Selling to employees

What you need to know in advance of your exit **Interviewed by Jerry Roche**

One way the owner of a privately held business can successfully exit the marketplace is to sell out to a family member (see last month's *Smart Business*). Another is to sell to a key employee or a group of employees.

Either way, the process can be difficult.

"There is always a sense of loss because the business has been the owner's baby for so long," says Joel J. Guth, an advisor in the Citigroup Family Office at Smith Barney, a division of Citigroup Global Markets. "Former owners who are ultimately happy have a common thread. They took the time to perform a thorough exit-planning strategy; they set their objectives; they understood what they were trying to accomplish; they found the most efficient way to transfer ownership of the business to someone else; and they had a mission for what they were going to do — and be — after the sale."

Smart Business talked with Guth about how to successfully sell a business to employees.

Joel J. Guth
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Why sell a company to a key employee or a group of employees?

In some cases, the owner truly feels the employees have been critical to the growth of the business and therefore owes them the opportunity to buy the company. Sometimes, the owner feels he has had a fantastic opportunity to accumulate wealth and wants to pass it on to people who are near and dear to him. Thirdly, an agreement with key employees could exist from when they were first hired. It could be that there is no other market for the business — that the only true buyers are employees of the company. Lastly, the owner might believe that if he sells to a key employee he may have a higher probability that the culture or mission of the company will remain intact.

What are the risks?

Selling to one, two or a group of key employees has many of the same risks or disadvantages as selling to a family member.

First, are the key employees qualified enough to continue to run the business in the owner's absence? Sometimes the business has outgrown the management group. It might have been a great management group when it was a $10 million company, but now it is a $40 million company, and management is not as well equipped to handle the larger size. The owner has to be willing to perform an honest appraisal of that management group.

The second risk is that normally, the employee group does not have the ability to write a check for the purchase, which means the owner's payout has to be based on the future success of the business. The owner has to be very comfortable that this group can continue to run the company profitably.

Finally, there is always the risk that this type of sale may require the former owner to transition the responsibilities or nurture key relationships or employees after the sale is complete.

If you are selling to key employees, what are your options?

The owner could sell the stock outright, which is not probable, because most employees will not have enough money to buy the company.

The owner could establish an Employee Stock Ownership Plan (ESOP), which is a leveraged transaction enabling the company to borrow on the cash flow of the business. The company uses the loan to purchase stock.

An owner can choose an installment sale where employees are going to buy the business over time, primarily using the cash flow of the business to purchase stock.

Which is the most popular?

ESOPs are getting a lot of press right now due to some real advantages. For instance, if the ESOP is structured correctly, the former owner can avoid paying capital gains on the stock if he reinvests the proceeds in qualified investments like stocks and bonds. For other types of transactions, he'd be required to pay taxes on that amount. Another benefit of using an ESOP is that the owner gets cash up front, unlike many other mechanisms. This means he may be able to leave the business immediately due to the fact that he is not tied to the future success or failure of the business. Lastly, he does accomplish the objective of giving the company back to the employee group.

Of course, setting up an ESOP can be complex, expensive and may involve disadvantages such as significant debt financing and various requirements that are related to the special tax treatment. It is important to evaluate whether an ESOP structure makes sense for each specific situation.

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