MANAGEMENT BUYOUTS: SELLING OUT TO SENIOR MANAGEMENT

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Many owner managers include senior employees in their succession plan, either because of previous commitments, because they feel the employees "deserve" the opportunity, because the represent the best possible buyers, or because of some combination of these factors. This can work very well for the owner manager, for the senior employees, and for the company, if the transaction is properly structured and implemented.

Senior Employees Can Be Ideal Successors

Senior employees can be ideal successors. After all:

_ They are the only people likely to know the company as well or better than you.

_ They should be people you respect and trust – otherwise they should not be working for you.

_ Your senior managers should already have a lot "invested" in the business emotionally and career-wise.

_ Since maximizing price requires purchasers who are comfortable with the risks of the company at the time of sale, your senior managers represent excellent potential buyers. They know the risks and opportunities associated with the business and should be comfortable with their ability to manage them.

_ Your other stakeholders – customers, suppliers, employees, and lenders – will probably be familiar and comfortable with your senior managers.

_ You will have a chance to prepare them to take over the business.

_ They are more likely to permit you to leave lines of communication and tentacles of control in the business than a true third party purchaser.

_ You can often phase things over time and keep control of the business until the right moment.

_ Management buyouts are usually earn out based with lots of vendor take-back financing, two factors which usually result in a higher sale price for the business.

Selling To Senior Management Will Not Be The Same As Selling To A Third Party Buyer

On the other hand, management buyouts usually come with limitations that may or may not suit your situation. You must appreciate that you will not get the same deal from your senior managers that you would get from with a third party buyer.

Things to consider include the following:

_ ***Management buyouts tend to be earn out based.*** Few management employees have access to the kinds of capital or financing required to buy the business they work for. While earn outs are often part of a third party sale, they usually form a much smaller part of the overall deal than a management buyout of an owner managed business. Earn outs offer can never be as "clean" as a simple sale for cash to a third party.

_ ***Management buyers tend to use more of the company profits to pay for the business.*** Management buyers often pay the outgoing owner manager with his or her own money. This needs to be managed carefully. The owner manager must accept that a manager buyer is usually implementing a leveraged buyout in the true sense of the word. This means the buyout can take longer and the owner manager continues to remains at risk to a downturn in the business.

_ ***Manager buyers tend to need a longer time to pay.*** The retiring owner manager often provides most of the financing in a management led buyout, depending on the financial leverage available in the company. While there is often some vendor take-back financing in third party sales, it is usually a lot less significant than in a management buyout.

_ ***The retiring owner manager may stay more involved with the business for a longer period of time.*** Most third party buyers are ready to move in and quickly take over the management of the businesses they buy. However, because so much of the purchase price in a management buyout is paid over time and out of company profits, most outgoing owner managers hang on to more control and stay around longer in a management led buyout than in a third party sale, to manage the risk and ensure that the deal works out. Also, in many cases, the managers buying in need more coaching and mentoring before they are ready to fully take over the business.

These limitations are not present in all cases. Some managers can fully fund their deals and are ready to takeover right away. However, any owner manager thinking about a management buyout as a succession plan needs to consider these matters as early as possible.

On the other hand, there are some potential positives for an owner manager to keep in mind when considering the limited financial resources of manager buyers:

_ ***If the owner manager is financing the deal, the owner manager can get the best price and the most advantageous deal structure.*** Price and terms are linked in any deal. If the owner manager is financing the deal and allowing a leveraged buyout, they will be able to ask for and receive a better price than they might get from a third party buyer. They may also get more favourable terms on interest rate, security and tax structure. This can be structured to provide benefits to the selling owner manager that they might not get from a third party buyer. This also creates an opportunity for the selling owner manager to manage the risks of earn out financing that are often a significant part of management led buyouts.

_ ***The owner manager will be able to keep more control over the business.*** This is not a good thing if you are selling because you want out of the business. But this can be positive for owner managers looking to ease out of the saddle, rather than jump off the horse all at once.

