Simply BUYOUT

A guide to employee buyouts and becoming an employee owned business
A good number see employee ownership as complex. It need not be. The company can be much like any other company. What is different is how it is owned.

Co-operative models are a welcome part of the employee ownership landscape here and abroad. There are many leading employee owned businesses that can be classified as co-operatives under accepted international definitions. I have helped to advise and form many myself. Co-operative forms of employee ownership help to underpin an active role for employees in terms of governance and accountability.

The review I conducted for the Government on employee ownership, which reported in 2012, concluded that clear advice and information is now a key requirement, particularly at the point of business succession and transfer. I warmly welcome this guide as key to this and wish you the best for using it.

**Foreword**

Employee ownership is high on the business and economic agenda and for good reason. Where a business is owned by its workforce, everyone has a stake in success. The longevity of companies with employee ownership is impressive. Their productivity is undoubted.
# Contents

**Introduction** .................................................................................................................................................................................... 2

Who this guide is for and what it hopes to achieve ............................................................................................................... 2

How to use this guide ....................................................................................................................................................................... 3

1 **What is employee ownership and why choose it?** ............................................................................................................. 4
  
  1.1 What is employee ownership? ............................................................................................................................................ 4
  
  1.2 The routes to employee ownership ................................................................................................................................... 5
  
  1.3 The benefits of employee ownership ................................................................................................................................ 9

2 **Choosing an employee ownership model and considering methods of governance** ...................................................................... 11
  
  2.1 The different types of employee ownership models .................................................................................................11
  
  2.2 Direct ownership ...................................................................................................................................................................11
  
  2.3 Indirect ownership ................................................................................................................................................................14
  
  2.4 Hybrid ownership ..................................................................................................................................................................15
  
  2.5 Methods of governance ......................................................................................................................................................17

3 **A co-operative dimension** ........................................................................................................................................19
  
  3.1 Voluntary and open membership .....................................................................................................................................19
  
  3.2 Democratic member control ..............................................................................................................................................20
  
  3.3 Member economic participation .....................................................................................................................................20
  
  3.4 Autonomy and independence ...........................................................................................................................................21
  
  3.5 Education, training and information ................................................................................................................................21
  
  3.6 Co-operation among co-operative employee owned businesses .........................................................................22
  
  3.7 Concern for community ......................................................................................................................................................22

4 **Key stages to achieve an employee buyout** .................................................................................................................................23
  
  4.1 Establish that a buyout is in principle possible ...........................................................................................................23
  
  4.2 The valuation, financial analysis and projections .......................................................................................................24
  
  4.3 Considering financing options ..........................................................................................................................................24
  
  4.4 Detailed presentation of investigation findings ..........................................................................................................25
  
  4.5 Preparation of legal structure and legal documents ...................................................................................................26
  
  4.6 Written offer, subject to contract ....................................................................................................................................26
  
  4.7 Conclusion of negotiations on terms of sale ...............................................................................................................26

5 **Next steps** ...........................................................................................................................................................................27

Acknowledgments ........................................................................................................................................................................... 29
There are many individual success stories, whether the iconic John Lewis Partnership with a turnover of £9bn, Mondragon Co-operative Corporation employing 83,000 people around the globe or the many smaller worker co-operatives such as Edinburgh Bicycle Co-operative with 100 worker owners and forecast to double in size by 2017.

Evidence shows that whereas only 65 per cent of conventional businesses survive the first three years, over 90 per cent of co-operatives are in still in business.

Research shows that, because employees in employee owned businesses share ownership and control, they increased their productivity over a four year period by 33 per cent, whereas employees of conventional businesses improved by just 17 per cent.

So the reason for the employee ownership sector accounting for only 2–3 per cent of GDP is not due to failure rates or poor productivity, but the lack of awareness of the model by owners, employees and professional advisors.

Worker and employee owned co-operatives form part of this wider employee ownership sector and offer a real option for those wishing to embed democratic and ethical principles into their business. This model need not be seen as a more complicated or radical option and this guide will show you why.

Therefore opportunities to adopt employee ownership are lost when employers, employees and advisors are unaware of its relevance and benefits.

This guide has therefore been produced for business owners, employees, professional advisors and individuals who are interested in what employee ownership is and how to create it, either as a result of an employee buyout of an existing business, or through the establishment of a start up business.

This guide focuses on how co-operative principles and ways of working can be enshrined into employee owned businesses.

**This guide aims:**

1. To develop a basic understanding of what employee ownership looks like for those unfamiliar with the model;
2. To provide an outline of how employee buyouts can be achieved;
3. To signpost to specialist employee ownership experts who can help to create successful and sustainable employee owned businesses enshrined in co-operative principles.
4. To inspire people to convert to employee owned businesses by showing a variety of models that could be adopted.

This guide has been written largely from the perspective of completing an employee buyout in a business succession scenario. However, the majority of the information contained within applies equally to other situations where employee ownership is being considered.

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**Introduction**

Employee owned businesses can be found succeeding across the economic sectors and operate at all levels. They are characterised by greater employee engagement, higher productivity, resilience to economic downturns and better connection with their local communities.

A key finding of the 2012 Nuttall Review of Employee Ownership was the lack of awareness of employee ownership. This was cited as one of the barriers to the further uptake of employee ownership in the private sector. Simply put, employee ownership is not widely known and is undermined by misperceptions,
How to use this guide

The guide is split into different sections covering the following areas:

1. **What is employee ownership and why choose it** – what we mean by employee ownership, the different definitions of employee ownership, the benefits associated with employee ownership and the academic research supporting it;

2. **Choosing an employee ownership model** – explaining the key models that are often implemented and highlighting their respective advantages and disadvantages;

3. **A co-operative dimension** – the key factors that need to be addressed in order to enshrine co-operative principles into an employee owned business;

4. **Key steps to achieve an employee buyout** – a step by step guide to the key actions and decisions that need to be taken to complete a successful employee buyout.

5. **Next steps** – signposting to specialist organisations that can help to deliver successful employee buyouts and suggestions of further reading and research into employee ownership.

This guide is a companion to an easy-to-use model legal template, free to download on [www.uk.coop/simplybuyout](http://www.uk.coop/simplybuyout)

Business owners and employees want to read about how employee owned businesses work in reality. Therefore throughout this guide we make reference to a number of successful employee owned businesses and highlight their ownership structure, governance systems and how they embed co-operative principles in these areas.

These businesses are:

- **School Trends** supplies school uniforms to primary and secondary schools across the UK. The company is based in Sheffield and has 120 employee owners.

- **PrimePac Solutions** is a contract packaging company based in South Wales that fills bottles, sachets and tubes for clients, including leading brands in the health and personal care sector.

- **West Highland Free Press**, based on the Isle of Skye, has been a successful Scottish regional paper for over 40 years, playing a much valued role in the communities it serves.
1. What is employee ownership and why choose it?

1.1 What is employee ownership?
There are many successful employee owned businesses in the UK operating across a spectrum of industries. They range from large businesses such as the John Lewis Partnership with more than 84,000 ‘partners’ to smaller businesses such as Ecosulis with 13 employees – and of course pretty much any size in between.

Employee ownership normally occurs as a result of a business owner selling their shareholding to the employees and, although less common, there have also been cases where a business owner has gifted their ownership stake in the business to their employees.

The number of employee owned businesses in the UK is increasing. In 2009 these businesses accounted for around £25 billion of the UK economy, or equal to 2.5 per cent of Gross Domestic Product (GDP). In 2012 it was estimated that these numbers had risen to around £30 billion and 3 per cent of GDP.

There isn’t a definitive definition of employee ownership that is universally recognised and accepted. Different businesses, trade bodies and politicians may have a slightly different definition. However, employee ownership is regularly defined as those businesses where employees own a significant stake in the business that they work for.

