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Ownership Transitions: Four Common Paths

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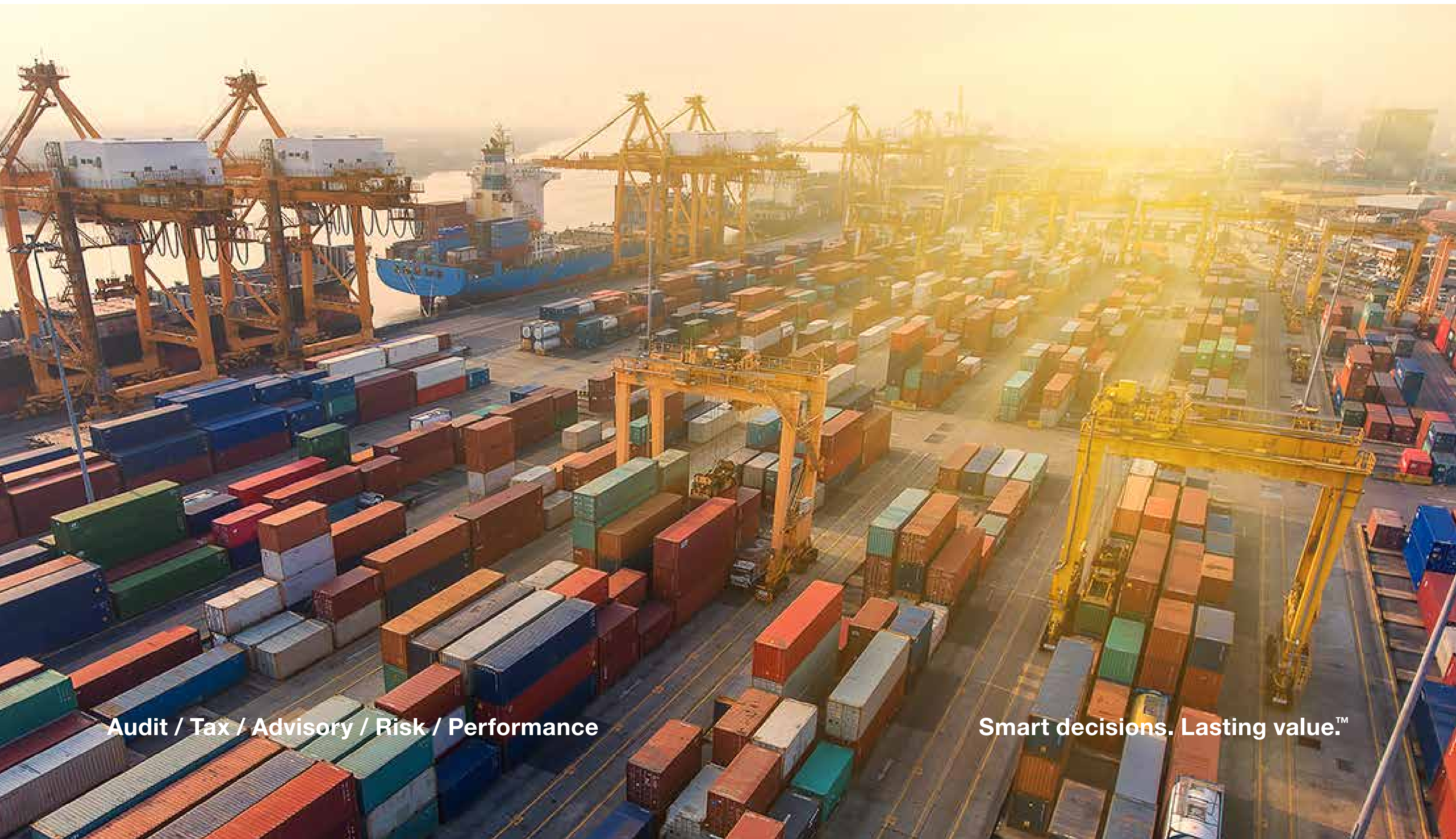

Throughout the next decade, numerous baby boomers who own manufacturing and distribution businesses will retire and exit the marketplace.

For many of these business owners, a good portion of their personal wealth is tied up in their businesses. To maximize financial gain upon retirement, owners will benefit from a well-planned transition strategy.