_ ***If things don't work out, you are more likely to be in a position to take the business back while it is still in good shape.*** Third party buyers who pay over time usually default because they make a mess of the business. This not only means you fail to get all your purchase price, but it often means that taking the business back is not an option. With management buyouts the security and owner manager involvement is usually structured so that the owner manager can step back in before things get that out of hand.

Selling to senior managers may not involve any more risk than selling to a third party if the deal and company are right and if the risk is reflected in the purchase price and terms.

Selling to you senior management is an option to consider if you have good reasons for preferring a manager led buyout over a third party sale, and if you have considered all the other options available to you.

Picking The Right People

A management led buyout only works if you have the right people to succeed you.

Not many people are capable of being successful owner managers. If you are getting cashed out on closing, you might not care. However most owner managers don't get cashed out on closing when they sell to employees, and have a significant stake in who takes over their legacy.

In a management buyout scenario you must be sure that your successor can do a good job with the business and will make a good owner manager. In fact, you better be pretty sure before you even approach them. If you get the wrong person excited about the opportunity, but then decide that they don't have the right stuff, you might lose a key employee.

There are some things you can do to make sure that you do not over-estimate or under-estimate the talents of your senior managers:

- ***Consult your professional advisors.*** If your advisors are good at what they do and work with owner-managed businesses on a full-time basis, they will have a good idea of what a successful owner manager looks like. Let them get to know your senior managers and ask them for a frank assessment. Take their advice very seriously. They no stake in your decision other than seeing you fulfill your dream of a safe and profitable exit from your business.
- ***Consider implementing an advisory board and including your senior managers in the advisory board meetings.*** You will be able to see how your senior managers respond to your independent advisors, and you will be able to get your advisory board to assess them on your behalf.

If you do want go ahead with a management buyout:

- ***Make sure your senior employees want the business.*** Many very effective employees in owner managed businesses are quite happy to be employees and are not looking for anything more. Not everyone thrives on the kind of pressure you do. Let them speak for themselves in a frank and safe environment. They need to know that their jobs are not at risk if they do not jump on the opportunity, and that you will respect their decision, no matter what it is.
- ***Make sure they will appreciate the opportunity.*** People do not take good care of things they take for granted. Some employees overestimate their importance to the business, think they are "owed" something, or otherwise don't fully appreciate how fortunate they are to be offered a management buyout opportunity. For most it is the chance of a lifetime – equivalent to winning the lottery. It should give them a real opportunity to end up better off

than they ever thought possible. Trying to deal with employees who don't fully appreciate the opportunity is frustrating at best, and a disaster at worst.

- ***Make sure they are entrepreneurs.*** Entrepreneurs are not big risk takers, but they can accept a lot more uncertainty than most people. The average person trades opportunity for certainty. They perceive and assess risk differently than owner managers. They need to know "for sure" how things will turn out. These kinds of people do not make good owner managers, except in a franchise situation where the whole business is spelled out for them.
- ***Make sure they are capable.*** Most businesses are a three-legged stool, with the three legs as:
  - Product development and delivery *(inventors, craftsman artisans, tradesmen, technicians, engineers)*;
  - Sales and marketing *(salesmen)*; and
  - Finance *(accountants)*.

  Most owner managers can do one of these things well, while others can do two. An owner manager who can do all three is quite rare. If your senior managers are going to succeed, they will need to be very good at one of these things, pretty good at another, and capable of hiring, motivating and keeping the talent for everything else.
- ***Make sure other stakeholders will support your managers.*** This is especially important when it comes to other employees, key customers, key suppliers, and company lenders and financiers. Without their support, your buyers are going to be in a tough spot. The same is true for the other important people in your manager's life. You need to feel confident that their family and other important stakeholders will support them in the challenge they will be taking on.
- ***Educate, train and develop them.*** You should strive to develop your management team if you want them to succeed you. How else are you going to be comfortable giving them control of the business? How else will you feel comfortable that you will get paid what they agree to pay you? Give conscious consideration to the training and development needed to prepare your managers to succeed you.