This definition takes in wholly employee owned businesses like Arup and Suma Wholefoods all the way through to Sainsbury’s PLC and Sports Direct PLC which operate employee shares schemes (see part 2.2) where employees own a minority stake.

There is nothing necessarily wrong with the definition above, or the position taken by different businesses and individuals. However, it doesn’t require that employees own, at least, a controlling stake in the business (over 51 per cent), nor does it ensure that employees have a significant degree of influence over the business. This is something that the co-operative sector believes is central to the notion of employees owning their business and draws a clear distinction between employee ownership and employee share schemes. The former is about employees owning their business and ensuring that it ultimately operates for the long-term benefit of employees now and in the future, whereas the latter can often be simply a form of enhanced remuneration without any influence over the business.

This guide is written for those interested in creating employee owned businesses where employees own at least a controlling stake, not for those looking to incorporate enhanced remuneration schemes.

For the purpose of this guide we define co-operative employee ownership as:

‘A business that operates primarily for the benefit of all of its employees, that involves them in key decision making and that is owned by them, ideally in whole or, failing that, with a majority stake.’

We can break this definition down as follows:

‘Operates primarily for the benefit of all of its employees’ – the business should operate for the benefit of all employees, not just for a select few. The business needs to be commercially viable, but profit at the expense of everything else is not the sole driver.

The purpose of the business is to provide employment opportunities now and in the future, good terms and conditions, opportunities to share in the profits generated and to do good in society.
‘Involves employees in key decision making’ – for the avoidance of doubt we are not advocating that employees should be involved in every single decision that is made! What we do advocate is that decisions should be pushed down the organisation as far as possible and employees should be consulted on key decisions that will affect them and the future of their business.

‘Owned by employees in whole or with a majority stake’ – as a co-operative, the business should be at least 51% owned and controlled by the employees, or be working towards this via a phased sale to employees. Anything less than this means that ultimately the purpose and long term future of the business might not be aligned with the employees’ interests.

The co-operative dimension helps to ensure that a business is not just owned but is also ultimately controlled by employees.

1.2 The routes to employee ownership

There is a variety of different situations that might result in people exploring the possibility of becoming employee owned. This guide focuses on employee ownership as a result of a business succession scenario as outlined below.

1.2.1 Business succession

Most business owners recognise that one day they will want, or need, to withdraw or retire from their business. Businesses owned by a small number of people may find business partners want, or need, to exit the business. Family owned businesses might struggle to pass on the business to the next generation. In any of these situations it makes sense to plan for these types of eventuality rather than become a victim of circumstance and unplanned consequences.

Business succession can often be categorised as follows:

- **Retirement** – where a business is privately owned, the sole or principal shareholder may be nearing retirement and may want to sell their stake in the business. An increasing number of business owners are concerned about whom they sell their business to, especially if they want to maintain the independence of the business and ensure it doesn’t deteriorate and jeopardise employees’ jobs. For some owners the prospect of selling to a competitor with whom they’ve competed for a number of years is not attractive. The sale of the business to employees protects the workforce, maintains its independence, keeps the business in the community and ensures that the name above the door need not change.

- **Family business** – recent studies have highlighted that most family businesses do not continue past the second generation of family members. Employee buyouts can often be seen as the best way of ensuring that the family business ethos and culture can continue.

- **Realisation of investment** – the current owners of a business may require their funds, or may not want to continue with their investment in the business, or due to personal circumstances might need to realise their value at short notice. Employees may see the unrealised potential of a business and be willing to purchase the business from the outgoing owner.

- **Exit of a business partner** – where only one of the owners wishes to exit the business and the remaining owner is unable or unwilling to buy the shareholding available, the employees are likely to be seen as a far better option than an unknown outside replacement investor.

- **Divestment** – there have been a number of instances where a parent business wishes to sell a subsidiary, which is not part of its core activity or part of its future plans, in order to obtain funds to reduce borrowings or make an investment elsewhere, or for other strategic reasons.

If the subsidiary can continue to be a viable business an employee buyout can ensure that jobs are preserved and the business can continue to impact on the local economy. The reality is that these situations have been few and far between in the UK. Business succession is obviously a key issue facing business owners, who often see no easy way of realising the value built up over the years while safeguarding the jobs of longstanding and loyal employees.

Selling the tangible assets may realise only a fraction of the going concern value and a trade sale opens up the intimate details of business to competitors.

In most circumstances exiting business owner will be advised to consider a trade sale, management buyout or liquidation as their primary exit options. Professional advisors might suggest employee ownership as an option, but historically this has not been the case and is one the barriers to the growth of employee ownership amongst private business.
identified by the Nuttall Review. The result is that business owners might well be making an ill informed exit decision if employee ownership has not been considered.

**Liquidation** – when a business is terminated or bankrupt, its assets are sold and the proceeds pay creditors. Any leftovers are distributed to shareholders.

**Management buyout** – when a business is bought by the management team and the majority of employees are excluded from the process.

A trade sale, management buyout or liquidation might be a suitable solution for some business owners, but when making such an important decision we would suggest considering the following questions to help determine whether these options are feasible and will deliver the desired outcomes:

- **Do you really want to sell to a competitor?** – do you want to share the businesses accounts? Do you want the name above the door to change? Do you want the business to lose its independence?

- **Will the management team really be able to fund a purchase?** – will they be able to raise sufficient funds to buy you out? What about the other employees who have not had an option to be involved? Does this create a sound platform for the future of the business?

- **Is secure employment for your longstanding and loyal employees important?** – will a trade sale ultimately result in the business being stripped back, with roles consolidated and job losses? Will a management buyout ultimately lead to a future trade sale?

- **Is continuity of the business important?** – if you have spent years building up the business do you really want to shut the doors? Would a liquidation of the assets realise anything like the value of the business as a going concern?

- **Do you want the value and commitment to the local community to disappear?** – a trade sale will occur where an external party sees value in your business either now or in the future and the feasibility of many trade sales is based on the costs savings to be found by removing duplication of functions and people.

In addition to these questions it is advisable to consider the respective benefits and shortfalls that are associated with these exit options.

**Earn out** – when a payment to shareholders selling their shares in a company is contingent on the achievement of certain performance criteria (e.g. company profits) over a specified period after the closing of the sale.

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### Shut down/liquidate

**Benefits**

- Quick and easy
- Know what the resulting business is worth
- Not reliant on waiting for payments spread over a number of years

**Shortfalls**

- Normally the last resort option
- Could be the lowest return
- No desire to see employees benefit
- No legacy
- No continuity for customers/suppliers
- Jobs lost from local economy
- Redundancy and other costs associated with liquidation often underestimated
### Management buyout

**Benefits**
- Positive if the management team has the required skills
- Gain for managers
- The management team should understand the business
- Does not have to open up books to competition
- Job continuity likely for all/most
- Owner could retain an interest in the business
- Owner gets a reasonable price
- Increased loyalty of managers
- Continuity for suppliers and customers

**Shortfalls**
- Benefits the few managers, not the many employees
- Burden of debt secured against the company, but benefits only management owners
- Concern if management team doesn’t have the skills
- Only delays the succession issue (managers will want to sell once they have increased the value)
- Non-management employees’ contribution not recognised/rewarded

### Trade sale (traditionally the most common option)

**Benefits**
- Owner gets the best price (highest bidder) and can exit
- Incentive for the owner to get the business in the best possible shape
- Can be positive in terms of growth opportunities if a ‘good’ takeover with synergistic opportunities

**Shortfalls**
- Could be a longer process than other options (due diligence, price negotiation, etc)
- Little protection for employees as cost savings identified and job losses more than likely
- Could require relocation of business
- No heritage guarantee (business could be wound up or rebranded)
- Opens up books to the competition
- Business might be bought solely to asset strip
- If business closed down, owner may be perceived negatively in the community and remaining there could be uncomfortable
- Employees who helped grow the business are unlikely to benefit in any way
- Could require continued involvement of owner if ‘earn out’ is included
Some business owners will of course still opt for a trade sale, management buyout or liquidation. However, the statistics show that an increasing number of entrepreneurs, business partners and family owners wish to retain what is unique, distinctive and valuable about their business and have been persuaded to choose the employee ownership option because they have been made aware of the numerous benefits that an employee buyout could deliver.

