing. This structure can be an ideal way to reward your 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.

1. A management team that is capable of operating and growing the business without your involvement.
2. Stable and predictable cash flow.
3. Good prospects for future prosperity and growth. The growth of the company should be described in detail in a management-prepared business plan.
4. 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.

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 advisor seek an equity investor offering 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 of my former clients. This medical device manufacturing business had revenues of approximately \$5 million and was highly profitable. 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 \$5 million, payable in cash to the owner at closing. The management team’s biggest and only problem was that it had only \$50,000 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:

|  |                    |
|--|--------------------|
| Cash to seller at closing  | \$5,000,000        |
| Transaction fees   | 50,000             |
| <b>Total Cash Needed</b>   | <b>\$5,050,000</b> |
| Sources of funds:  |                    |
| Revolving Line of credit from bank<br>(secured by A/R and Inventory) | 1,000,000          |
| Cash flow term debt from<br>Small Business Investment Co.            | 3,500,000          |
| Private Equity Investors (Individuals)                               | 500,000            |
| Management Equity  | 50,000             |
| <b>Total Sources of Funds</b>  | <b>\$5,050,000</b> |

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. Four 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 enables a

business owner to accomplish the majority of his original objectives.

### EP 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 15,000 active ESOPs. The benefits and limitations of ESOPs will be described in a forthcoming issue of **The Exit Planner**. For now, consider it a method worthy of exploration with your legal, tax and financial advisors.

### EP 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 do not need to reap a windfall from the sale of their businesses but who want or need fair value. It is also the one that best meets the typical owner’s objectives described above. The difficulties and opportunities presented to owners as they transfer their businesses to key employees using the Modified Buyout are summarized in the chart following the case study.

## EPD CASE STUDY

Several years ago, I met Dan Hudson, 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.

After our meeting, I prepared a planning memorandum describing a suggested plan to meet his exit objectives. The body of the planning memorandum read as follows:

Dan's objectives are:

- To establish a plan for the eventual buyout of his total ownership in the company;
- To begin implementation of the plan by providing for the current buyout of a portion of his interest in the company to two existing key employees, Brian Banbury and Lisa Derbes, as well as additional key employees to be selected at a later date;
- To have the plan in place and effective as of March 1, 1999.

Immediately, Dan wants a commitment from Brian and Lisa to purchase up to a total of 10 percent of the ownership of EPD (represented by non-voting stock). In the future, he wants other key employees (as yet unidentified, and probably not yet hired) to participate in the stock plan.

The memorandum continued by proposing a two-phase sale of the business.

### Phase I—Sale of initial minority interest.

Dan would make available a pool of 40 percent of EPD's total outstanding stock (converted to non-voting stock) for current and future purchases by your key employees. Initially, you would offer five percent of the outstanding stock (non-voting) to Lisa and five percent (non-voting) to Brian.

For purposes of the initial buy-in (and any future repurchases of that stock),

the value of EPD will be based on a valuation formula of 1.25 x the net book value (which yields a value of \$2,500,000 for the company), prepared by EPD's certified public accountant ("Valuation Formula"). For example, if the value of EPD is \$2,500,000, the initial 10 percent of the stock will be valued at \$250,000. (Note that this is one-half 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 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 accomplish this, EPD may be willing to guarantee the key employee's promissory note to a bank.

Even though the key employees will not receive voting stock, there are 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 position not being guaranteed;
- Participate in the tentative conversion of non-voting stock to voting stock planned for after December 31, 2005, provided that a plan is in place for the buyout of all of Dan's stock;
- Participate in determining which additional key employees are offered stock out of the pool and their percentage amounts—this determination to 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 at 1.25 of the then net book value in the event of death, long-term disability, or termination of employment. After the seven-year period, the Company anticipates re-valuing the company to reflect a sale of the majority interest of the stock. This, in turn, will be based upon a fair

market value formula driven primarily by an earnings stream formula, rather than a net book value formula.