In the meantime, protect yourself by making sure that you have good contracts in place with your senior managers, including confidentiality clauses, non-competition clauses and non-solicitation clauses.

Finally, manage their expectations. Keep control of the situation by being fair and reasonable, without letting anyone getting too carried away.

Structuring The Deal

Since other articles on our website ***www.thompsonlaw.ca*** get into the details of structuring deals, I will not duplicate the discussion here. The articles on price negotiation, management buyouts and deferred payment transactions could be of particular interest to you.

However, some special issues related to structuring management led buyouts include the following:

- ***Make a commercially sensible deal.*** This is the #1 rule of succession planning, no matter who your buyer is. After making sure you have the right people to buy your business, the next most important thing is to make a commercially sensible deal – for you, for them and for the business. This can be a challenge in manager led buyouts, as the parties have a "history" which might create conflict between the parties.

- ***Decide if this is a mandatory or optional deal.*** Sometimes people regret deals after they close them. Some manager buyers want to test drive before they commit to buying. Some deals are structured to give them an option to buy, or with staged buy-ins that can choose to exercise. Sometimes the owner manager seller has the option of selling a part of the business (e.g. 50%), and then deciding whether to proceed with the rest. No two deals are identical, and the level of commitment needs to be confirmed at the very beginning.
- ***Make sure you agree on a "fair" price for your business.*** If the price is too low, you may not secure what you need. If the price is too high, you risk demoralizing your buyers after the deal is closed. Manager buyers who realize that they have taken on an unfair or unrealistic burden have been known to walk away. Get good professional advisors involved, and make a realistic assessment of what you have to sell.
- ***Take any special circumstances into account.*** On the other hand, your manager buyer may have already contributed a great deal to your business, and it may be expected that this will be reflected in the purchase price. This is fine as long as both sides think the final price is fair and reasonable in the circumstances. However, this can be a touchy issue if your manager buyer is expecting a "deal."
- ***Consider the impact of seller-provided financing on price.*** While past contribution may lead to discussion about reducing the price, the fact that you may be providing extraordinary financing support should lead to a discussion about increasing the price. In most cases, the more financing support the seller provides, the greater the purchase price to the seller.
- ***Make sure the deal is financeable on reasonable terms.*** Even after you get a deal on price, you need to make sure that is financeable on reasonable terms to both parties. This not only includes third party financing, but whether the business can carry the cash flow burden of the buyout. Accounting assistance is critical.
- ***Your management buyer should put as much money into the deal as they reasonably can.*** Deals work better if the buyer puts up as much real money as possible. It may not be much compared to the overall purchase price, but it should seem like a lot to them. It's evidence of their commitment. It puts them at risk. It gives them a sense of ownership. It may come from a mortgage on their house, it may be borrowed from a relative, or it simply may be a significant reduction in pay. Whatever it is, it's best to have tangible on the table.
- ***You need to secure the unpaid part of the purchase price.*** The seller will eventually give up a significant amount of control. It is likely that the buyer will have much more impact on the likelihood of a successful earn out than the seller. Therefore, there is often a significant security component if there is a large earn out component to a manager buyout. Sometimes it involves assets other than the business or parties other than the buyer or both. Occasionally real estate or other significant assets are pledged to support the deferred part of the purchase price. However, most often the security for an earn out or vendor take back financing includes:
  - A pledge of the purchased shares or all shares of the business (if a share deal), plus

_ Security over all the assets of the purchased business ranking behind normal trade debt and bank and other third party financing.

The detailed agreements will include parameters on:

_ Any financing ranking in priority,

_ Reporting and accountability mechanics so the seller can keep tabs on things,

_ Notices of default from the seller and options to cure from the buyer,

_ Acceleration clauses, and

_ Rights to enforce the security by taking over, taking back or selling some or all of the secured assets with or without forfeiture of all or some of the purchase price paid to date.

