



## AIA Best Practices: Essential elements of ownership transition

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Contributed by Deborah A. Gill, CPA, SDA/C, Profit by Design Ltd.

### Summary

An effective transition plan is an essential element of design firm ownership. The existence of a clearly delineated plan sets the stage for a solid financial foundation and signals to both new and established employees that the owners are invested in preserving the firm's prosperity. To create a solid transition plan, a firm must determine and delineate valuation of the firm, a buy-sell agreement, a financing vehicle, and a successor-development plan.

### Why plan now?

Every design firm, regardless of its size, needs a transition plan. It is as important to a sole practitioner with two employees as it is to a multi-office multinational firm.

Having a transition plan is important not only at the time of transition but throughout the life of the firm. A transition plan helps ensure that the monetary value of the firm will be preserved, which is essential if the principals are to be rewarded for the many years they have invested in building the business. It provides younger members of the firm—the next generation of owners—with a clear stake in their future and a powerful incentive to stay with the firm and help it prosper. Even employees who may not be in the line of succession are affected, as they are assured of a stable work environment and do not need to worry that they might be a “heartbeat away” from unemployment. Finally, clients are assured that the design firm on which they depend is more likely to remain a going concern well into the future.

All of these factors affect the prosperity of the firm long before an ownership transition occurs. Conversely, the lack of a transition plan can adversely affect a firm throughout its history—if it survives long enough to have one.

A transition plan consists of four basic elements:

- a valuation of the firm
- a buy-sell agreement
- a financing vehicle
- a successor-development plan

## Firm valuation

The valuation of a professional services firm is not an exact science. “Fair market value” can be determined only for corporations whose stock is publicly traded in an unrestricted market. Because A/E firms must restrict their ownership to professionals, they are closely held and cannot be easily traded. Further, the principal asset of a design firm is its intellectual capital—the knowledge and skills of its people—which cannot be quantified on a balance sheet. So other formulas must be used to account for this intangible value and for “goodwill,” defined as “the company’s advantage in the marketplace resulting from reputation, business connections, quality of service, and advanced technology, which enables the firm to continue to generate fees to earn similar earnings.”

The formula is never exact. What is important is that the initial valuation be determined, that the stakeholders agree that it constitutes a fair assessment of value, that it be reviewed and revised annually, and that it be recorded in writing.

## Buy-sell agreement

The buy-sell agreement should delineate the valuation method or clearly reference another document in which the valuation method is delineated. It should enumerate the events that trigger a change of ownership (e.g., death, retirement, disability, or divorce). It should also clearly state who has the right to buy stock or a partnership interest. Lastly, it should state how the buyout will be financed.

Ownership of professional service firms is often restricted by state law. It is important that the buy-sell agreement conform to the law in the state in which the firm is incorporated. A buy-sell agreement that includes a prohibited class of shareholder could be found invalid.

Many states, for example, require that 50 to 66 percent of the shareholders of professional service firms be licensed individuals actively engaged in the business of the firm. In some states, design firms may be incorporated as general business corporations, while in other states they can be incorporated only as a professional corporation (PC) or professional association (PA). Other forms of ownership that may be allowable include limited liability partnership (LLP) or limited liability corporation (LLC). With respect to federal law, “S- Corps”—corporations having “Subchapter S” status for tax purposes—could lose that status by having a prohibited class of shareholder.

## Financing vehicles

There are many methods of financing buy-sell agreements either through cross-purchase arrangements or stock redemption. Many design firms fund minority shareholder buyouts with cash flow. They use current earnings to pay the departing shareholders over a specified period of time. This can be a drain on the firm's cash reserves, and reduce the profits available for distribution to the remaining owners. However, because some of the events that trigger a buyout cannot be forecast with certainty (disability or sudden departure), it is the most common financing method.

The most popular method of financing ownership transition due to retirement or death is through company-owned life insurance (COLI). The firm uses the compounding benefit of interest and/or the death benefit of

the insurance policy to pay its obligations to retiring partners or to decedent shareholders' estates. COLI can also be used to fund unplanned buyouts, provided it has been established sufficiently in advance of the triggering event.

Unlike individual life insurance policies, which insure the life of a single individual, COLI insures an entire "class" of shareholders. To be practical as an ownership-transition financing vehicle, the first prospective buyout must be at least 10 years in the future. When the first shareholder retires or departs, the firm borrows against the cash value of the policy to buy out the retiring or departing partner. When the first member of the class dies, the death benefit of the policy is added to a trust (known as a "rabbi trust" or "grantor trust") that is established to fund the firm's payout obligations until the last member of the class dies. In an actuarially sound plan, the value of the plan at its end would be \$0. COLI and/or simple annuities are better methods of funding ownership transition when established in time.

### **About rabbi trusts**

A rabbi trust is a type of grantor trust that acquired its popular common name following a landmark IRS ruling in the early 1980s that confirmed the tax-deferral status for a rabbi who was the beneficiary of a trust established to pay him retirement benefits. Rabbi trusts are commonly established by an employer as a source of funds for the future payment of benefits to directors, officers, and employees.

## Cultivating successors

Advance planning is essential not just for financial reasons. Because ownership of professional service firms is restricted, the firm must cultivate its "market" of successors in order to preserve the value of the firm. If the firm has no prospective buyers, the firm has no value. A plan must be devised, implemented, and communicated to prospective successors that sets goals for the first and second generations at least 10 years before the first member of the first generation will retire. A popular successor-cultivation method is the "10-year rule," wherein each senior employee identifies and mentors at least one employee 10 years younger who is a prospective successor owner.

It is important that the successor-cultivation plan recognizes the inevitable vagaries of life and the desire of emerging professionals to gain a broad range of experience. Occasionally, principals identify and cultivate prospective successors only to have them leave the firm. It is important to part company with these employees on good terms. Talent is talent and, after all, the firm had already decided they were worthy successors. These candidates may return in the future, with knowledge and experience that will increase their value to the firm. One large firm formally celebrates such returning employees, whom the firm recognizes as "boomerangs."

The knowledge that the firm will remain an ongoing concern can be a significant boost to the morale of all employees. A firm with happy, productive employees who feel secure about their future is a more valuable firm. Thus the very existence of an effective and practical transition plan can enhance the firm's value.

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