Although this guide focuses predominantly on a business succession scenario the following are also routes to becoming employee owned:

1.2.2 As an engagement mechanism – some business owners have embraced widespread employee ownership of the business as they believe it will lead to greater levels of engagement and this will ultimately lead to productivity and performance gains.

Some business owners have adopted this approach as a ‘starter/feeder’ mechanism to becoming fully employee owned over the longer term. In these scenarios a small percentage of ownership is initially shared by all employees on the basis that the owner will sell the remainder of the business at a later stage when the value of the business has increased as a result of all employees having a vested interest in seeing the business grow.

1.2.3 Business in distress – a poorly performing business may be threatened with closure by its current owners to prevent further losses. In order to save their jobs, the employees could buy the business from the current owners. This is a high risk situation and it would not be advised unless a viable business proposition has been identified and there is evidence of why an employee owned business would succeed where others had failed. A useful start point is to read Saving Business through Worker Co-operatives by Dr Anthony Jensen.

1.2.4 Public service mutuals – in the current economic climate the UK government has sought to move out some public sector departments and services to the private sector with the intention of allowing some form of employee ownership as an option. This guide is aimed at encouraging private sector transitions; however more information about setting up a public service mutual can be accessed through the Mutual Information Service.

http://mutuals.cabinetoffice.gov.uk/

### Employee owned

**Benefits**

- No negative effect on local economy through loss of business/jobs
- Continuity for customers and supplier
- Owner can secure fair price
- Books (accounts) not shown to competition
- Some tax benefits
- Loyal employees gain secure employment
- Owner perceived highly in the community
- Owner can retain a role in the business
- Business can take long term decisions as less dependent on external investors
- Owner can gradually exit over time as agreed with employees

**Shortfalls**

- Payment might be spread over a number of years
- Burden of debt on the business
- The business may not have the necessary skills if the owners step away
- Might be the need for a significant culture shift if the owner has been autocratic
School Trends became an employee owned business in 2004 when the founder owner decided that he wanted to consider his exit options. A key consideration for the owner was that he wanted the business to continue to operate with the community type ethos and culture that had been developed, wanting the employees to benefit from the future opportunities open to School Trends and not wanting to sell out to a competitor. An employee buyout was the obvious choice to achieve his objectives. Employees were consulted on the possibility of an employee buyout and a ballot was held, with over 80 per cent of the employees voting in favour.

PrimePac Solutions was formed when Budelpack decided to withdraw from Wales following a fire, which destroyed its packing facilities. Having been inspired by the famous nearby Tower Colliery buyout where 250 miners bought the pit from the National Coal Board, 19 former Budelpack employees used their redundancy payments to form PrimePac and buy machinery in order to resume trading.

West Highland Free Press moved to employee ownership in 2009 when the original founders and shareholders looked for an exit strategy as they reached retirement age. The owners were keen to ensure that the paper remained independent and offered the employees the option of purchasing the business. However, had the employee buyout not been completed, the reality is that a trade sale would have been chosen and the paper would have lost its independence and place in the community.

1.3 The benefits of employee ownership

Businesses across the UK wrestle daily with the challenge of ‘engaging’ employees. Most business leaders accept and agree that the financial success of a business relies on the wholehearted participation and discretionary effort of their employees. The most successful businesses are those that devise strategies and tactics that encourage employees to actively go about creating value rather than passively following others.

There are many tried and tested tactics implemented to drive ‘engagement’ that result in employees ‘going the extra mile’ and feeling positive about the role they play within the organisation. The reality though is that the wealth generated as a result of this going the extra mile in the main flows to somebody else rather than the employees and they become acutely aware of this.

Employee ownership presents a ‘win-win’ opportunity for everyone involved in a business, the logic being that employees with an ownership interest will be more motivated and committed to producing successful outcomes. If this is combined with a culture of engagement where employees are treated with respect and involved in appropriate levels of decision making, the business becomes more productive, competitive and entrepreneurial. Employees share in the benefits resulting from the use of their talents and energy, so going the extra mile is now in their interests as owners which in turn will help the business outperform its competitors.

The ever increasing body of research provides compelling evidence that employee ownership provides a range of benefits to the business, individuals and the macro economy.

Academic studies have associated employee ownership with higher productivity levels compared to companies without employee ownership.

Employee owned businesses with fewer than 75 employees performed better on profitability compared to non-employee owned companies. This is significant when you consider that the Office for National Statistics reported that of the 2.08 million enterprises registered for PAYE and VAT 98 per cent of these had fewer than 50 employees.

Employee owned businesses tend to be more sustainable (less likely to fail than traditionally owned businesses) and are able to take a longer term view as there are no external shareholders requiring short term returns. In times of recession, employee owned businesses are shown to outperform traditionally owned businesses. Research from the Cass Business School found that their performance over the business life cycle is more stable and sales growth between 2008 and 2009 was 11.8 per cent for employee owned businesses compared to 0.61 per cent for non-employee owned businesses.
The Employee Ownership Index (EOI), compiled by Field Fisher Waterhouse LLP, is an index of the share prices of UK public companies quoted on the London Stock Exchange and AIM that have 10 per cent or more of their issued share capital held by or on behalf of employees other than main board directors. The EOI started in 1992 and shows that, despite the drop in performance seen in 2011, employee owned businesses have outperformed FTSE All-Share companies by on average 12 per cent each year. Over successive three-year periods they have outperformed by 37 per cent and over successive five-year periods by 71 per cent.

Employee owned businesses that combine share ownership and employee involvement report very high levels of employee engagement, employee commitment and retention and low levels of absenteeism. The Sunday Times Top 100 Companies To Work For included a number of employee owned businesses such as Lindum and Childbase. The Macleod Review of employee engagement, the most significant review of employee engagement in the UK, found that “employee ownership was a profound and distinctive enabler of high engagement”.

Employee owned businesses benefit the communities they operate in because the rewards are shared among the people who work within the business rather than going to a single owner or external shareholder, as is the case in more traditional structures.
2. Choosing an employee ownership model and considering methods of governance

2.1 The different types of employee ownership models
An employee owned business can be structured in a number of ways. However, most will normally choose direct, indirect, or a hybrid models of ownership.

**Direct ownership** – individual employees directly own shares in the business they work for. This ownership may have been facilitated through employees purchasing shares using tax advantaged share schemes.

**Indirect ownership** – an employee trust owns shares in the business on behalf of beneficiaries. The beneficiaries of the employee trust are the existing employees, past employees and future employees. The employee trust holds these shares with no intention of ever selling them and any benefit derived from holding them is solely for the beneficiaries.

**Hybrid ownership** – a mixture of both direct and indirect ownership – ie individual employees directly own shares and an employee trust also owns shares.

It is important to remember that there is no ‘right’ or ‘wrong’ employee ownership model and ultimately businesses will choose different models to achieve different objectives.

It is worth considering the key differences between direct and indirect ownership before making any decisions on how to structure an employee buyout.

2.2 Direct ownership
The direct ownership model allows employees to become shareholders in the business they work for. One of the compelling arguments for direct ownership is that owning a tangible personal stake might make ownership feel ‘real’ when compared to an employee owned business owned indirectly through an employee trust.

As a shareholder, employees are able to influence key decisions that affect their business such as appointing and removing directors, any sale of the business or its subsidiaries, any acquisitions of other businesses or joint ventures, etc. The governing documents for the
business will determine what types of decisions need to be referred for shareholder consent.