All in all, this is a pretty complex part of any deal, and good professional advisors and lots of patience will be required to get through it.

_ ***The manager buyer make should serious commitments on matters other than price and payments*.** The manager buyer needs to focus on paying for the business before moving forward with his or her own plans for the company. In addition, if the deal is too easy to get out of, the buyer may not push hard if something unexpected or difficult arises. No one ever wants to unwind a good deal. Typical commitments include:

_ Security as discussed above,

_ Reporting and accountability,

_ Limits on other third party financing,

_ Limits on capital expenditures, hiring and operational expansion,

_ Limits on profit taking,

_ Redirection of profits to the seller in payment of the deferred purchase price component,

_ Salary and compensation caps,

_ Non-competition and non-solicitation obligations, and

_ A consent to the seller taking back or selling all or part of the business if a serious default is made which is not rectified.

As a seller, you are looking for real commitment. You want to see appreciation. You want to see risk. You want to see the buyer's self-confidence and their belief in the business and the deal.

_ ***The owner manager seller needs to be willing to let go on a reasonable timetable.*** It can be tempting for the selling owner manager to hang on to control until the last dollar is paid. This does not work well in manager led buyouts. There need to be some defined points of reference. There are many issues to consider when structuring the manager led buyout deal:

_ The manager buyer might have a significantly elevated position of authority right away, such as getting a seat on the board or being made an officer of the company.

- Based on defined points of reference – passage of time, payment of a certain percentage of the price, achievement of certain milestones – the buyer might assume an equal position of responsibility and authority to the selling owner manager.
- Finally, based on the next level of reference, the manager buyer should end up with the primary and majority position in the company.

The timetable should be spelled out, be acceptable to everyone, and motivate the manager buyer and the owner manager seller to get there quickly and together.

- ***<u>There need to be milestones and consequences for missing them.</u>*** This can be a tricky issue, especially if the manager buyer is not in control of the business from the outset. But the conditions need to be there nevertheless. They may include failure to make certain payments, or to get the business to certain milestones. Consequences can include:

  - Purchase price or interest rate adjustments,
  - Reductions in personal compensation,
  - Reduction in control or autonomy,
  - Termination with or without a severance package,
  - An unwinding of all or part of the deal, or
  - Some combination of the above.

  No two deals are identical, but creative and experienced professional advisors can help you and your manager buyer work out a system that is fair and commercially sensible.

- ***<u>You need to spell out how profits will be used as the deal moves forward.</u>*** Businesses need profits for many reasons – to pay down debt, to fund capital expenditures, to fund research and development, to fund new opportunities, to provide bonuses, raises or improved benefits to employees, or provide return on investment to its owners. In a management led buyout all these needs continue, plus the profits are needed to pay off the purchase price. You need to work out who will make the decisions on how to use the profits, especially if there is surplus money available. It is not unusual in management led buyouts for the buyers to agree that all profits of the company which they pay out to themselves for bonuses and dividends must be applied to the purchase price after payment of any relevant tax burdens. This allows them to leave profits in the business, which improves the security for the seller, but it makes paying for the business the first priority on any profits they want to take out for themselves. This prevents manager buyers from improving their own personal financial situation – other than by improving the value of their shares in the business – until they take care of their financial commitments to the owner manager seller.
- ***<u>You need to deal with the ongoing financial needs of the business.</u>*** You still need to allow the primary needs of the business to be financed, especially if the hope is that the business will continue to grow. It is not unusual for the owner manager seller to be obligated to postpone his or her security in the company assets to new and ongoing bank financing in the ordinary course of the business of the company, as long as that money is being used in operations and not to distribute profits to the buyers. The deal needs to determine who makes such decisions and how they get made. The owner manager seller is not going to want to postpone for financing which he or she thinks is too expensive, or will not be wisely used.

