



Exit Planning Information & Education for America's Business Owners

*The Exit Planning Review™* is an opt-in, bi-monthly newsletter published by Business Enterprise Institute, Inc.



*This issue is provided to you by Weatherby & Associates, PC Attorney, Hank Weatherby.*

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Counselors at Law  
Helping Families Preserve and Protect Assets and Values

Issue 10

## Transfers to Insiders

When transferring your company to insiders, a Low Value can put Dollars in your pocket.

Owners of successful businesses valued between \$5 and \$10 million face two difficult exit problems<sup>1</sup>:

1. Cash buyers are usually seeking larger companies; and
2. Owners are generally unwilling to assume a long-term installment note because of the risk of non-payment.

Given these hurdles, the owner has four transfer options:

1. Long term installment sale to employees;
2. Leveraged Management Buyout;
3. Employee Stock Ownership Plan; or
4. Modified installment/cash sale.

Let's look briefly at each.

### **Long Term Installment Sale**

In this sale, the former owner holds a promissory note that the buyers (employees) pay off over a seven to ten year period. The note is secured by the assets and stock of the business and the personal guarantees and collateral (usually residences) of the buyers. Little or no money changes hands at closing. Of course, if the new management cannot maintain the company's profitability, the owner does not receive his purchase price.

### **Leveraged Management Buyout**

An owner chooses this transaction structure when she wants to achieve the goals mentioned above and if her company has:

- I A management team capable of operating and growing the business without owner input;
- I Stable and predictable cash flow;
- I Good prospects for future prosperity and growth; and
- I A solid, tangible asset base.

Again, the key to this transaction structure is for the owner and management team to agree on a fair value for the company. Once agreed, the management team arranges the senior bank debt to fund a portion of the transaction. The bank, in turn, requires management to make an equity investment prior to closing. At this point, the management team finds and offers an equity investor a complete package of price, terms, debt financing and management talent. If a 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.

#### **Employee Stock Ownership Plan (ESOP)**

Avid readers of **The Exit Planning Review™** recognize this transfer technique from our last issue of **The Review**. For our purposes here, in an ESOP arrangement, 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.

#### **Modified Buyout**

Of all the methods of "insider" transfers identified here, the Modified Buyout is the choice of many owners because it best meets the typical owner's objectives described earlier.

In a nutshell, an owner makes available a pool of non-voting stock (about 40 percent of total ownership) for current and future purchase by key employees. That stock is valued using an agreed upon Valuation Formula but adjusted downward using minority discounts (*to be affordable and to provide an incentive for employees to stay with the company.*) Employees purchase stock via a Stock Purchase Agreement. After the employees have paid for the stock (usually three to four years) the owner can then decide to:

1. Sell the balance of the company to key employees at true fair market value for cash because they can likely get bank financing;
2. Sell to an outside third party; or
3. Continue to own the company.

The advantages to the Modified Buyout are:

- I Acquiring part of the company at a reduced cost rewards and motivates key employees;
- I Key employees knowledgeable in business and trusted by owner receive the entire business; and
- I Owner receives all of the company's fair market value.

The disadvantages to the owner are that:

- I He does not receive the entire purchase price for three to four years; and
- I He generally remains active in the business until the initial employee buy-in is completed.

In summary, the Modified Buyout works because the low initial value:

- I Allows a buy out with future cash flow;
- I Reduces taxes; and

- I Provides an incentive and sets up a low price for the eventual cash buy out.

Creating and implementing your Exit Plan can be the most important business and financial event of your life.

*Subsequent issues of **The Exit Planning Review**<sup>™</sup> discuss all aspects of Exit Planning. The provider of this Newsletter ([Hank Weatherby](#)) offer you unbiased information about what you may need to know — *How To Run Your Business So You Can Leave It In Style*<sup>™</sup>.*

<sup>1</sup>Kevin Short - Clayton Capital Partners

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