### Phase II—Sale of balance of ownership interests.

At the end of Phase I, you will decide upon one of the following courses of action:

1. 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 from you; or
- Financing your buyout by means of a long-term, installment sale to the employees at true fair market value; or
- Using a combination of an installment sale of the business at a low, but defensible, value, and a non-qualified deferred compensation leasing arrangement, in order to maximize the tax benefits to both seller and buyers in the sale process.

2. Alternatively, you may decide to sell to an outside third party. In either a sale to employees or to an outside third party, your intention is to retire from the company.

3. Continue to maintain your ownership in the company and likely continue your management and operational involvement in the company.

I suggest you base your decision on whether to sell the balance of your stock to the key employees upon the following criteria:

- Your analysis of the key employees' abilities to continue to move the company forward while paying you full fair market value for your remaining ownership interest. In other words, how much risk is there in allowing the key employees to move forward without your supervision, management, or control? How much risk is there in depleting the company of the cash flow needed to pay you for your ownership? How much risk is there that business, economic or financing climates may sour, thereby jeopardizing your buyout? If you are unwilling to assume these risks, you must require a cash buyout by the employees at this Phase 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 you. If they own twenty to

forty 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 you out.

- The marketability of the company should you decide to sell the company at any future point in this process.

After receiving this memorandum, 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 below.

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 may be seven years or longer.
- **Willingness** to take less than true fair market value for at least a portion of your stock, assuming your stock is sellable to an outside third party for cash.

Why is time and selling for less than FMV so crucial to this sale to employee type of sale process? Read the answer to Dan's fundamental question.

**Why can't I sell my business to my employees for the same price a third-party buyer would pay?**

My answer: *"In today's active merger and acquisition marketplace, good companies, such as yours, can command premium prices. This usually means the earnings multiple used by financial or strategic buyers is greater than what can be paid over a reasonable time period by the available cash flow of the very companies these outside buyers seek to buy. In addition, financial and strategic buyers tend to pay the vast majority of the purchase price in cash or marketable securities at closing"*

To illustrate the difference between a

cash sale at fair market value and an installment buyout to employees, we start with EPD's earning history. EPD had an average earning stream of \$800,000 per year for the past three years. Companies can often be sold for four to six times that earning stream, or as much, in this case, as \$5 million. Assuming a 20 percent capital gains tax rate Dan could walk away — today — with \$4 million. For Dan to accumulate \$4 million net of taxes from the excess annual earnings (\$800,000 pretax), it would take at least eight years, in the absence of a third-party cash sale. Of course, the company would need to continue to at least maintain that cash flow for that time period. (This computation assumes that the owner's receipt of the cash flow is subject to a 40 percent income tax yielding \$500,000 after tax — \$500,000 each year for eight years equals \$4 million.)

The comparison grows bleaker when we examine how the employees, if they buy out Dan, can use the company's available cash flow of \$800,000. Assume Dan sells his stock to the key employees and that he wants \$4 million net of taxes, the same amount he would receive today in a third party sale. Because the employees have but one source of cash to use to buy the stock — the future revenue stream of the business — it will take Dan ten years to receive \$4 million net of taxes. The extra cash flow of \$800,000 per year now needs to first be paid out to the key employees as compensation. Naturally, the key employees will pay an income tax (approximately 40 percent State and Federal) upon receipt of \$800,000.

As you can see, the decision to sell a business interest to key employees means that you either have an extended pay-out or you must sell for less than

you would on the open market. To make matters bleaker still, consider that Dan would want to receive interest upon the installment obligation from the employees since he would not be receiving cash up front. Assuming an interest rate of seven percent and available cash flow to the employees of \$800,000 per year, it would actually take them almost 12 years to pay Dan his \$4 million net of taxes.

