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Advice on Ownership Transition Strategies

by Richard N. Pollack, FAIA, FIIDA

In my column last month, I described the initial process for an effective ownership transition. This month, I will focus on details of typical strategies, such as selling the company's stock to new leadership in the firm, selling the firm to another company, merging with another firm, and establishing an Employee Stock Ownership Plan (ESOP).

The final transition selection needs to be feasible for both firm and principal. I adopted an ESOP for my transition out of the firm that I founded 28 years before, Pollack Architecture. I'm not suggesting my plan is appropriate for all scenarios, nor am I providing any legal advice. Like most other business transactions, the involved parties must perform their own in-depth analyses. This information is simply a starting point for your decision-making process.

Sell the stock to the firm's next generation of leadership

A commonly implemented strategy is to sell one's stock to the firm's next generation of leadership, but it can provide the participants with the most angst. Often, the principal takes a note promising payment to him or her over some years. In some cases, the firm either cannot continue to make the payments because of a lack of available funds, or simply loses interest in paying. If the departed principal was the chief rainmaker, then it may be difficult for the next generation to generate sufficient revenue. Or new principals pay for a period of time and then say: "Why are we making these payments? We don't have enough money to give ourselves the incomes we deserve." So they stop paying, and ligation ensues. These issues can be mitigated with continuing communication, and sending the departed principal the financial statements to ensure him or her that funds are available.

Sell to another company

Selling a firm to another company is also a common strategy. While leading Pollack Architecture, I was asked on more than one occasion by principals of larger firms if I was interested in selling my firm. I always listened but never elected to execute, primarily because I would have become an employee of the larger firm, which is not what I had wanted. Selling to another company is a significant change to a principal's work life, even if the acquiring firm insists otherwise. In this scenario, the principal will be reporting to someone. Principals will often think that they can make a killing in such a sale, but that is not often the case.

Merge with another firm

One variation on selling is to merge with another firm. In that case, the selling principals receive a compensation package, but the vast majority of deals that are termed "mergers" are actually acquisitions. A true merger of equals consolidates two businesses into one with a new name. The points made earlier regarding a sale to another company also apply to a merger; all parties must have a clear understanding of their future roles.

Establish an ESOP

An ESOP was my chosen ownership transition. The firm received a loan from an investment company to pay me for my stock, the stock was then distributed to staff via a vesting schedule, and the firm was responsible for paying back the loan. Principals sometimes believe that administrative costs of an ESOP are too expensive, but I found that not to be the case. The concern about the new principals not paying me directly was my primary reason for choosing an ESOP.

Final thoughts on transition strategies

Consider how long you want to remain with the firm after putting the plan into effect. If the transition is internal—via sale to new leaders or an ESOP—you will most likely be with the firm for at least two years. If you hold a note for the firm's payments to you for your stock, you need to remain connected at least until the note is paid off and have full access to the books on a monthly basis. If the transition is external—via merger or acquisition—the acquiring firm will typically expect a three- to five-year transition plan and the agreement will usually require adherence to revenue and profit goals and a potential reduction in your payout if the goals are not met.

As a firm owner considering your transition strategy, it is also important to find the right consultant to value the firm. That consultant is likely not your current CPA. And perhaps my most important advice is this: implement a strong communications plan to ensure that you, your colleagues, and partners will all be on the same page.

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