In addition to being able to influence the business, employee shareholders also have the opportunity to benefit directly from its successes. This benefit is normally through dividends (which are more tax efficient than cash bonuses) and an increase in share value. When an employee leaves the business they own shares that they can offer for sale and realise the value they have helped to create over the years.

However, like any other investment, should the business not be successful employee shareholders carry the risk of their investment losing value and potentially becoming worthless should the business fail.

The direct ownership model occurs in buyout scenarios where employees purchase shares from the outgoing owner.

The shares purchased would normally be Ordinary Shares issued on a one-person one-vote basis, irrespective of the number of shares purchased. It is normal to have a shareholding limit written into the Company’s Articles of Association so that, for example, no employee can have more than 5 per cent of the total issued share capital. This ensures a spread of ownership and prevents a block of shares being held by a small number of employees who might develop different objectives and agendas.

The benefits and potential shortfalls of direct ownership are summarised in the table below.

In most cases it will not be possible for employees to raise sufficient funds to purchase all of the shares from an outgoing owner and therefore the opportunities for a direct ownership model are limited.

When PrimePac Solutions was originally formed in 2005 it was directly owned by the 19 employees who each purchased shares to fund the formation of the business. The employees agreed that they would each purchase an equal number of shares so that there was no potential for people to build up a disproportionate stake and want to have more influence. After a challenging start PrimePac has been very successful and employees have benefited from dividends in excess of their original investment, alongside an increase in the value of their shares.

### Direct ownership

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Potential shortfalls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Able to influence/control the business</td>
<td>At some point shareholders will want to sell. Needs some form of market for the shares</td>
</tr>
<tr>
<td>Right to dividends based on number of shares held by each shareholder</td>
<td>Limited market if only other purchaser is fellow employees who may already have enough shares</td>
</tr>
<tr>
<td>Right to attend the annual general meeting (AGM) or general meetings (GM) and vote on key decisions that will affect the business</td>
<td>If the business wants to fund the purchase this will impact on cash as the money will need to be found from within the business’s own funds</td>
</tr>
<tr>
<td>If the business is successful, shareholders have the potential of seeing this reflected in the share price</td>
<td>New employees who join and contribute to the success may not be able to buy shares if existing holders do not want to sell and will not agree to new shares being allotted</td>
</tr>
<tr>
<td>Shareholders share in the capital of the business if it is wound up</td>
<td>Value of investment could of course drop if the business isn't successful</td>
</tr>
</tbody>
</table>
2.2.1 Direct ownership facilitated through HMRC approved share schemes

Many of the employee owned businesses in the UK operate employee share schemes. Different commercial or cultural reasons will have a bearing on which employee share schemes are implemented. Employee share schemes are normally implemented for the following reasons:

- They facilitate employees owning shares and give tangible ownership in the business;
- They align the employees’ interests with that of the business through share ownership;
- Employees are encouraged to think, feel and act like owners through linking between better business outcomes and performance to increased share value and dividends for individuals;
- They attract, retain and motivate employees;
- There are possible significant tax savings for both the business and employee while offering long term reward.

It is vital that when determining the employee ownership structure and detail of the employee buyout that consideration is given to these reasons before deciding on whether or not to implement an employee share scheme.

2.2.2 What are the options?

Employee share schemes can be structured to incorporate all, or a mix, of the following three main aspects:

- **A gift of shares** – an employee immediately becomes a shareholder as a result of being ‘gifted’ shares, free of charge, in the business they work for. As a shareholder the employee can then benefit from any dividends and any increase in the share value. However, in most instances where an employee is given something of monetary value, such as shares, by their employer this will be treated as a benefit in kind. As such the employee will be subject to income tax and National Insurance contributions and the business will be subject to employer’s National Insurance contributions.

- **Employee share purchase schemes** – these facilitate employees buying shares from the company, share incentive plan, or employee benefit trust. Again, the benefit of an employee owning shares is through dividends and any increase in the share value.

- **Share options** – this gives an employee the right to purchase shares in the business at some future point at a predetermined price. There is no risk, or benefit, for the employee until the shares are bought. If the price increases the employee exercises the option: if the price decreases the employee can decide not to exercise the option.

There are HMRC tax advantaged share schemes (see below) that incorporate the above options and make it easier for employees to acquire and own the business’s shares.

2.2.3 Tax advantaged share schemes

There are currently four HMRC approved tax advantaged share schemes that might be considered by a business:

- **Share Incentive Plan (SIP)** – offers tax and National Insurance advantages for employee gifted and purchased shares.

- **Save As You Earn (SAYE) share option scheme** – employee share ownership via options.

- **Enterprise Management Incentive (EMI)** – an option scheme designed to help smaller businesses retain talent.

- **Company Share Option Plan (CSOP)** – allows options to be granted to selected senior employees.

As the primary purpose of this guide is to encourage the transfer to employee ownership as a result of an employee buyout we focus on the Share Incentive Plan (SIP) as it is the only tax advantaged share scheme that allows for the purchase of shares.

A number of employee owned businesses use a SIP to encourage direct share ownership. A SIP is basically a trust, designed by HMRC, to encourage the direct ownership of shares by employees in a tax-efficient way.

The SIP is an ‘all employee’ scheme and the legislation provides for four main types of plan shares to be used. They are:

- **Free shares** – each employee can receive ‘free’ shares worth up to £3,000 each tax year;

- **Partnership shares** – employees can use their pre-tax and pre-National Insurance contributions salary to purchase up to £1,500 of shares each tax year;
• **Matching shares** – employers can give matching shares at a ratio of up to two matching shares for each partnership share bought by employees;

• **Dividend shares** – employees can use the dividends received from their other plan shares to purchase more shares through the SIP.

A SIP can be used to facilitate the purchase of shares in a buyout situation by providing a tax effective route to encourage direct shareholding, but the limit of £1,500 for partnership shares means that using a SIP alone is unlikely to result in a buyout being completed.

As financial reward is through dividend payments, **PrimePac Solutions** installed a SIP in 2012 to encourage those employees without any shares to directly purchase shares in the business in a tax efficient manner. As the SIP is an all employee scheme all employees were given the opportunity to participate. The SIP was chosen as it allowed employees to purchase shares through monthly deductions from their gross salary, before deductions for PAYE and National Insurance contributions, rather than require a lump sum payment for the value of the shares.

**School Trends** is in the process of installing a SIP. Although all employees already own shares in the business it is hoped that offering a method to receive shares in a tax advantaged way will encourage employees to build up their shareholding.

### 2.3 Indirect ownership

An employee trust owns shares in the business on behalf of beneficiaries. The beneficiaries of the employee trust are the existing employees, past employees and future employees. The employee trust holds these shares with no intention of selling them and any benefit derived from holding these shares is solely for the beneficiaries. One of the compelling arguments for indirect ownership is that it ensures long term stable employee ownership because the shares in the trust don’t need to be sold again, whereas shares held directly by employees will be regularly sold when employees leave the business and this needs to be financed.

Trustees manage the employee trust and a ‘trust deed’ details the purpose of the employee trust and the power and duties of the trustees in managing the affairs of the employee trust. The key duty of trustees is to act in the best interests of the beneficiaries. The trustees take on the role of shareholder and are able to influence key decisions that affect the business such as appointing and removing directors, any sale of the business or its subsidiaries, any acquisitions of other businesses or joint ventures.

**Trust deed** – a legal document that sets out the powers and duties of the trustee. An example trust deed can be downloaded from [www.uk.coop/simplybuyout](http://www.uk.coop/simplybuyout) as part of the model rules.

Employees are beneficiaries of the employee trust, not direct shareholders, therefore they have no right to any dividend, nor do they own shares they can sell when they leave the business in order to realise the value they’ve helped to create.