_ ***You need to deal with other operational decisions.*** Until he or she is paid out in full, the owner manager seller will be seriously interested in the operational decisions of the company. They will want payment of their purchase price to be a priority, and will not approve decisions made which will jeopardize that requirement. It is not unusual for operational limits to be placed on the business, including capital expenditures, expansions, geographic locations, and similar matters. This needs to be acceptable to the buyer and the seller, and ties in to the level of control the seller will have as the deal goes forward.

_ ***You may need to deal with the offer that cannot be refused.*** Either the buyer or the seller may receive an offer to buy the business from a third party that they simply "can't refuse". Your deal may need to address how that will be dealt with. Again, that ties into the milestones and tipping points.

  _ It is not unusual for the owner manager seller to retain the right, until certain milestones are reached, to accept such offers subject to a right of first refusal in favour of the existing manager buyer.

  _ It also not unusual to authorize the manager buyer to accept such offers, as long as they are sufficient to pay off the purchase price.

  _ Sometimes they also contain price adjustment clauses, so that if the third party buyer is paying more than an initial threshold, then the owner manager buyer does not get to keep all of the windfall but has to share it with the owner manager seller if the buyer accepts the third party offer, and the seller owner manager has to share more of it with his or her manager buyer if it is the seller owner manager who triggers acceptance of the third party offer.

Dealing With The Unthinkable – Death, Disability and Default

Your deal also needs to address certain unthinkables:

_ ***Your death.*** Depending on how your deal is structured, your death might have a big impact on the deal. Your death could trigger an acceleration of the purchase price, including an option for your estate to sell the business to a third party if the buyer could not meet the terms of the acceleration. They may also be a role for insurance in this situation

_ ***The death of your manager buyer.*** Your whole succession plan could go out the window if your manager buyer dies. The deal may have to be unwound in some way that is fair to everyone. There may be issues of acceleration or a role for insurance.

_ ***Disability – yours or your buyer's.*** Similar issues arise in the event one of you becomes disabled in some way. If it happens at a time when the deal contemplates your or your buyer being active in the business, then a disability could be devastating to the deal. The deal has to consider how to manage those eventualities. Unwinding the deal or selling to third parties are always considerations. Insurance, however, is not as useful in managing this risk.

_ ***Default must be anticipated.*** Things could go wrong. Your manager buyer could end up defaulting in some way. The deal must consider what happens in those circumstances. The fact that your defaulting buyer was and probably continues to be a key employee of the business could be significant consideration you do not have to deal with in a third party buyer situation. Not only do you lose your succession plan and your buyer, you might be losing a key employee.

Another Unthinkable: Insolvency - Yours, Theirs Or The Company's

Privately owned businesses are high-risk investments. They lack the management and financial depth of larger enterprises, making them tricky to manage. Most of us would rather ride out a storm in a cruise ship than a canoe. That risk will not disappear while you're waiting for your manager buyer to finish paying you. In fact, the risks will go up. The risk of insolvency can be a thorny issue in a management led buyout.

- ***Your insolvency will probably not mean much to the deal.*** Your creditors will simply step into your shoes. The manager buyer might insist that certain rights be peculiar to you, such as the right to take over management of the company. Certain rights and remedies might unwind if you are not around to personally execute them. But overall, the insolvency of the seller is not usually a significant issue in a management buyout.
- ***Insolvency of the buyer, on the other hand, is a serious event.*** It opens the door for the creditors of the buyer to take over the deal. Most outgoing owner managers find that unacceptable, and most management led buyouts of owner-managed businesses provide remedies if the buyer goes bankrupt or into insolvency. The manager buyer should not care how draconian those rights are, since the point of the deal was not to enrich the buyer's creditors.
- ***The insolvency of the business during a management led buyout is a disaster.*** Your deal must be structured to anticipate problems before they occur. Typical risk management techniques include:
    - Your ongoing involvement;
    - Distribution of financial reports;
    - Access to information;
    - Ongoing board representation;
    - Limitations on decision-making (expansion, hirings, capital expenditures, borrowing); and
    - Maintenance of basic financial covenants (tangible net worth, liquidity, profit distribution).

