Transferring Ownership of Small, Closely Held Businesses

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Family-owned businesses account for a significant portion of the U.S. economy. Unfortunately, only about 30 percent of these businesses will make it into the hands of the second generation (Stalk and Foley). As the Baby Boomer generation reaches retirement age, an increasing number of small businesses face succession challenges.

While some family-owned businesses develop plans to transfer ownership and executive decision making to other family members, this is not a viable strategy for all small businesses. These firms will need to examine and implement strategies for transferring business ownership to external or internal buyers.

External Buyers

Low Return, Low Probability Options

When discussing succession planning and strategies, it is prudent to briefly mention liquidation and initial public offering (IPO). For small businesses, particularly those that are not profitable, liquidation offers owners a way to divest themselves of the business and pass on any assets while incurring modest losses. While liquidation may be the least complex of the transition options, the owner is unlikely to receive the full value of the business by selling individual assets and many employees will be without jobs. For owners who value loyalty or wish to see their business continue, liquidation is a poor, albeit always available, option.

At the other end of the spectrum, a business could explore the option of an IPO. Going public would allow the business to continue and result in a greater return than selling the individual assets in a liquidation, but not all firms are good candidates for a public offering, particularly small, family-owned businesses. The time and effort required of the management to demonstrate sufficient profitability and create market demand for an IPO, along with the prohibitive expenses associated with underwriting, reporting and accounting, make an IPO a complex and high-risk ownership transference strategy for the majority of small firms.

Between liquidation and an IPO, small business owners can consider an external sale to strategic or financial buyers, which would also allow the business to continue after the owner's departure. Strategic buyers are usually in the same industry and are interested in exploiting the benefits of synergies from technology, special skills, proprietary processes and customers, or creating economies of scale in processing and eliminating duplicate administrative duties. Financial buyers are typically private equity firms or high net worth individuals looking for a return on their investment.

Strategic Buyer

Potential synergies may lead strategic buyers to purchase the firm at a premium. The cost for the price premium is that trade secrets may be revealed to a competitor. This is especially problematic if the deal falls through. Additionally, a direct result of the synergies and economies of scale are the loss of jobs in redundant positions. Industry expertise of the buyer may decrease the complexity of, and time needed to, complete the due diligence process. However, these gains could be offset by the additional time required to arrange financing. Strategic buyers typically purchase 100 percent of the business in either cash or cash and stock of the purchaser's firm, and expect the owner to step down from all leadership roles. Owners who value loyalty of their employees and are hesitant to reveal trade secrets to competitors may wish to consider other buyers.

Financial Buyer

In contrast to strategic buyers, private equity firms are familiar with various valuation methods, due diligence and the closing process, which allows them to conduct the purchase rapidly. These firms also provide flexibility by allowing the owner to determine the role they want to have in their business after the sale. Some owners will want to retire completely from their business and others may want to remain active in a lesser role to transition leadership. Sale to a private equity firm allows the owner to retain an equity stake in the business, and retain a leadership role in some cases. Financial buyers provide discretion by allowing trade secrets to remain private. Whereas strategic buyers may offer a portion of the purchase price in stock, financial buyers may offer all cash.

The cost for added flexibility and discretion is that private equity firms may offer a price lower than what the strategic buyers would offer. However, this may be offset by larger gains related to the future sale of any retained ownership interest or earn outs. Many private equity firms require the new management and key managers to purchase stock in the business. This ownership requirement is a powerful motivator to care and succeed. As private equity firms bring a new perspective and management expertise to the business, the gains from any future sale could be significant.

The reputation of private equity firms has not fared well in the last several years. Private equity firms use higher debt levels in the capital structure of acquisitions and may over-leverage the business. In 2013, private equity firms took out $66.2 billion in dividend payments from acquired firms, which could have been reinvested in the business (Tan). Saddling companies with heavy debt, which is used to finance dividend payments to private equity executives, is one behavior tarnishing the image of private equity firms.

Private equity firms are also perceived as being a driving force for job reduction and elimination. A common practice in restructuring is to replace management and streamline or eliminate positions. This is especially true in cases where the business is not profitable or does not meet performance expectations. This perception of destroying jobs may not be fully deserved. *The Economist* reports direct employment losses two years after a private equity deal average 1 percent (*The Economist*). However, personnel changes and reductions are a common tactic of private equity firms to increase the profits of their investment.