The employee trust is discretionary, allowing the trustees wide scope in deciding how benefit should be allocated to beneficiaries. For a vast majority of employee owned businesses using a trust this benefit might simply be a cash bonus paid to all employees in lieu of the employee trust receiving its dividend. This cash bonus would attract the normal PAYE and National Insurance contributions deductions.

The John Lewis Partnership is probably the best known example of an employee owned business with an indirect only ownership model. The 39 John Lewis
stores and 291 Waitrose supermarkets are owned by a trust on behalf of the 84,500 John Lewis partners. In 2013 John Lewis announced that the partnership bonus payable to ‘partners’ was equivalent to nine weeks’ worth of salary. In addition to these financial benefits ‘partners’ also benefit from discounts on their purchases from the department stores and supermarkets, a range of ticket subsidies and holiday and leisure facilities.

2.4 Hybrid ownership

This is a combination of direct and indirect ownership. For example, 80 per cent of the shares could be held by the employee trust, with the rest directly owned by the employees. There are no fixed proportions for this shareholding split.

The compelling argument in favour of the hybrid model of ownership is that it combines the various benefits of both direct and indirect ownership while reducing their respective shortfalls.

Indirect ownership

Benefits

A key attraction is that the business can be run for the benefit of the employees for the long term as the employee trust would never need to sell the shares and it would be established with the purpose of ensuring that the business is run for the benefit of the employee owners.

It would be possible to enshrine some principles and guidelines into the trust deed to guide the trustees to ensure that the business operates in a certain manner.

As nobody other than the employee trust would own shares there is no requirement to find money to buy shares when employees leave.

As the shareholder the employee trust could receive dividends and pay these to employees as a bonus, or simply waive their right to dividend and let the business use the waived dividend to pay a cash bonus.

The employee trust is a discretionary trust so the trustees can determine how they want employees to benefit from time to time.

Potential shortfalls

The employees are not direct shareholders – they are simply beneficiaries – and as such have no legal right to attend and vote at the AGM or any general meetings.

The employees would have no legal right to any dividends, as they are not direct shareholders. Any dividends would be received by the employee trust who may decide not to distribute them to the employees.

If the value of the business increases the employees will not benefit from this as they don’t directly own shares that could have increased in value.

Bonuses paid via the employee trust will be tax inefficient and additionally the employees would be liable for PAYE and National Insurance contributions on any bonuses they receive from the trust.

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Hybrid ownership

The shares held by the employee trust can be ‘warehoused’ for the long term to ensure that the business runs for the benefit of its employees.

The shares held directly by employees will allow them to receive dividends, share in any increase in value of
the business and allow employees to influence the business through the voting rights attached to the shares.

As with the direct model there is still a need to finance the purchase of shares from employees when they leave the business, but if the vast majority of shares are held by the employee trust the purchase of a minority of shares will be easier to finance. The employee trust can act as a ‘market maker’ and purchase shares from outgoing employees and sell shares to new employees.

**West Highland Free Press** has a hybrid model whereby 85 per cent of the business is indirectly owned through an employee benefit trust on behalf of employees and this ensures that the business can remain forever employee owned. The employees as individuals own the remaining 15 per cent of the business and will be able to benefit from any increase in value of the business in the future.

**School Trends** has a hybrid model. An Employee Benefit Trust owns around 95 per cent of the business with the remaining shares owned directly by employees. A SIP has recently been installed to encourage employees to directly own more shares. To ensure future employee ownership, the employee benefit trust’s shareholding cannot fall below 50.1 per cent.

**PrimePac Solutions** has a hybrid model. It has shares held directly by employees and indirectly through an employee benefit trust and through a SIP. Unlike School Trends and West Highland Free Press the vast majority of shares are owned directly by employees because PrimePac believes that employees should benefit directly through owning shares. An employee benefit trust was installed in 2012 in order to act as a ‘market maker’ and purchase shares from employees when they leave.

**Hybrid ownership**

**Benefits**

- The majority of shares can be held in the employee trust to secure long term employee ownership
- The minority of shares can be held directly by employees, giving them the legal right to attend AGMs, receive dividends and benefit from any increase in the value of the business
- An employee trust can act as a ‘market maker’ and purchase shares from employees who leave (subject to it receiving ‘gifts’ from the business)
- The employee trust could sell shares to new employees
- The employee trust could still waive its dividend and the other shareholders could share the dividend pot

**Potential shortfalls**

- Depending on the voting structure of the business the employee trust may be able to determine the outcome of all key decisions – which might be seen by employees as undemocratic
- The employee trust doesn't normally receive any income. Therefore it is reliant on the company to provide funds to allow it to purchase shares
- Management and administration are linked to managing the employee benefit trust and any share scheme (compared to direct ownership)
2.5 Methods of governance

An essential ingredient of co-operative employee ownership is ensuring effective employee voice and governance. Employees should have a right to participate in the governance and, where appropriate, management of their business. They should have easy access to relevant information relating to the success, or otherwise, of the business that they own.

There are no ‘right or wrong’ methods of governance and businesses will be influenced by their individual objectives and circumstances when determining what methods to implement. However, it is important that some form of mechanism is put in place to ensure:

- That there is some form of representation or democratic voice for employees at board level;
- That employees are able to hold the board of the directors to account for the running of the business, either directly or indirectly through elected trustees;
- That employees are encouraged to improve the business and play their part in identifying and implementing suggestions;
- That there is a regular flow of relevant information, delivered in a way that employees understand, relating to the progress the business is making in relation to its stated objectives.

Employee owned businesses use a variety of methods to provide governance and employee voice. These may include:

2.5.1 Employee directors

Employees elect a fellow (often non-management) employee to become a director of the business. The purpose of this position is to provide the board with an employee perspective to aid its discussions and decisions. This means they work with the board to ensure that employee views are taken into account at all decision-making levels – strategic, operational and tactical. This role can also help to maintain open channels of communication with the employees to help foster better understanding of views and concerns. The employee elected director has the same legal duties as other directors and their first and foremost responsibility is to the business.

2.5.2 Employee trustees

If an employee owned business has either an employee benefit trust or SIP it will require trustees to manage the affairs of these trusts. Employees elect a fellow (often non-management) employee to become a trustee. The role of the trustees is to manage the affairs of the employee benefit trust and hold shares in the business and act in the best interest of beneficiaries. The employee elected trustee works with other trustees (for example an appointed and an independent trustee) to hold the board of the trading business to account and ensure that the business is being run as a successful employee owned business. The trustees do...
not run the company and therefore should not try to interfere with how the board run the business.

2.5.3 Employee ownership council

Employees are elected to some form of representative body. This body might for example act as a conduit between the employees and their board and may have a remit to act in the best interests of the employees.

Ultimately it is up to the business to decide what types of governance it wishes to include. Some employee owned businesses use all of the above governance methods, whereas some may operate only one method.

**PrimePac Solutions** doesn’t specifically require employee elected directors as part of its Board, but it does allow any employee members to put themselves forward to be appointed to the Board at the AGM of the business.

**West Highland Free Press** elects three employees to the Board and they play an active role in helping to develop the business both commercially and culturally.

**School Trends** operates a ‘governing council’ comprised of four elected employees. The governing council remit is to “work with the Board in a participative style to keep the business strong and in employee ownership”. The governing council is involved in determining the social impact of future strategy and policy and any changes to terms and conditions of employment need to be agreed by them. The governing council elect two of its number to the Board and also to the Board that controls their employee benefit trust and SIP.
3. A co-operative dimension

Co-operative and mutual considerations
Co-operative employee owned businesses come in many forms, but underpinning these, in the UK and around the world, there tends to be a common set of values and principles. They apply the values of co-operation – such as democracy, equality and solidarity – in the way that they work. They are also aligned with a number of key principles. These key principles and examples of how they can be put into practice, for illustrative purposes, are described below.