This article introduces four common paths for changing ownership of a business: employee stock ownership plan, sale to a third party, initial public offering, and transition to family members or an existing management team.

Employee Stock Ownership Plan

An employee stock ownership plan (ESOP) essentially is a tax-qualified retirement plan that owns or invests in the company's stock. An ESOP differs from other tax-qualified retirement plans such as 401(k) and profit-sharing plans, however, in three main ways: the ESOP must invest primarily in the company's stock, it can borrow money to finance the purchase of company stock, and it offers additional tax advantages not available using other ownership succession strategies.

Some main benefits of using an ESOP as a transition plan include:

- A company that is owned by an ESOP and that elects subchapter S-corporation status for tax purposes pays no federal or state income tax on the portion of the company owned by the ESOP, which can greatly enhance cash flow.
- An ESOP generally is a sustainable form of ownership because beneficial ownership is spread over *all* of the company's employees, which, for the most part, avoids a large buyout or redemption obligation in the future because of demographics of the employee group.
- The business's exiting owner generally can stay involved for a time after the sale and exert influence over business matters.

Sale to a Third Party

Sale to an unrelated third party such as a private equity firm or other strategic buyer is another common business transition path. The main benefit of a third-party sale is that it often results in the highest value for the seller. It's worth noting that a sale process with several interested third-party buyers has the potential to yield a greater return for the seller versus negotiation with a single buyer.

Sellers, however, may want to consider the emotional side of such a transaction and be prepared for what a third-party buyer might do after acquiring the business, including changing organizational culture, terminating employees, or moving the business. A private equity group may be interested in purchasing the business to incorporate it into its current holdings or build onto the business with plans to resell it later. Often some of the selling price is in the form of contingent consideration based on future earnings.

Initial Public Offering

Another way for a business owner to transition a business and realize its cash value is by taking the company public in an initial public offering (IPO). With a traditional IPO, a private company issues new equity shares that are listed on an exchange (or, alternatively, traded in over-the-counter markets) and made available to the general public to buy and sell.

The most prominent benefit to establishing an IPO is the access to liquid capital that results from opening the company up to a wider pool of investors. IPOs as a transition strategy do come with a host of complexities, however, including regulations, legal and other costs, increased public scrutiny on the business, and other factors that call for careful research and consideration.

Transition to Family Members or the Management Team

Transitioning the business to family members can be a comforting option for those business owners who wish to continue the legacy and tradition of the business, especially if the family's name is attached to it. Many business owners love the idea of having one or more of their children enjoy – and build on – the success of the business they have developed.

One potential pitfall involved with a family transition is balancing ownership among multiple family members, which can create conflict. The most successful transitions to family members are those in which the family successors spend several years working in the business, learning the business, and building respect among the employees.

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After determining a family successor or successors, various options exist for selling ownership to the family member or members and legally exiting from ownership. The transfer method chosen depends on numerous factors and circumstances. If an owner is financially secure, transfer options include a grantor-retained annuity trust (GRAT) sale, a straight gift, or an intentionally defective irrevocable trust (IDIT) sale. These options primarily use a form of gifting, which is designed to reduce the estate tax the family will owe upon the passing of the parent or parents. If the owner is seeking value from the business, then a sale of stock would be an appropriate option.

Selling the business to members of the current management team is another common transition path for business owners. This option can be a rewarding one, with business owners putting their faith in the people with whom they have worked and developed the company.

Options for selling the business to members of the management team include:

- Selling directly to the managers (generally for a promissory note funded by the earnings from the business in the future)
- Granting stock to the employees as a bonus, followed by the company redeeming the exiting owner's stock
- Selling multiple blocks of shares each year for a period of years (known as a serial redemption)

With these arrangements, the business's earnings essentially fund the purchase, which makes it a good option for employees who generally would not have the funds to directly purchase the business. Likewise, these arrangements offer benefits to the seller, including being able to leave behind the stress, challenges, and risks of running the business while still gaining financially from it.

Not a One-Size-Fits-All Approach

Business owners deserve to realize the wealth forged by the hard work of creating and running their businesses. Just as each business is unique, the transition strategy that may work for one company may not work for another.

It's important for business owners to be knowledgeable about the various transition options. Understanding the alternatives and selecting one carefully will go a long way toward making a smooth transition to retirement. Business owners should carefully weigh benefits and risks associated with various transition options and seek professional advice in moving forward.

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