Private-to-Private Transactions

A less known function of private equity firms is that of a market maker for private-to-private transactions (Siming). Evidence supports that stable businesses, referring to firms requiring few operational improvements, are being held for longer periods and offered to industrial buyers and other private equity firms (Siming). This market maker function is likely to increase as more Baby Boomer business owners retire or cash out of successful, ongoing businesses.

Business owners will have varying degrees of concern about how the business and employees fare after they exit. An external buyer causes additional investor oversight and results in outsiders being involved in management decisions. Proper seller due diligence should reveal the methods most commonly employed by the external purchaser to manage and increase business earnings. A seller should expect that the buyer will conduct extensive due diligence to investigate their business and the seller should reciprocate this effort. For those sellers who are invested in the livelihood of the business and its employees, a primary goal of this due diligence should be to inform them of the organizational changes that are most likely to occur after the closing.

It is important for the owner to understand the strategic plan for the business and employees before concluding the sale. Many small business owners will have a strong emotional attachment to complement their financial investment in the business. Having an understanding of this fact and facilitating owner due diligence will increase both the success and satisfaction level of a sale to external owners.

Internal Buyers

Owners with a strong management team in place who wish to reward loyal employees should consider selling to internal buyers. While selling the business to current employees may result in a lower price for the business, less due diligence is required, the business will continue beyond the owner, employees will not lose their jobs, the owner can transition the sale and maintain a management role, and trade secrets are not revealed to outside parties. Sales to internal buyers are also attractive if there are limited external markets for selling the company.

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Management Buyout

An owner can sell the business directly to the management team. However, not all businesses will have a management team or group of employees who are motivated to purchase the business. As mentioned previously, the sales price to current managers may be smaller than the price offered by a strategic buyer. Banks that fund loans for management purchases are typically quite conservative on credit underwriting. Employees who are serious about obtaining financing to purchase the business will have to make a significant investment of their own capital. Even for modest businesses, this investment could total between $250,000 to $1 million, depending on the size of the deal (Borkowski). The small business owner will often have to retain a position in the company for lenders to provide the financing for a management or employee group purchase.

Owners can also consider other ways to facilitate the financial ability of an employee team to purchase the company. Owners can arrange low interest rate loans to be repaid from future income. Few managers are entrepreneurs, and many are not willing to accept the high personal financial risk and exposure of an entrepreneur or do not have the funds available for a management buyout.

Although the owner may not be able to get the best price for the business in a sale to management or group of employees, there are other advantages. A direct sale to a group of employees avoids conflicts that often arise between management and outside buyers. The sale can be conducted more quietly and efficiently than a sale to an external buyer. This method of selling is appealing to owners with a strong interest in the future operation of the business and welfare of the employees.

Employee Stock Ownership Plans

The Employee Retirement Income Security Act of 1974 (ERISA) made Employee Stock Ownership Plans (ESOPs) available as qualified retirement plans. ESOPs allow the owner to sell a portion or all of their business interest. There are several tax advantages to the owner and employees to encourage employee ownership of businesses. The tax advantages and market creation for closely held stock are attractive ESOP features for small business owners. Additionally, ESOPs are a compelling option when the owner wants the firm to be controlled by loyal employees, but the management team lacks the resources for a management buyout.

ESOPs help align the interests of the employee and the owner. Research shows that ESOP companies are more productive and more profitable; they also have a higher survival rate (Bergstein). Additional studies found that businesses with shared-ownership plans showed strengthened employee loyalty, higher productivity and better survivability during the recent recession with fewer layoffs (Loten). Research reports overwhelmingly positive results over a 10-year period indicating that ESOPs appear to have increased sales and employment, and are more likely to be in business than non-ESOP companies (Blasi and Kruse). In addition to the ESOP, these firms are more likely to provide other retirement benefits for employees.

The ESOP is a trust that holds shares of stock purchased from, or contributed by, the business owner. This form of tax-qualified defined contribution retirement plan is exceptional in two ways. First, an ESOP invests primarily in the employer's common or convertible preferred stock; second, the leveraged ESOP is allowed to borrow money to purchase the stock. In a leveraged ESOP, the trust borrows money to purchase the shares from the owner. As related party loans are allowed with an ESOP, the company borrows the money from the bank and then loans the funds to the ESOP. In the future, the company will make tax-deductible contributions to the ESOP to repay the loan.

Internal Revenue Code (IRC) Section 4975 provides a tax exemption for the principal payments of qualified ESOP loans. Debt principal payments are generally not deductible for income tax purposes. This tax treatment allows the ESOP to be financed by pretax dollars and any dividends used to service the loan are tax deductible. An additional benefit for companies structured as S corporations is that ESOPs are tax-exempt trusts. Any income attributable to the shares held by the ESOP is exempt from the pass-through income tax.