Worker co-operatives are a form of employee owned business that operate with specific commitments to democratic practices. Their code of good governance can be found here: www.uk.coop/workercode

3.1 Voluntary and open membership
An employee owned business functions best as an inclusive team of members with long-term collective interests in the success of the business.

Membership must be open to all employees who are able and willing to accept the responsibilities of membership. Membership must be voluntary and might require that employees complete a probationary period before being eligible to apply for membership.

School Trends requires that employees purchase a minimum number of shares (5 per cent of annual salary) as a condition of employment. New employees have 12 months to purchase shares, but this purchase of shares is a non-negotiable condition of employment.

At PrimePac Solutions employees must have completed a period of 12 months’ continuous employment (either full or part time) before they are eligible to purchase shares in the business.

10 of the 15 employees of West Highland Free Press raised 15 per cent of the money required to complete their employee buyout. Without this show of commitment from the employees the buyout would not have been completed.

It is vital that employees understand how the ownership structure works and why it should be beneficial to them, their colleagues and the wider community. Additionally, there should be an agreed set of responsibilities that all members understand and adhere to. Being an owner is about sharing the risks and benefits; not just the benefits!

School Trends ensures that prospective employees understand the ownership structure of the company by covering this as part of the recruitment process. Additionally, on joining the company employees take part in a thorough induction process that details the ‘rights and responsibilities’ of being an employee owner.
3.2 Democratic member control

Employee owned businesses are democratic organisations controlled by their members, who also set policy and make key decisions. These businesses succeed when employees actively participate in transparent and fair decision making and long term planning.

A core aspect of democratic control is that key ‘governance’ decisions are decided on the basis of ‘one person one vote’ regardless of the number of shares an individual employee might own. Operating in an inclusive way makes for a different kind of workplace, but it is misconception to assume that this makes for slow decision making. Giving people some form of a say in relation to big strategic decisions can make all the day to day decisions that follow easier to apply.

People take more of a responsibility for decisions if they have had a say in how they have been reached. Leadership in a co-operative employee owned business, in turn, can be more effective, because there is a mandate on where to lead … and where to follow.

The application of this principle varies between employee owned businesses.

PrimePac Solutions applies this principle for all key decisions. Even though the employee benefit trust owns over 25 per cent of the business’s shares the trustees still only have a single vote and as such are treated in exactly the same way as any other employee member of PrimePac when it comes to determining key decisions. This approach is written into the articles of association. Therefore, any key decisions that require shareholder consent are determined by the employees in a democratic manner.

Decision making related to day to day operations should be pushed as far down the organisation as possible on the basis that employees with a vested interest in the businesses success will want to find the best ways of completing actions.

3.3 Member economic participation

The primary objective of any employee owned business is to operate for the benefit of the employees. Therefore the business should aim to offer pay and benefits sufficient to sustain long term employment and membership, to enable the business to attract and retain the required skills and experience.

Employee owners don’t bite the hand that feeds them and while they might want to share in the profits of the business, they will also want to ensure a sustainable business that operates with a long term vision.
School Trends is a seasonal business and is typically very busy through the summer months. The business has historically relied on using temporary staff to cope with the additional demand, but this has required using an overdraft facility to cover the additional costs, particularly for building stocks for that busy period. Following the economic crash of 2008/9, School Trends asked employees for ideas to generate savings. Among the 200-odd ideas was a suggestion that, rather than employ temporary staff to cover the additional summer demand, employees would work five extra hours per week for free. Over 98 per cent of employees agreed (within a day of sharing the idea) with this suggestion, saving the business over £70,000. Overall, all of the cost saving initiatives that were implemented saved the business £800,000.

Where employees have individually invested in the business there should be clarity around how they might benefit from this investment in both the short and long term.

At PrimePac Solutions the directors have given consideration to how profits will be split between reward for shareholders and ensuring the sustainability and growth of the business.

Sharing of profit should be fair and equitable between employee owners, relative to their contribution.

3.4 Autonomy and independence

Employee owned businesses should be controlled and influenced by the employees not by external individuals who might have conflicting aims and objectives. If there is a need to raise external finance this should not be at the expenses of this autonomy.

Like any other successful business it is essential that good financial and management controls are in place and appropriate employees actively manage key aspects of the business.

Being aware of internal and external risks will mitigate challenges and possibly provide opportunities to take advantage of business opportunities.

3.5 Education, training and information

Employee owned businesses provide education and training for employees so that they are able to contribute effectively to the development of the business and appreciate the benefits of the employee owned structure. They also ensure that employee owners are regularly kept informed about their business. This approach ensures that employees understand their business and in terms of the ownership model are better able to inform the general public of the nature and benefits of employee ownership.

West Highland Free Press has embraced the idea of sharing relevant information with its employee owners. Every month a meeting with all employees is held and the business’s finances and cash flow are discussed, minutes from the previous Board meeting are shared and employees are encouraged to question any aspect of the business they are unclear about.

PrimePac Solutions holds regular briefing sessions with employees to ensure that everyone is aware of what is happening within the business in terms of sales, financial results and any other relevant information such as changes to policy.

School Trends operates a monthly ‘policy and ‘information’ meeting and also has ‘action groups’. These meetings cover all employees and are used to share information and also to generate ideas about how teams can improve their parts of the business. Additionally, School Trends make sure that employees feel valued. A recent award night held to celebrate the efforts of their employees was attended by 123 of the possible 124 employees.

It is essential that the business assesses the technical, management and co-operative skills needed to achieve long-term plans and ensure replacements for employees who retire or leave.

Alongside education and training related to the running of the business, it is also essential that employees involved in the governance of the business receive training to help them fulfil their role.
### 3.6 Co-operation among co-operative employee owned businesses

A large number of employee owned businesses regularly open their doors and allow other organisations to learn about their business and methods of operation. Sharing of best practice and encouraging trade between co-operative employee owned businesses helps to widen knowledge.

**School Trends** regularly hosts visits from other employee owned businesses and also for individuals and groups who are considering employee ownership.

Paul Wood, the Managing Director of **West Highland Free Press**, is an ‘Employee Ownership Ambassador’ for Co-operative Development Scotland and talks to business owners about the benefits of employee ownership.

**PrimePac Solutions**’ MD, Steve Meredith, has been involved in a number of employee ownership awareness raising events organised by the Wales Co-operative Centre to promote the business model to owners considering succession.

### 3.7 Concern for community

Employee owned businesses tend to have strong links with the local community because their employees live and work there. Building good relationships with the local and wider communities helps to create goodwill and gives employees an opportunity to give ‘something back’.

**School Trends** plays an active role in its local community and has been involved in a ‘right to read programme’ helping people to read, and also supported and helped raise money for Amy’s Retreat, a charity helping families who have children with cancer.

**West Highland Free Press** has always fostered very strong links with its community and its continued independence, possible only through employee ownership, means that it is able to continue to give a voice to the local community.
4. Key stages to achieve an employee buyout

Employee buyouts provide an ideal business succession solution and the key stages involved in achieving a successful buyout are listed below.

An employee buyout is a complex transaction and will normally involve a range of professional advisors such as solicitors and accountants. Anyone considering undertaking an employee buyout should seek advice from employee buyout specialists to ensure that the ownership model and future of the business is delivered as intended.

Stage 1

4.1 Establish that a buyout is in principle possible

For any employee buyout to succeed it is essential that there is a business owner who wants to sell their ownership stake in the business and employees who want to become owners of the business. At this early stage it is important to establish some key facts to help determine whether an employee buyout is feasible.

- **Who actually owns the business?** The business might have a single owner, but there are many instances where ownership is spread across different parties. Some business owners may have transferred a proportion of their ownership stake into a trust for future family generations. Therefore it is imperative to identify all of the owners of the business to ensure that there is a general agreement to the concept of selling to the employees.

