Management Buyout vs. Employee Stock Ownership Plan

Comerica WEALTH MANAGEMENT

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Key Takeaways:

- Two common alternatives for transferring ownership to employees are management buyouts (MBOs) and employee stock ownership plans (ESOPs).
- MBOs allow you to choose the group of employees who will become future owners.
- ESOPs provide ownership to all employees and certain tax advantages to both the seller and the company.

All business owners will transition from their businesses at some point. How it happens can vary significantly. Many business owners feel an affinity toward employees who helped create success in the business and want to include them in future ownership as a reward. Two common ways to transition ownership to employees are management buyouts (MBOs) and employees stock ownership plans (ESOPs). If transferring ownership is important to you in your transition, spend time considering and comparing these two types of employee ownership options.

There are a lot of factors to explore when considering a transfer of ownership to employees, many of which relate to one another. Some factors to consider are risk, transition timeline, tax implications, transaction structure, ongoing personal involvement, and personal financial needs of the seller. Beginning the process by asking and answering questions related to these topics can provide clarity as to which, if either, of these alternatives is a good choice for you.

"If including employees as future owners is important to you, understanding the differences between these different types of employee ownership is critical."

Management Buyout (MBO)

MBOs are transactions in which a limited group of existing employees—generally members of the company's management team or key employees—purchase the shares of the company from existing owners. For this discussion, we will assume the purchasing employees are not current shareholders. Important considerations for this type of transfer include:

- The buyers

  Determining which employees will be offered ownership is an important step in completing an MBO. Including too many, few or employees unprepared to be owners are all issues that should be carefully considered.

- Current shareholders' agreement

  If you are not the sole owner of your business and have a current shareholders'/buy-sell agreement, the agreement may define how transfers occur and at what values, at least between existing shareholders. If not all shares are to be transferred and the new owners will be subject to the existing agreement, it is important to understand how the agreement might affect them, you and other shareholders. Some amendment may be advisable.

- Transaction structure

  Most W-2 employees will not have the financial means to purchase the shares of their employer's company and are often unable to obtain sufficient financing. This is particularly true if all shares are transferred at once. In these cases, the buyers will rely on the selling shareholders to finance the purchase by holding notes for at least a portion of the purchase price. The terms of these notes are important factors for both the buyer and seller.

- Valuation

  MBOs are often priced at some discount to market value
  Because the buyers are internal and do not have any strategic synergies to bring to the table, the purchase will likely be financed largely by the ongoing company cash flows. Existing buy-sell agreements may control the valuation, and sellers may wish to consider transfers to new owners outside of the existing agreement terms.

- Future management and decision making

  As the buyers move from employees to owners, there may be many issues to address, including how management decisions will be made in the future, how the relationship between the new owners will change, what role you and other existing shareholders will play in future operations and in guiding the transition, and whether new governance structures may be necessary to ensure a smooth handoff of control.

Employee Stock Ownership Plan (ESOP)

An ESOP is a "qualified plan" regulated by the Employee Retirement Income Security Act of 1974 (ERISA), which establishes minimum standards for certain retirement plans in private industry. Because ESOPs have specific governmentally regulated standards, there are certain factors that will not be determined entirely by your own desires. However, ESOPs are designed to provide significant flexibility within the regulated framework. Important considerations for transfers to ESOPs include:

- Size

  ESOPs are generally appropriate for companies of a certain minimum size. Although there is no absolute minimum, companies with very few employees or revenues and/or earnings below certain thresholds are unlikely to be good candidates.

- Percentage

  Part of the flexibility of ESOPs include the ability to sell as much or as little ownership as you like. Determining the right amount for you as the seller requires assessment of many factors including control, value, tax ramifications and your long-term objectives. Once formed, the ESOP will stand as a ready buyer at all times into the future, but the price and terms of future sales may differ from those of an initial transfer. It is also important to understand that certain tax benefits are available for both sellers and the ESOP company. Some of these benefits may vary depending on how much of the company is transferred to the ESOP.

- Transaction structure

  Because the company is the borrower in a leveraged ESOP transaction, bank financing often plays a role in the overall structure. However, depending upon the percentage of the company transferred, it is also common for sellers to finance some portion of the purchase price by holding a note.

- Valuation

  The valuation of shares purchased by an ESOP will be determined by an independent appraiser in a manner that complies with certain governmentally imposed guidelines. There is generally a negotiation process that occurs, but the ESOP may not pay more than "fair market value."

- Future ownership and control

  ESOPs are intended to provide ownership benefits to a company's entire employee base. Ownership is held in trust by the ESOP Trust for the benefit of participating plan employees. Management of the company generally continues much as it did prior to the formation of the ESOP, and a clear succession plan is an important factor. The percentage of ownership transferred to the ESOP (or retained by the sellers) will affect future management and control.

- Taxes

  Primary benefits of ESOPs include the associated tax advantages. Certain ESOP structures can provide significant tax advantages to the selling shareholders and to the company. Considering how these tax benefits affect the seller and the company is critical in comparing ESOPs to other transition alternatives.

Conclusion

All transition alternatives have their pros and cons. For some business owners, transferring ownership to employees either to a small group of key employees via an MBO or to all employees through an ESOP, is appealing. If including employees as future owners is important to you, understanding the differences between these different types of employee ownership is critical.

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