# Employee Ownership Trusts

## *Your questions answered*

RVE – Realising value through Employee Ownership

## 1. What exactly is an Employee Ownership Trust?

- An EOT is a trust formed to acquire a controlling interest in a business being sold by its owners. The trust acquires the shares for the benefit of all the company's employees giving the employees indirect ownership of the company
- An EOT is run by trustees a majority of which must be independent of the former owners of the business. Trustees typically include the company's directors, employee representatives and external professionals

## 2. What businesses are suitable for an Employee Ownership Trust transaction?

- To qualify for the generous tax treatment the business being sold by the owners needs to be a trading company (as opposed to an investment company) and to have a minimum level of employees who are not the owners or connected persons (e.g. spouses)
- The owners must also be able to sell a controlling stake (more than 50% of the company's shares) to the EOT
- Because the EOT model is self financing (no external finance is required) the business needs to have a certain level of financial resilience to make it suitable for an EOT transaction. The business should not have significant borrowings and its trading outlook should be profitable and cash generative
- Having surplus cash in the business is a positive benefit as it can be used to part fund the purchase consideration
- Professional service businesses find selling to an EOT particularly attractive

## 3. What price does the trust pay for the business and how does it finance the acquisition?

- The EOT pays a fair market price for the shares it acquires from the owners based on an independent valuation. This is a full price reflecting the sale of a controlling interest rather than a minority stake
- The purchase consideration typically comprises a cash payment at completion (paid out of surplus cash in the business) together with deferred consideration which the EOT repays over an earnout period (typically 5 years in length) using cash generated by the business

## 4. How does a sale to an Employee Ownership Trust work?

- Selling to an EOT is effectively an "in-house" transaction controlled by the owners and negotiated with the company and the EOT, which the company establishes
- The business is independently valued to ensure the trustees of the EOT can be satisfied they are paying a fair market value. This valuation sets the sale price to be paid to the owners which the EOT settles in cash (using any surplus cash in the business) and through deferred consideration
- The deferred consideration is paid by the EOT over the earnout period, subject to the EOT receiving funding from the company. During the earnout period or until the deferred consideration is fully repaid the rights of the EOT are restricted and the owners will continue to retain an element of control of the business

## 5. What are the tax benefits of selling to an Employee Ownership Trust?

- Owners who sell a controlling interest in a business to an EOT benefit from very generous tax breaks paying 0% capital gains tax on all sale proceeds
- In addition, a company controlled by an EOT can pay its employees tax free cash bonuses of up £3,600 per annum

## 6. Who runs the business after it is sold to the Employee Ownership Trust?

- The company's directors continue to run the business following a sale to the EOT
- The trustees of the EOT have a supervisory role with the right to remove company directors acting counter to the EOT's interests. In principle the trustees can also sell the business
- During the earnout period or until the loan notes are fully repaid the rights of the trustees are restricted and the owners will continue to retain an element of control of the business

## 7. Can the owners continue to work in the business?

- Yes, the owners can continue to work in the business and typically do. This does not affect them being able to sell their shares free of capital gains tax

## 8.
## How long does it take to do an EOT transaction?

- Selling to an EOT can be a relatively quick process once the owners have made the decision to sell. This is because the key steps in an EOT transaction are relatively straightforward and the negotiations are "in-house" involving the owners, the company and the EOT
- With an EOT transaction there are no long delays in identifying buyers, preparing information memoranda, waiting for debt and equity finance to be arranged and negotiating with potential buyers over price, disclosures and onerous warranties

## 9.
## How do EOT deal costs compare with other exits?

- Deal costs for an EOT transaction are typically much lower than with a traditional trade sale or management buyout
- As with all share sales, stamp duty is paid at 0.5% of the sales price and is borne by the acquiror (the EOT in an EOT transaction)

## 10.
## What are the deal risks with an EOT transaction?

- Deal risks on an EOT transaction are much lower than on other exit routes because:
  - There is a clear buyer (the EOT)
  - The price is set by an independent valuation
  - There is no requirement for external financing
  - Because negotiations are "in-house" involving just the owners, the company and the EOT
- The key deal risks for an EOT transaction are the owners changing their mind over whether to sell and unforeseen changes in the trading outlook for the business

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*RVE is a member of the Employee Ownership Association and the Corporate Finance faculty of the ICAEW*

## About RVE

RVE

RVE is a corporate finance advisory firm which advises owners of small and medium sized companies on the sale of their business. We specialise in structuring employee buyouts, where the owners sell the business to a newly formed Employee Ownership Trust.

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