



Employees benefit

Employee-owned companies are becoming increasingly fashionable.

Jon Moulton sees the pitfalls

Some of you will be familiar with employee ownership trusts (EOTs), some of you won't. They are becoming more popular. Last year, there were around 600 acquisitions of UK companies by EOTs, mostly smaller businesses. The total employee count of those working in British EOT-owned companies is put at 125,000.

Essentially, EOTs are a way for a company to buy out controlling shareholders, who will get total relief from capital gains tax. That 24% is obviously a big – maybe the big – attraction for selling entrepreneurs. It removes one reason for moving to a sunny tax haven for the same saving.

There are also more complicated, even less-known and little-used inheritance tax breaks. There is a more popular ability to pay a tax-free bonus (which is subject to national insurance) of £3,600 per annum to such businesses' employees. This seemingly arbitrary amount was set in 2014 and if indexed would now be more than £5,000. That 'bonus' could easily replace a couple of years' pay freezes, without adding to ongoing base pay, so only our Exchequer loses out.

Devilish details

The primary criterion for an EOT is that the trust must purchase at least 51% of the business. There are the usual HMRC-generated structural traps waiting, so vendors must be careful. Taking advice probably helps.

But how can the employees muster the cash to pay for the business? Typically, this involves the company borrowing as much as possible from a bank, as senior lender(s), often combined with a loan from the seller to the trust, to be repaid over time. The cash then goes to the selling business owner(s), who might sail off into the sunset – although he or she will still want their loans paid off. The fact that the cash raised has left the business can leave the company with limited resources for investment or working capital.

It is interesting to consider vendor motivations. On completion they can get all the cash the company can raise on commercial terms, normally with a first fixed charge. They will want to receive the remainder of the desired consideration via the largest possible second secured loan, which will be paid out of the business's surplus cash flows (if there are any). The vendor can

remain a 49% owner, a (non-controlling) director and be an EOT trustee with considerable power. If the loan goes into default the former owner is very well placed to buy the business back in a pre-pack insolvency using the unpaid loan as ammunition.

EOTs can work very well in some circumstances: a business that is not highly valued – perhaps a business with a good cash flow, but limited in its growth prospects and ideally some excess assets to provide a good lending base – can reasonably buy out an entrepreneur owner using just bank debt.

But things get more difficult if the realistic value of the business is higher and cash contributions from the employees are needed. EOTs really do not work well for highly valued businesses. Of course, those businesses should have more exit options for their owners.

Lasting legacy?

Perhaps the owner has a close relationship with his employees and charitably will not seek a high price or alternative routes of sale – though I suspect this is not as common as is perhaps claimed.

EOTs share all the benefits and detriments of any employee trust arrangements. Their primary objective is looking after employees rather than maximising profits. That does not work well if the business needs to reduce staffing or relocate. The leverage inherent in most EOTs will restrict investment and increase insolvency risk.

There are proponents of the EOT structure who claim benefits from employee ownership, motivation and involvement. Doubtless there are situations where that is true.

But there is often a misalignment between the new owners of the business and the managers. The vision and strategic direction at the board and senior leadership level can often be messy.

As a corporate financier, there are obvious opportunities to use EOTs constructively, perhaps even attracting a third-party minority investor as part of a transaction. More simply, the threat of an EOT can be used to generate competitive tension in a not very strong sales process.

Are EOTs worth the complexity and tax breaks? I don't know. I'm not even going to touch on how the trust might later realise some value from an EOT-owned company.

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