OWNERS, KEY EMPLOYEES AND THE TRANSFER OF OWNERSHIP

The life cycle of a closely-held business usually ends with a sale. Some owners simply want to receive the financial reward due them for their hard work and investment, while others may want to preserve their legacy by transferring ownership to key employees. The owners who would prefer to sell the business to key employees will likely be confronted with the fact that those whom they would prefer to take ownership of the business do not have the capital resources or the ability to borrow from a lender to pay the purchase price. In order to accomplish the goal of the owner, the buyout structure has to be a hybrid approach that involves debt.

One possible structure is a long-term installment sale in which at least one key employee agrees to buy the company and promises to pay a mutually accepted price based upon either an agreed upon or formal valuation. The owner/seller agrees to finance the transaction on an installment basis and holds a promissory note with a term that is agreed upon; i.e. 5, 7 or 10 years. The note would be secured by the assets of the company, stock, and guaranteed by the employee/buyer. There may also be additional collateral in the form of a mortgage on the personal residence of the employee/buyer. Typically, there is no cash exchanged at closing and the owner/seller is relying upon the cash flow of the business. If the employee/buyer is unable to maintain the business, the owner/seller may end up back in the business.

There are several planning techniques to reduce or minimize the owner/seller's risk in an installment sale, including deferred compensation, severance payments, rent from the building and/or transfer of cash from the business prior to the sale. In order to further reduce the risk, the owner/seller may require personal guarantees that are secured by assets outside the business, as well as delay transferring a controlling interest in the company until the owner/seller is confident that the employee/buyer has the ability to maintain operations in a manner that will enable the company to pay the installments. It is also possible to secure outside financing and/or sell a portion of the business to someone outside of the business who is confident that the investment would be profitable.

If the management team, which includes the key employees, are capable of operating and growing the business without the owner/employee's involvement, consideration for a leveraged buyout by the management team is a possible structure together with owner/seller equity, outside equity and/or debt. This structure is possible if the company has steady cash flow and strong prospects for future growth and a strategic plan that is agreed upon prior to the closing. In order for this type of transaction to be successful, the company would have a strong asset base; i.e. accounts receivable, inventory and equipment with little or no debt.

In order to attract outside investment, the company value would have to be fairly significant. A critical component of this structure is the agreed-upon value of the company, which becomes the basis for installment payments over a timeline that is acceptable to the owner/seller.

In the above-described scenario, the key employees will need adequate time to raise senior bank debt to fund a portion of the purchase price while at the same time, arrange for an equity investment from outside investors, which may involve a private equity investment firm that has an interest in the type of industry in which the company operates. The employee/buyers would have to negotiate with the equity firm in terms of ownership percentage and the type of investment to be made; i.e. equity and/or subordinated debt which a bank will treat as equity to support the debt financing portion of the purchase price.

There are advantages and disadvantages to either structure, which include tax considerations, control issues and risk tolerance. The owner/seller and employee/buyer must have counsel and financial assistance in evaluating the potential structure and balancing the risk to either side of the transaction. For further information on this topic or other business matters, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

Gary R. Pannone
Managing Principal

PANNONE LOPES DEVEREAUX & O'GARA LLC
counselors at law