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How 'prisoners' dilemma' applies to selling your business to your key employee

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Fotolia *Prisoner's dilemma is where both parties choose to protect themselves at the expense of the other participant, rather than co-operating to achieve a better combined solution.*

A reader of this column recently presented me with a rather common private company scenario to consider: A family member of his (I'll call her Jane) was a key employee at a small private company, whose owner (Tom) was considering retirement. Jane was a key contributor to the product offering of the company, and had an important and expanding relationship with key customers. She was a natural option for Tom to approach to buy the business.

The transition discussions rolled along nicely until the keystone issue of valuation — how should Jane value the company? Status quo — with her in her current role? Pro forma as if she was not there and not replaced? Or, pro forma without her, but presuming she has been replaced by a comparable employee at market compensation rates?

Here is where Game Theory — the study of strategic decision-making pioneered by mathematician, John von Neumann — comes in. Best known for the prisoner's dilemma, where both parties choose to protect themselves at the expense of the other participant, rather than co-operating to achieve a better combined solution.

For simplification, we'll assume the company status quo is worth \$15 million based on a fundamental valuation; without Jane, assume a value of \$10 million, which isn't unreasonable for a senior employee and lieutenant to the owner of a small company. However, in the scenario where Jane is replaced by a new senior employee the value is an unknown, because we cannot be certain either of the cost to replace her, or of the performance of the new employee.

This often leads to a potentially uncomfortable situation. In this example, splitting the difference and selling the company to Jane for \$12.5 million would result in a loss of \$2.5 million in the eyes of both parties. Tom could conceivably sell his company for \$15 million. Jane could keep working under the status quo and hope Tom changes his mind, rather than buying at \$12.5 million or \$2.5 million more than she feels the company is worth without her.

Jane may be willing to crystallize her loss if she fears being replaced, thereby losing all her \$5 million sweat equity. Tom may be willing to absorb the \$2.5 million if he believes replacing Jane will be difficult, time-consuming, expensive and a risky distraction. The problem is there will almost inevitably be bad blood, as both parties will consider themselves to be forced by the other into whatever compromise results.

This problem arises when an individual cannot value a company as a closed system, independent of the effect or impact of being a member of the team. The reason management buyouts work, is that the individual members of the team tend to not feel they have individual power, and do not want to risk holding fast to optimize their perceived personal value in the equation.

As a result, the company in a manager buyout tends to be valued objectively on its historical operating performance and outlook. There generally is some interaction with the employees and the price, but it tends to be minor relative to the overall fundamental value of the business.

If you have a single employee with as much impact on its value as Jane has, you are not in position to value your company objectively. It is incumbent on you to build a team and a business that is sustainable no matter who owns it, or who gets hit by a bus, so to speak. Otherwise, the situation will generally come down to a stare-down, which has more downside for Tom and Jane than it does upside.

The downside tends to be more fundamental for Tom than Jane, who could conceivably find another job and carry on after licking her wounds at her opportunity loss ($5 million of sweat equity). Tom, on the other hand, imperils his entire $15 million value by rolling the dice.

So what should Tom, and Jane, do? Initially, Jane holds all the cards. But is she prepared to play hardball and threaten to walk away if the business isn't sold to her for closer to the $10 million value. If not, the power shifts to Tom, who must decide how replaceable Jane is.

Generalizations can be dangerous, so your specific situation may have unique elements that push things toward a more constructive outcome, but the point is you need to pay attention to the game.

Brad Cherniak has spent more than 20 years as a principal, advisor to and investor in private companies. He is co-founder and partner at Sapient Capital Partners, a Toronto-based advisory firm to companies from early stage to $50-million in revenues. His column appears monthly in the Financial Post. He can be reached at brad@sapientcap.com *and you can follow him on Twitter as @SapientCapital.*