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The Importance of Time in an Employee Buy Out

Michael Wildeveld, CEPA, M&AMI, CM&AP, CM&AA, CBI, CBB
michaelw@veldma.com

Veld Mergers & Acquisitions
www.veldma.com
1 Park Plaza, 600
Irvine, CA 92614
310-652-8066

Many, probably most, business owners would like to sell their businesses to their employees, but for one nagging problem: *Their employees have no money*.

The desire to sell to employees collides with the owner's overarching need for financial security. Owners simply cannot risk selling a business to employees who have no cash.

Take James Johnson, the fictional owner of fictional company Johnson Consultants, Inc. James's management team was capable and interested in buying the company. The business had little debt and good cash flow.

When James met with his advisors to discuss the topic, one of their first questions was, "When do you want to leave the business?"

If James answers, "Now!" a sale to employees who lack cash is fraught with risk. If James's answer is, "I'd like to be out—and cashed out—of the business in five to eight years," a well-designed exit plan can make that happen—if James starts today.

Plan Goals

Any buy-out plan must accomplish three goals:

1. Minimize the owner's, the company's and the employees' risk, by *keeping the owner in control of the business and the sale process* until the owner receives the entire purchase price.
2. Ensure that *the owner receives full value* for his or her ownership interest.
3. *Minimize the income taxes* of both the owner and the employees.

Unless a buy-out plan meets these goals, owners would be wise to reconsider selling their companies to their employees. If, on the other hand, owners plan and begin to execute a transfer plan well in advance of their departures, they can achieve these three goals. Of course, special planning is required to meet the income tax minimization goal.

Two-Stage Plan Design

A plan to execute an employee buy out has two stages.

Stage 1: Each year employees buy small amounts of stock until they have purchased and paid for approximately 35% to 40% of the ownership (usually non-voting). Ordinarily, this stage takes five to eight years. At the end of this stage, key employees are in a position to approach a bank.

Stage 2: Assuming the business continues to be profitable, paid-up owners of 40 percent of a company are usually able to secure bank financing to purchase the remaining balance of the owner's stock.

James's buy-out plan kept him in full control of his business until he received all of his money. Because he maintained control, he significantly reduced the risk of not receiving full value. He successfully cashed out of his business because he did not wait to begin his exit planning until he was ready to leave. By starting before he was ready to leave he was able to choose his successor, exit on his timetable, and leave with the cash he wanted.

The two-stage plan outlined above is a very brief summary of a relatively involved buy-out plan. There are many additional design issues that owners should discuss with their advisors.

Caveats:

1. This plan does not work for all businesses, but can work well for companies valued between $500,000 and $5 million.
2. Executing the plan takes time, usually at least five years to allow the employees to purchase a significant chunk of the company.
3. This plan requires a cooperative bank aware of the owner's intentions well in advance of the transfer.
4. This plan requires a strong management team interested in owning a company financially fit enough to allow most of the available cash flow to be used to pay off the purchase debt.

If you are interested in whether this type of plan is appropriate for you and your company, please contact me.