

Having Your Employees Cash You Out of Your Business: Time is Money

Many, probably most, business owners would like to sell their businesses to their employees, but for one nagging problem: Their employees have no money. The desire to sell out to employees collides with the overarching need for financial security. Owners simply cannot risk selling a business to employees who have no cash.

Take James Johnson, owner of Johnson Consultants, Inc. His management team was capable and interested in buying the company from James. The business had little debt and good cash flow. When James met with his advisors, however, one of their first questions was, "When do you want to leave the business?" If James answers, "Now!" a sale to employees is fraught with risk. If James's answer is, "I'd like to be out — and cashed out — of the business in five to eight years," a well-designed exit plan can make that happen.

First, with James's input, his advisors created an incentive compensation plan for James's Key Employee Group (we call the Key Employee Group the KEG). The bonus plan was designed so that, as the profits of the business increased, the KEG's bonuses increased. Instead of paying them 100 percent of their bonus, the company deferred half of it and promised to pay the KEG the balance at a future date **if** each member stayed with the company. This type of a plan is known as a nonqualified deferred compensation plan and it is subject to vesting. In the case of Johnson Consulting, the plan was designed to vest the KEG over a five to ten year time frame.

Second, *because James planned ahead and gave his advisors the "luxury of time," James was able to continually* evaluate each member of the KEG to determine which employees were suitable for ownership. As his exit date approached, James met with the key employees he felt were best-suited and most motivated to ownership.

Third, James offered to sell the KEG a significant portion of his ownership (usually thirty to forty-five percent of the overall ownership of the company and in James's case, forty percent). Of course, James, like you, wanted cash for that stock.

Where do the employees get that cash? James offered to have the company vest each interested KEG member's deferred compensation 100 percent, if it would be used as payment for his stock. If the deferred compensation plan is well designed and well funded, there could be hundreds of thousands of dollars of deferred bonus money, belonging to the employees, at the company level. In James' case, there was over \$400,000 accumulated in six years.



That money, with the consent of the key employees, was paid to them, and a tax deduction was taken at the company level. The key employees then paid James as full payment for, in this case, twenty percent of James' stock.

Fourth, James sold the KEG another twenty percent of the stock using an Installment Note. With the expected distributions from the 40 percent of the stock they now owned, it was anticipated that the KEG could pay off the Installment Note in two years.

Fifth, with the key employees now owning and, not incidentally, having paid for 40 percent ownership of the company, they secured bank financing to purchase the balance of James stock.

James was cashed out. Because he did not wait to begin his exit planning until he wanted out, he was able to exit his business in style — which we define as selling out, for cash, when you want and to whom you want.

Obviously, this plan does not work for all businesses. It works for many companies having a value between \$500,000 and \$2 million to \$3 million. It also takes time, usually at least five years to fund the deferred compensation plan. It requires a cooperative bank that knows of your intentions well in advance. Finally, this plan takes 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 down the purchase debt.

The bottom line: you remain in full control of the business (in fact, you own all of the business) until a sale of all of your stock for cash to your key employees.

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