- **What is being sold?** Typically an employee buyout will involve either the purchase of the owner’s shares, or the purchase of the assets of the business. It is important to clarify exactly what is expected to be included as part of the deal. For instance, some businesses will trade from property that is owned by the seller individually rather than the business and this will not be included within the sale.

- **Why does the owner want to sell?** In most cases the exit will be due to retirement, realising investment value, a desire to do different things etc.

However, it is important to clarify the reasons behind the exit and ensure that the operation of the business is commercially viable and has a future.

- **What is the attitude of management/employees to the prospect of an employee buyout?** While the business owner might be a ‘willing seller’, it is obviously important that the management and employees of the business are open to the prospect of an employee buyout and becoming a ‘willing buyer’.

- **What does the business do?** Clearly it’s important to understand what the business does, where it gets customers from, its level of sales and profitability and its viability in the future.

- **What are the valuation assumptions?** An independent valuation may have been undertaken, or the owner may have a value assumption based on other factors. Most valuations will be based on either earnings multiples, net asset value, or a mixture (see section below). Any valuation must be affordable to the business both at the time of the buyout and going forward.

- **What is the method of exit?** Realistically in the current economic climate it is difficult to raise sufficient finance to allow the owner to receive the full consideration on completion. Therefore, is there the option of a phased exit over time?

- **Is external finance required to complete an employee buyout?** It is quite possible that the employees alone cannot meet the valuation of the business, and that cash held in the business will not be enough. Therefore there may be a need to consider seeking external finance (see section below). The ability to raise finance will be reliant on a number of factors such as any security in the business, levels of profit and possibly any co-investment by employees.
• **Is there preferred employee ownership structure?**
  Most owners will have a view of the future ownership structure of the business. However, before any firm decisions are made it is important that thorough consideration has been given to ensure that the ownership model provides the benefits that employees might want from becoming owners.

• **What are the timescales?**
  Ideally, when would the owner like to complete the employee buyout process? Typically a buyout process can take anything between three and nine months to complete. If a phased transfer of ownership is being considered, this transfer might take place over a number of years.

A key consideration for the owner will be the possible tax implications associated with selling their shareholding. This requires careful planning and professional advice should be sought. The UK Coalition Government has made announcements that £50 million will be made available annually to encourage owners to sell a majority shareholding to an employee owned structure. The specific detail in relation to this announcement is yet to be released.

Ultimately, by the end of stage 1 you should know whether there is a ‘willing seller and a willing buyer’. If yes then continue to stage 2; if no then an employee buyout may not be the succession solution.

Assuming that the employee buyout will proceed it is wise to consider involving a small group of employees to form a ‘buyout’ team so that they are able to influence decisions that will be made throughout the following steps.

**Stage 2**

4.2 **The valuation, financial analysis and projections**

Once it has been established that an employee buyout is agreed in principle it is necessary to analyse the history of the business, its finances and the ability to fund the buyout price.

With a share purchase it is only the ownership that changes: the business itself continues, and so do any liabilities, hidden and contingent though they may be; moreover, the value of the shares will reflect in part such assets as book debts, whether or not past practice has established habits of late and disputed payment.

• **Methods of valuation** – it is sensible to deal with the valuation of the business at a very early stage. If the valuation cannot be funded and there is no room for negotiation then quite simply an employee buyout will not be possible.

The two most common approaches to valuation are by reference to the assets and earnings of the business:

– **Net asset value** – the value of the business assets (land, buildings, plant, machinery, stock, debtors etc) minus the businesses liabilities (creditors, other long term liabilities etc) can be used as the base for the valuation.

– **Earnings basis** – usually arrived at by applying a multiple to either pre-tax or post-tax previous years’ earnings. The multiple might be calculated by taking an average of previous years’ earnings, and/or including forecast future earnings.

• **Financial analysis and projections** – ultimately any valuation has to be fundable. In order to determine what the business can fund it is necessary to prepare cash flow forecasts to identify what level of borrowings the business can fund. These cash flow forecasts will also show the impact of costs that might no longer be incurred, such as directors’ remuneration. In addition to looking at the future it is also important to look at historic financial trends such as levels of turnover and profitability.

**Stage 3**

4.3 **Considering financing options and making initial contacts**

Once stage 2 has been completed it should be possible to determine whether the valuation is realistic and, of course, fundable. The financial analysis and future projections will allow for decisions to be made regarding how the employee buyout can be financed.

Employee buyouts will often be financed through a mixture of ‘debt’, ‘equity’ and the business’s own resources. The mix of any finance package will be unique to each buyout and will depend on many factors.

• **Debt** – banks and other financial lenders may be prepared to offer loans to the business to finance an employee buyout. These loans will attract a commercial rate of interest and will require regular (monthly/quarterly) repayment for the period of the loan. These loan repayments must be made in good times and bad and in the event of a loan repayment default these loans must be repaid before any repayment of subordinated debt (see over), or return on equity.
Debt is usually secured against the assets that the business owns such as land and buildings, plant and machinery, stock, debtors etc, and should the business default on its repayments the lender will be able to take ownership of assets in lieu of the debt.

Once the loan has been repaid in full the lender will cease to have any charge over the assets and the loan repayments will of course cease.

The benefit to the employees is that this form of finance has a definite end date and, as such, after this date the business ceases to make loan payments and could use this extra money to expand the business, improve terms and conditions etc.

Subordinated debt is debt which ranks after other debts should a business fall into liquidation or bankruptcy.

- Equity – it is also possible to raise finance as a result of employees taking an equity stake in the company by buying ordinary shares from the outgoing owner(s).

Employees normally decide to make an equity investment for two reasons: (1) they believe that the value of their shares will increase over a medium to long period of time; (2) they believe that the business will make sufficient yearly profits to cover the debt repayment, and any surplus will be shared with the equity holders through the payment of dividends.

It is important to note that any debt obligations of the business will always have to be repaid before any profit can be shared among equity holders. As such there is no guarantee that equity holders will receive any return on their investment.

In most employee buyouts, employees are encouraged to help fund the buyout by purchasing ordinary shares. These shares will entitle the holder to part ownership in the business, to a proportionate share of dividends and net assets in the event of a winding up.

It is worth noting that one of the strengths of an employee buyout is the opportunity to raise equity from a larger number of people than from a management buyout, as well as generating a greater commitment to the future success of the business because employees now have a vested interest in the outcome.

- Business’s own resources – some businesses build up cash reserves over a number of years. This money could be contributed to an employee trust to be used to fund the purchase of shares from the outgoing owner. However, very few businesses build up sufficient levels of cash to fund 100 per cent of an employee buyout.

- Vendor deferred consideration – in the current economic climate it is difficult for businesses to raise debt finance unless they can provide asset security. As a result vendor deferred consideration is regularly part of the funding mix. Essentially the outgoing owner (vendor) receives a proportion of the total deal value on completion with the remainder deferred and paid to them over a period of time (typically 3–7 years depending on the size of the deal).

The vendor will of course have to be convinced that the business will be capable of making the deferred payments and this can be decided by all parties only after future cash-flows for the business are prepared that clearly demonstrate the ability to service these payments as well as any other debt.

Once the various forms of finance have been considered it should be possible to agree on the preferred mixture of funding, make contact with lenders and approach employees, assuming they will be asked to invest.

- Producing information to support the employee buyout – it may be necessary to produce a business plan and financial forecasts to justify how the buyout can be financed, especially if external investment or equity from employees will be sought.

Stage 4

4.4 Detailed presentation of investigation findings to investors and bankers and agreement of finance in principle

This is a critical point in the buyout as it requires external finance providers to confirm their intention to make funds available and also for employees to confirm any equity investment.

- Presentations to finance providers – finance providers will use this opportunity to gain a greater insight into the business and its future management.

