# ARCHITECTURE
## NEW YORK STATE

# THE BUSINESS OF ARCHITECTURE


FEBRUARY '23

AIA New York State

# 3 OWNERSHIP TRANSITION OPTIONS FOR SMALL FIRMS

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The last three years have wrought major changes to how we do business, where we do business and, even, if we do business at all. While much press has focused on the younger generations leaving the workforce, the pandemic also caused many work force veterans to seek an exit strategy or, at least, put the wheels in motion for a smooth transition of their businesses to the next generation. It is never too early to understand and prepare for ownership transition, particularly for those practicing in small firms.

## TYPES OF TRANSITIONS

**Internal Sale.** Many design firms transition ownership internally, whereby an existing owner or owners sell their ownership interests to others in the business; this type of internal transition is a sale of some or all of the firm's equity. Most often, this involves older owners transferring ownership to the next generation. An internal transition is typically least disruptive to the business overall and provides the greatest continuity for the existing business while allowing it to evolve.

In small practices, firm founders or other pivotal owners may spend five to ten years transitioning ownership to the next generation. The lengthy time frame allows for a purchase and sale model that is financially viable to both sellers and purchasers. In these cases, there is usually an annual payment from buyers to sellers. Ownership may transfer as payments are made or it may not transfer until all payments have been made. In my experience, the financial deal for the sale of a practice is only the starting point. To maximize the chances of a successful transition, existing owners will also commit to a management transition plan during the buy-in period. By the mid-point of the buy-in period, the new owner(s) should be taking on meaningful duties with respect to firm management and business development.

**ESOPs.** Beginning in 2024, New York design professional corporations (DPCs) can be wholly owned by employee stock ownership plans. ESOPs, because they allow for ownership by all firm employees (and require ownership by a substantial percentage of those deemed non-highly compensated employees), licensed or not, may be quite attractive for recruiting and retention purposes. The establishment of an ESOP can serve as an exit strategy for existing firm owners, and the economic relationship between sellers and buyers is less direct than in a traditional purchase and sale in that employees are not paying for shares but are awarded shares based on their salary and/or tenure with the business. This option may be prohibitive for small practices, due to the legal and accounting fees involved in establishing an ESOP and the ongoing requirements to have a trustee or trustees (more than 75% of whom will need to be licensed professionals in order to comply with NY legal requirements), who are required by law to protect the financial interests of the employees.

**Third Party Sales.** There is a robust marketplace for successful design professional practices. Potential purchasers may be looking to acquire project typology expertise, a new geographic toehold or, simply, employees. As a general rule, sales to external parties will be more lucrative for sellers than will

internal ownership transitions. Moreover, if firm owners do not have a clear transition plan or next generation of potential owners in place, a third-party sale may be their only option to realize some financial remuneration from the practice they have built.

External purchasers may purchase either the stock or assets of a seller. If the transaction is structured as a stock sale, the purchaser will pay either cash to or exchange its own stock for the stock of the sellers. A stock purchase means the whole business entity is sold, including its liabilities. It is very important for New York practices to consider and plan for the licensing implications of a stock sale; in almost all cases, design professional practices authorized to provide services in NY must be owned primarily by licensed human beings. This means, for example, a NY professional corporation or D.P.C. cannot be purchased and operate as a wholly owned subsidiary of another business entity.

If a purchaser buys the assets of a business, liabilities often remain with the seller business and the owners of that seller business entity do not change. The seller business entity is usually left as a non-operating entity with the sole purpose of addressing any remaining liabilities and winding down. Asset sales mean that only the assets and liabilities specifically included will be transferred to another business entity; typically, this will include substantially all the operating assets of the business, but some liabilities may be left with the seller e.g., leases, loans, tax liabilities and legal claims against the seller. In addition, since the seller business remains behind and the purchaser is a different entity, it is important to develop a clear path and allow adequate time for project contracts to be assigned or novated to the purchaser (which may require the consent of the other parties to the contracts).

The third party sale can be more disruptive to a practice than an internal transition for numerous reasons. First, there may be a very quick branding shift, in which the name of the seller firm is combined with the purchaser for a short period of time or the seller's brand disappears entirely upon the sale. Second, if the seller firm is physically joining forces with a third-party purchaser, there can be cultural changes to get used to and the buyer may quickly make personnel changes in the name of economic efficiency. Third, the sale of a business, whether it is a stock sale or an asset sale, may trigger requirements for client approval under many projects contracts, particularly for those firms that work in the public sector.

Which ownership transition is most appropriate to any firm will depend on many factors such as the financial health of the firm including its backlog and management of its finances, whether or not the firm has a capable next generation, and whether the firm's specific practice areas or geographical reach might be attractive to potential purchasers. It is healthy to think about potential exit strategies from time to time, regardless of how close the firm owners may be to the door, and whether management and growth decisions are in line with creating an attractive and healthy business for a potential purchaser. Although it may be true for the Rolling Stones, in this case, time is not on your side.

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## FEBRUARY ‘23

**ARCHITECTURE NEW YORK STATE**
is a quarterly publication developed by
AIA New York State, 50 State Street, Albany, NY 12207

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