



Maintaining Control, Minimizing Risk, and Rewarding Your Best Employees

For many small-to-mid-market business owners, there are few things more important than maintaining control of the company, minimizing risks for the company, and rewarding the employees that make the company successful. Ownership transfers to the company's most valuable employees can do all of these things with proper planning, but there is a caveat.

While it's admirable for owners to try to reward their key employees with ownership, many owners want to do everything they can to receive maximum value during the process of transferring their ownership interest. In many ownership transfers to employees, the owner's successors can't afford to pay the owner for their shares upfront. Instead, they often buy their shares of ownership using a promissory note and then use their subsequent share of the company's cash flow to pay the owner (paying off the note over time).

But many owners know from experience that company cash flow cannot be predicted with certainty and may fluctuate. How can owners transfer to employees while protecting themselves against cash flow fluctuations? Consider the story of an owner who experienced this.

Rhonda Flint owned a 65-person building-materials supply company that specialized in high-end stone fabrication. After 33 years of growing the company, she decided that she was ready to start transitioning out of her business. She wanted to transfer the business to her four key employees: Glen, David, Marge, and Mary.

Rhonda was confident in her management team taking over, but she was also cautious. During the Great Recession, her company's cash flow had bottomed out for several years. She had managed to guide her management team through the lean years, but the company's survival relied on Rhonda's intuitive talents, something the management team wouldn't have once she left. Even though Rhonda had installed safeguards that strengthened the business and made it attractive to outside buyers (she had received several offers from strategic buyers), her goal was to keep the business in the hands of people she trusted.

With this in mind, Rhonda spoke with an advisor who had experience in business transitions named Susan. Rhonda wanted to know how she could transfer ownership to her management team without having to perpetually babysit during the toughest times.

"My hope is that I can give each of them a 25% stake. I still like the work I do, but I want to dial it back and retire within the next 10 years or so," Rhonda said. "I know that none of them can pay me for their stakes upfront, but I don't want to just give them ownership and hope for the best. They're all excellent workers, but they fell a little short when things got really rough. What can I do?"

"Are you sure that all of them are interested in ownership?" Susan asked.

“Positive,” Rhonda replied. “We’ve been talking about this for quite some time. I’m just not sure how to go through with it.”

“It’s good that you confirmed that they all want ownership,” Susan began. “What we can do is rather than simply giving your employees ownership, we can give them the opportunity to buy it from you over time instead of having you accept four promissory notes for larger sums that make you uncomfortable.”

“And how would that work?” Rhonda asked.

“We’d give your employees specific cash flow targets to hit every year. If they hit those yearly targets, we’ll give them a chance to each buy a limited portion of your ownership and all the perks that come with it, other than voting stock, which they’ll get once you’re entirely out,” Susan explained. “And since you’re still motivated to work for about 10 years, you can stay onboard and guide the company as much as is necessary, delegating your most important responsibilities slowly over time as your management team matures. We’ll put all of this in a written plan so that everyone is working off of the same page.”

“I didn’t know I could do that,” Rhonda said. “I thought I had to give them ownership all at once.”

Rhonda and her advisors crafted a plan that would allow her key employees to buy pieces of ownership only if they met her specific cash flow targets. Motivated by this plan, her key employees exceeded her targets in each of the next five years, with minimal help from Rhonda. The increased cash flow allowed the key employees to buy the remainder of Rhonda’s ownership in Year Seven using a bank loan. In the end, Rhonda was made whole and her key employees took over leadership and operations entirely.

Properly planned ownership transfers to employees can be a great vehicle to keep you in control of your business, minimize risks, acknowledge your employees, and still reach your financial goals. Please contact us today if you’ve ever wondered about how you can eventually transfer out of your business on your terms.

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