Of course, unlike EPD, some businesses cannot be sold to outside third parties for cash. They may be too small or may not be sufficiently profitable. They may be the type of business that traditionally does not sell for high cash flow multiples, such as a general contractor or professional services organization. In such scenarios, purchase prices do not approach \$5 million because the multiples paid on cash flow are much less, or a different formula, such as book value, is used to fix value.

To sum up, Dan can:

- Get \$4 million net of taxes — now — by selling the business to a third party buyer; or
- Get \$4 million cash (net of taxes) over the next eight years by staying active in the company and not selling the business to anyone but, instead, keeping the cash flow for himself; or
- Receive \$4 million over the next 10 to 12 years by selling the business to employees.

The surprising result of this analysis is that *unless owners sell their businesses for cash to their employees, and leave at that time, owners are giving their businesses away — free — to their employees. This is true because the entire purchase price comes from the future cash flow of the business — cash flow the owner can keep for himself by simply not selling the business.*

| CHART for EPD  |   | Fair Market Value = \$5,000,000 | Cash Flow = \$800,000/year |
|--|---|---------------------------------|----------------------------|
| <p><b>PHASE I</b><br/>(Value \$2,500,000 —using minority discount)<br/>Employee A - 5%<br/>Employee B - 5%<br/>Remaining stock in "pool" - 30%</p> <hr/> <p>Sell 40% of company for total \$1 million (40% of \$2,500,000)</p> | <p><b>PHASE II</b> (Sale of balance of company)</p> <ul style="list-style-type: none"> <li>• <b>Option A</b><br/>Require employees to secure outside financing; sell balance of company for fair market value, for cash (60% of \$5 million or \$3 million—perhaps more, if premium is desired)</li> <li>• <b>Option B</b><br/>Sell all remaining stock for true fair market value (assumed to be \$3 million) to key employees on installment basis or in "chunks" of stock—5%-10% increments, for cash</li> <li>• <b>Option C</b><br/>– Sell stock at low value (perhaps \$1.5 million); and<br/>– Receive tax-deductible (to company) money directly from business to you, in form of nonqualified deferred compensation, rental income, or similar deductible types of income</li> </ul> <p>Total A and B will equal 60% of company fair market value, net of taxes to you.</p> <ul style="list-style-type: none"> <li>• Adopt "wait and see" provisions and either keep company or sell company for true fair market value to Outside third party or ESOP (Employee Stock Ownership Plan)</li> </ul> |                                 |                            |

## EP SUMMARY OF BUSINESS SALE TO KEY EMPLOYEES

The advantages and disadvantages of each exit method are:

### EP Installment Sale

#### Advantages

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

#### Disadvantages

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

### EP Modified Buyout

#### Advantages

1. Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
2. Key employee receives entire business.
3. Owner receives at least 75 percent of FMV of the business.

#### Disadvantages

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

### EP Management Leveraged Buyout

#### Advantages

1. Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
2. Key employee receives operating control of the business.
3. Owner receives cash at closing, which can be now.

4. Company may gain additional financial resources from equity investors.

#### Disadvantages

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

### EP Employee Stock Ownership Plan

(combined with Key Employee Buy-in)

#### Advantages

1. Rewards and motivates employee/buyer because part of the business can be acquired at a reduced price.
2. Key employee receives operating control of the business.
3. Owner receives cash at closing, which can be now.
4. Company may gain additional financial resources from equity investors.

#### Disadvantages

1. Key employees may want all or most of company.
2. Initial funding of plan usually needs to be made with company money otherwise payable to owner.
3. 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.

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*We, at The Exit Planner, are happy to answer any questions you have about articles that appear here. We also appreciate suggestions from readers about the Exit Planning topics that they wish to see addressed. We welcome your comments regarding our newsletter. You can address your questions, comments or suggestions to: John H. Brown, President, Business Enterprise Institute, 650 S. Cherry Street, Suite 1100, Denver, Colorado 80246 (303) 321-2242.*

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