MAKING THE HAND-OFF

Impact of the economy on cashing out and buying in

By Paul M. Lurie

Owners of architectural firms will someday depart either voluntarily or involuntarily. How will they fund their retirement? Who will lead the firm and preserve its legacy in future generations? These are questions addressed by ownership transition planning.

Since the publication in 2002 of the third edition of my book, Ownership Transition: Options and Strategies, uncertain economic times have created the need for a new way to look at ownership transition planning. Here are some points to consider:

Owners incorrectly assume that they will fund their retirement through a cash buyout of their equity over a short term. Cash sales to outside firms are usually unattractive to most owners of architectural firms. Most buyers are unwilling to buy anything other than hard and depreciated assets unless there is a predictable cash flow—a difficult requirement. Further, outsiders compensate former owners usually based on performance—a requirement inconsistent with someone thinking about slowing down.

The owner's firm is also seldom a source of retirement cash. Most firms distribute their excess cash over working capital in the form of compensation such as year-end bonuses. Maintaining cash as reserves for retirement is unusual. Unless the firm is growing, continued draining of cash to compensate owners may not leave enough cash to satisfy key employees.

The best sources of retirement cash are tax qualified plans and agreements of key employees to purchase equity. Key employee purchases are usually based on an assumption that the firm will finance such purchases from bonus monies. For marginally profitable firms, this can be a problem if there is not enough compensation cash for both selling owners and purchasing employees.

An excellent source of retirement funds are qualified corporate plans such as 401(a)s, managed by the firm or through individual IRAs in various forms. Many firms offer 401(k)s as their primary retirement vehicle with no employer contributions. The choice of plan manager often is made with little analysis on fund performance or the fees charged by such managers. In these "off-the-shelf" plans, there are minimal opportunities for the investor to influence the investment holdings. As a result, many architects are disappointed by the amount of retirement funds created by such plans. Now more than ever, owners need to establish these vehicles early enough to take advantage of their tax savings compounding. Firm cash flow should be managed to fully fund those plans every year. Choosing the right plan and investment adviser and watching performance should be carefully considered and discussed with the firm's trusted advisors.

Older owners need to understand that "retirement" today may involve working in a changed environment. Older owners need to understand that "retirement" today may involve a need to continue to work, but without the same degree of management control and with their management responsibilities having been transferred to others. Sales to outsiders seldom provide this flexibility. Planning for this scenario requires constant attention, long before retirement is contemplated to occur. "Maintaining control," long an excuse used at architecture firms to avoid transition planning, can be poorly understood by owners. As part of planning, persons who controlled their compensation by reason of corporate control can liquidate their equity and use contracts to protect their compensation.

The need for insurance funded buy-sell agreements. A standard requirement of any closely held business, such as most architectural firms, is life insurance on the lives of owners and a buy-sell agreement using this insurance to finance a purchase of their ownership interests in the event of death. If there is no insurance-funded buy/sell agreement requiring equity redemption for death or disability, those events will cause ownership to pass to the estate of the owner or to a disabled owner. If the owner does not have a will or trust agreement, then the ownership interest will be divided among the surviving spouse and children or their guardians. These situations can interfere with critical firm decision-making, which can be traumatic for the firm and the affected families, especially if insurance is inadequate.

Employees must understand the meaning and timing of equity ownership. If key employees are to stay and to buy equity, owners need to sell employees on the reasons why buy-in is a good investment. Does ownership of equity give enhanced job security? Increased compensation? Participation in profit and loss? Does it give a right to participate in management? When will the employees be able to obtain equity and what will be the terms? How long do existing owners intend to remain in control? Poor communication on these issues can lead valuable employees to leave because their future is not clear.

The most important task in transition planning is not valuation, but reaching planning consensus on financial goals, including acceptable prices and terms. Many architects wrongfully believe that a formal valuation of the firm is the first step in planning. While such valuation may be interesting and expensive, it seldom is very useful because the value opinions of most firms are so subjective and conditional because their cash flows are difficult to predict. The most important task in ownership transition planning is reaching consensus on financial issues among the stakeholders who often have different financial needs. An experienced transition facilitator, with skills in group dynamics, can help speed the process and create a win/win solution. These persons are often lawyers, accountants or management consultants. CA

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