In an ESOP, the stock is allocated to accounts for each employee and employees are able to contribute to the plan. Any employer-matching program can be completed with stock instead of cash. Upon retirement or exiting the firm, the ESOP will purchase the shares from the departing employee. This allows employees to have an ownership interest in the company, but they do not have control of the company. The employees will only have the right to vote in the event of a merger, liquidation, consolidation, recapitalization, dissolution or sale of substantially all of the company's assets (IRC Sec. 409(e)(3)). If the owner only sells a portion of their ownership interest to the ESOP, they will retain control of the business.

Similar to other retirement plans, employees are able to defer tax until they take a distribution from the plan. The employee can continue to defer tax on the distribution by rolling it into an IRA. ESOP transactions are stock sales, which qualify for capital gains treatment if the proceeds are not invested in an IRA. The ESOP is funded with employer stock by the owner, which means that typically the employee does not need to defer their regular salary to fund the retirement account.

Owners receive a number of benefits from an ESOP, as well. IRC Section 1042 allows the gain on the sale of stock to an ESOP of a C corporation to be deferred as long as the sales proceeds are invested in qualified replacement property, which are stocks or bonds of domestic operating companies. The sale of qualified replacement property will cause a taxable transaction, but if the replacement property is held until the death of the owner, the deferred gain would escape income taxation. The owner is also able to create liquidity while maintaining a controlling interest in the company.

ESOP Caveats

Creating and administering an ESOP is a complex process that requires the resources of lawyers, CPAs, financial planning advisors and independent valuation services, plus the appointment of an independent trustee. ERISA and the IRS place a myriad of compliance duties on the ESOP and the sponsoring business,

such as the rules regarding investing options, participant allocation, coverage, nondiscrimination, put options, appraiser independence, and general fiduciary and bonding (IRC Secs 401, 409, 410, 4975, Reg. 54.4975, ERISA, DOL Reg. 29 C.F.R. Sec 2550-408). The costs, compliance issues and complicated administration of an ESOP require a strong desire and commitment of the owner to execute this option.

Critics of the ESOP method of employee ownership charge that many of the plans are based on bloated assessments of the value of the business. Employees also assume significant risk through lack of diversification if an ESOP is their only retirement plan. The ESOP owns shares of the employer, so not only is there a single stock in the retirement plan, but this is also the source of employment. If the company fails, the employee sees a reduction in retirement assets and their employment. In a prime example of this, the retirement accounts of Enron's employees became worthless overnight, causing a great deal of financial difficulties for retirees who relied on those plans as their sole source of income.

An additional issue for an owner to consider before creating an ESOP is that they are not likely to get the highest value for the business. The share price is set by an independent valuation at inception and on an annual basis (How an Employee Stock Ownership Plan Works). This share price is likely less than what the owner would assess or would be offered by a strategic buyer. For an ESOP to be a viable option, the owner must possess a strong desire to reward loyal employees and accept a lower price.

By law, the company must purchase the employee's allocated shares when the employee leaves the company or retires. This requirement could jeopardize a business if many employees retire at the same time and the company is unable to purchase all of the shares. Companies that are not able to meet the purchase requirement face legal sanctions.

In addition, the expenses associated with setting up an ESOP are substantial. The National Center for Employee Ownership estimates costs of $40,000 for the simplest of plans in small companies (How an Employee Stock Ownership Plan Works).

Different Strategies, Different Advantages

The continuation and succession of a business require a great deal of effort and planning to succeed, and there are several strategies available to business owners. Regardless of which strategy is chosen, a successful succession of any firm will address several fundamental issues, most notably the transfer of ownership. The need for facilitators of this transfer of ownership will increase as Baby Boomer generation business owners reach retirement age and require succession plans or divestment options.

There are several strategies available to transfer ownership, typically involving an external or internal buyer. Business size and resources will limit or exclude some of the ownership transfer options available to larger businesses and corporations.

The sale of a firm is frequently a complex transaction with short- and long-term consequences. Many small business owners have most of their net worth tied to the business, and there are many financial and emotional considerations to address in the process of a sale.

The financial, estate and retirement planning factors, as well as complex tax consequences, require consulting skilled advisors before beginning any sale negotiation. Providing adequate consideration of all factors will lend itself to giving better advice, increasing the satisfaction with the results of the transfer of ownership and supplying valuable knowledge during the valuation processes. ■

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