- Presentation to employees – if employees are being asked to invest alongside external finance they will need to understand what it means to become a shareholder, understand the potential benefits and pitfalls and ask questions about the future ownership structure.
Stage 5

4.5 Preparation of legal structure and legal documents

The shares of the trading business currently held by the owner will at some future point be purchased and held by employees directly, indirectly or through a mixture of these. A number of different legal instruments will be required and these will need to be drafted by a solicitor, perhaps using as a foundation the model documents provided on www.uk.coop/simplybuyout.

In addition to dealing with the transfer of share ownership from the owner to the employees, the legal documents will also enshrine the specific governance structures that will operate after the buyout.

- **Creation of an employee trust** – an employee trust will be required if there is to be any form of indirect employee ownership. The employee trust will be established with the purpose of holding shares that are acquired from the outgoing owner.

- **Creation of an approved share incentive plan** – an all employee share incentive plan might be required if the future intent is to encourage direct shareholding by employees in the company.

- **Incorporation of a corporate trustee** – both an employee trust and share incentive plan require trustees to manage the affairs of these trusts. While it is possible to appoint individual trustees, there are a number of benefits of using a corporate trustee instead. The corporate trustee is essentially a company (either limited by shares or limited by guarantee) that is created with the sole intention of acting as a trustee and has directors, normally appointed by the board of the trading business and elected by employees of the trading business, who then appoint an independent director.

- **Share purchase agreement** – this details what is being sold, by whom, to whom, for what consideration, the date of the completion and records all of the warranties offered by the seller.

- **Articles of Association for the trading company** – while these might not need to be completely replaced, it is important that sufficient changes are made to enshrine aspects such as governance, eligibility of members, decisions that require shareholder approval and the process to be followed should someone wish to sell their shares.

- **Loan agreements and other associated documents** – assuming there is a requirement for external finance the conditions attaching to any debt finance and the ranking of creditors will be negotiated.

Stage 6

4.6 Written offer, subject to contract, made to the current owner(s). Information awareness raising and ballots for elected employees. Keeping management informed.

By this point the hard work should be out of the way. The finance package will have been agreed, the ownership model will have been largely agreed and unless there are any last minute hiccups the deal should complete without any major difficulties, assuming the previously agreed details still stand.

- **Information awareness** – a key element in the success of any employee buyout is ensuring that employees understand why the transaction will be of benefit to them and what changes, if any, will happen as a result. The buyout team will be well placed to keep everyone informed.

- **Ballot processes** – assuming that there are positions created for employee elected directors and trustees there will be a need to explain the purpose of these roles fully and manage an election process to identify elected individuals.

- **Keeping management informed** – this is a key aspect of the employee buyout process that is often ignored. Managers need to understand the impact that an employee buyout will have on their role. While managers will still manage post the buyout, the reality is that there is a change of dynamic. Employees are no longer a resource for hire who can be replaced if the owner tires of them; they are owners and will expect that managers will respect that they are fellow owners.

Stage 7

4.7 Conclusion of negotiations on terms of sale. Finalisation of finance arrangements. Transfer of shares.

At this point the transfer of ownership will complete and the employees will own their business. While this stage is the end of the employee buyout, it should signal the start of building a successful employee owned business with an ownership culture.
5. Next steps

Hopefully, after reading this guide you will see employee ownership as providing a sensible and realistic business succession solution and will consider converting to an employee owned structure enshrined with co-operative principles.

A website to accompany this guide has been created and contains links to other resources, some short films and a model set of documents that could be used as the foundation for creating an employee owned business with co-operative principles.

It is important that you seek professional expert advice before undertaking a move to employee ownership and a number of organisations can help guide you through the process and ensure that you are able to design a structure that works for your individual business. Details of these organisations can be found on our website.

www.uk.coop

Further information and guidance

Co-operatives UK publications
Simply Legal, 2010
Simply Governance, 2011
Simply Finance, 2011
Simply Startup, 2012

Co-operative Development Scotland publications
www.cdscotland.co.uk

Wales Co-operative Centre
www.walescooperative.org/
employeepropertyreport
www.walescooperative.org/resources

Co-ownership Solutions
Various guides and case studies on successful employee buyouts.
www.coownershipsolutions.co.uk/case-studies

Other employee ownership publications
The Employee Ownership Association has published a number of guides that provide compelling reasons why employee ownership should be chosen. These guides can be accessed at the EOA website.
www.employeeproperty.co.uk/publications/
Acknowledgments

**Co-operatives UK** works in partnership with organisations that help co-operatives to start up and grow their business. To find out more or contact a local support provider visit [www.uk.coop](http://www.uk.coop)

**Co-operative Development Scotland**

Co-operative Development Scotland (CDS) is a Scottish Enterprise subsidiary that promotes co-operative and employee owned enterprise. It has a Scottish-wide remit and helps deliver the Scottish Government’s strategy for sustainable economic growth. Recently supported employee buyouts include Clansman Dynamics, Scott & Fyfe, Stewart Buchanan Gauges and Hebridean Jewellery. It is anticipated that a healthy pipeline of enquiries will translate into a substantial increase in the number of Scottish headquartered employee owned businesses.

CDS offers clients free, early stage, impartial advice. This includes a formal assessment and feasibility study, undertaken by experienced advisors. In addition, CDS’s Employee Ownership Ambassadors, all directors of employee owned businesses and active advocates of the model, are willing to engage with clients.

[www.cdscotland.co.uk](http://www.cdscotland.co.uk)

**Wales Co-operative Centre**

The Wales Co-operative Centre was set up 30 years ago and ever since has been helping businesses grow, people find work and communities tackle the issues that matter to them. Its advisors work co-operatively across Wales, providing expert, flexible and reliable support to develop sustainable businesses and strong, inclusive communities. The Centre has a strong and long standing commitment to supporting employee ownership and increasing employee engagement within the workplace.

We have supported employee ownership transitions throughout Wales and were instrumental in developing the deal that led to more than 200 miners buying and running Tower Colliery in Hirwaun, Aberdare. The Wales Co-operative Centre employs a specialist employee buyout team that provides advice to businesses across Wales on succession planning and employee ownership.

[www.walescooperative.org](http://www.walescooperative.org)

**Co-ownership Solutions LLP**

*Simply Buyout* has been co-written by Andrew Harrison, Norman Watson and David Daws of Co-ownership Solutions LLP as a distillation of their experiences and practice of converting conventionally owned companies to employee owned businesses.

Co-ownership Solutions specialises in supporting and guiding employee owned business. Specifically, it helps business owners to choose employee ownership as their business succession solution, helps businesses to develop an ownership culture and provides technical advice relating to share schemes and legal aspects relating to employee ownership.

[www.coownershipsolutions.co.uk](http://www.coownershipsolutions.co.uk)

**Preston City Council**

Preston City Council’s current administration is committed to supporting co-operatives and employee owned businesses through a number of initiatives. These including helping people and communities start their own co-operative, looking at creating community wealth through co-operatives providing employment for those facing multiple deprivation and assisting those who wish to purchase the business in which they work.

The Council can provide links to experts, advice and finance to those who wish to form a co-operative or employee owned business.

[www.preston.gov.uk/businesses/co-operatives](http://www.preston.gov.uk/businesses/co-operatives)

2 The UK Co-operative Economy 2013 www.uk.coop/economy2013


4 www.uk.coop/sites/storage/public/downloads/savingbusiness_0.pdf

5 Matrix Evidence 2010.

Simply Buyout: A guide to employee buyouts and becoming an employee owned business is the co-operative sector’s contribution to the recommendations set out in the Graeme Nuttall Review of Employee Ownership carried out for the Department for Business, Innovation and Skills in 2012.

This guide was written by Co-ownership Solutions LLP and the model rules that accompany the guide are provided in association with Blake Lapthorn LLP Solicitors.