  Your deal must also allow you to take the reins if things take a turn for the worse. There are many ways of doing this, including:

    - Retaking board majority;
    - Suspension of buyout;
    - Rights to unwind all or part of the deal;
    - Taking over management control;
    - Enforcing security rights;
    - Receivership;
    - Terminating or suspending the manager buyer; and
    - Third party sale.

More Unthinkables: Employment Issues And The Manager Buyer

The special circumstances associated with most management buyouts – a significant earn out component, significant vendor take-back financing, ongoing employment relationship, phased transition of control and management – result in a number of thorny issues which challenge the commitment and creativity of the parties.

The issues arising from the dual roles of the manager buyer can be the most difficult. Your buyer is not only the person buying your business, they are often a key employee.

The negotiation of management buyouts can fall apart even after price and finance issues have been resolved, especially when the buyer begins to realize what other commitments are necessary to make the deal work.

For example, some manager buyers balk at the non-competition, non-solicitation and related commitments that are routine among partners and shareholders.

Also, some people who were confident and effective employees change when they become part of a management buyout. They can display a lack of competence in business at the next level, or they can turn out to be martinets of the worst kind.

Your deal has to consider typical ongoing employment matters while you are waiting to be paid out, including:

- ***The salary and benefits of the manager buyers will need to be addressed.*** Generally speaking, the seller wants to limit what the buyer can take out of the company until it's paid for. Not all manager buyers will find this reasonable. After all, if they are buying the business to become their own boss, then setting their own compensation should be one of the privileges of ownership. It is a good idea to resolve these issues as part of the deal.
- ***Accountability and reporting must also be considered.*** Who will the manager buyers report to? Who will supervise them and hold them accountable until the purchase price has been paid in full? What about setting targets or assessing their performance? Your deal should anticipate how these matters will be handled, including what will happen if the key milestones are not met.
- ***Can they still be terminated for cause?*** If so, by who? What constitutes cause? What happens to the deal? Management of this issue could include:
  - Acceleration of the balance of the purchase price;
  - Enforcement of security held to support the purchase price;
  - Retaking management of the company;
  - Selling to a third party;
  - Termination of employment without a severance package; and
  - Unwinding the deal and giving them their money back, with or without a financial penalty.

  Generally speaking some combination of these options is used, depending on where the parties are in the process.

_ ***<u>Can they still be terminated without cause?</u>*** If you or someone on your behalf retains control of the company, you will retain the right to terminate your manager buyer without just cause. Maybe they are just not working out. Maybe they have changed in some way. Maybe the company has gotten into difficulty and some big salary people have to go. Depending on the deal, the owner manager seller might retain the right to terminate the manager buyer without just cause. This is akin to your changing your mind. Most deals set out what happens in these circumstances, including:

_ How the deal is unwound,

_ The severance package for the departed buyer, and

_ Much less limiting restrictive covenants on the buyer post-termination.

After all, just as the seller will argue that the buyer should not be able to get out of the deal without some pain, the buyer will argue that the seller should not be able to get out of the deal without an equivalent pain factor.

Concluding Thoughts

There is no question that management led buyouts can be a very satisfying and practical way for an owner manage to exit their business. When they work, they work well.

However, a poorly structured or thought-out management buyout can be a disaster. Not only can you wreck your succession plan, you can end up stuck with a struggling company you were trying to get rid of without some of the important people you would normally count on to help you through tough times.

The keys to good management led buyouts include excellent professional advisors and lots of patience when putting the deal together.

However, just like any other successful deal, want you need most of all is the right people with the right attitude, openly communicating, and mutually committed to a win-win transaction.