Can You Afford To Sell To Your Employees?

By Scott Nordeen

Business owners often tell us that, in an ideal world, they would sell their businesses to their best, most loyal and/or most ambitious employees. Business owners frequently dismiss this option because their employees don't have enough money to buy the business. Is this the right decision? Is there a secret ingredient that might allow you to sell your business to one or more employees and still get the value you want and deserve?

Take Steve Sampson, the fictional owner of fictional company Sampson Scientific, Inc., a 30-year old scientific equipment distributor. Steve's management team was capable and interested in buying the company. The business had little debt and good cash flow.

When Steve confided in his advisors at an annual planning meeting that he had always hoped to sell his business to his employees but he just did not see any way to make that happen, one of their first questions was, "When do you want to leave the business?"

If Steve had answered, "Now!" a sale to employees who lack cash would have been fraught with risk. If Steve's answer was, "I'd like to be out — both financially and as a participant in management — in five to eight years," a well-designed Exit Plan would have made that happen—if Steve had started today.

Plan Goals

Any buy-out plan, regardless of the buyer, 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. Allow the owner to *stay in control* until full value is received.

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.

The Secret? …Time

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

Stage 1: Sell incremental blocks of ownership for a reasonable, or even conservative, price over several years, each for a promissory note at a reasonable interest rate. Employee purchasers pay down the note balances with some combination of earnings, bonuses and ownership distributions or dividends from the ownership they've acquired thus far. After a few years (depending on the company's ability to produce cash flow) the employee purchaser will own a portion of the company free and clear. During this period the owner usually reduces involvement and delegates more responsibility to the successor owners.

Stage 2: Assuming the business continues to be profitable, paid-up owners of 30 to 40 percent of a company can present themselves as strong, stable and well-prepared buyers to secure bank financing to purchase the remaining balance of the owner's stock.

Following this strategy, Steve'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.

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.