



## SUCCESS AND SUCCESSION

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Architects start firms for many reasons, including receipt of an unexpected commission, desire for self-determination, economic betterment, design control, or even lack of a perceived viable alternative. Most new architectural firms are initiated when their founders are in their early-to mid-thirties. Although some founders have sense of the kind of firms they would like to own and operate, most hit the ground running. Few develop strategic plans for the future, and even fewer think ahead to that future time, probably thirty years hence, that they will want or need to be concerned about their own retirement and the firm's successful succession beyond themselves.

Prior to World War II, succession beyond the founders was the exception. For architects who chose to be owners, the norm was to start a firm, practice as long as they were interested and able to do so, and then close up shop, whether voluntarily or involuntarily. So few firms succeeded beyond the first generation, many of their names are instantly recognizable: Shepley Bulfinch Richardson and Abbott, Holabird and Root, HLW (formerly Haines Lundberg and Wahler and before that Voorhees Walker Smith Smith and Haines), and SOM, to name a few.

Things changed. A new generation of firms emerged following the end of World War II. Although the great majority of firms continue to be modest in size, employing fewer than ten people, more mid-size (generally understood to be in the 11 to 50 range) and more large firms developed. Along with them, certain aspects of practice have become more common. Marketing and management, once anathema, became the norm and contributed to new understandings regarding the nature, extent and value of practice. Architects became more aware of the need for the successful succession of their firms, and its requisite transfer of ownership.

### **WHY DO OWNERS TRANSFER WHAT THEY OWN TO OTHERS?**

**Growth.** As firms grow in size, most find that they can not grow effectively only by adding staff at the bottom. They need to add principals at the top as well, particularly to secure and manage clients and provide necessary project and other internal leadership. (Although it is possible to employ professionals who enjoy, and are compensated for, principal-level responsibilities without having equity ownership, we will use the terms "principal" and "owner" interchangeably.) Firm growth spurs the need to expand ownership, either by elevating to principal status and transfer ownership to qualified candidates within the firm, or recruiting them from outside.

**Expansion.** Similarly, firms that wish to expand either geographically, or in markets within a given geography, find that they can do so effectively only if such expansions are led by entrepreneurial professionals - those who can do what principals do.

**Retirement.** A significant change arises when principals begin to think about their own retirement or, equally important, about how to realize the (usually increased) value of the capital investment in their firms. Certain things become very clear at those junctures: 1) Unless they choose to liquidate their firms, and likely suffer the economic penalties that usually occur, retiring principals must see to the successful continuation of their firms. 2) The firm will not be able to continue successfully without (other) capable principals in place. 3) Without principals in place, there will be no one to whom to transfer (i.e. sell) ownership.

**New expertise and leadership.** Firms lacking or needing new expertise and leadership, and not seeing such potential internally, frequently seek to import those necessary capabilities by bringing in new principal-level candidates and transferring ownership to them.

**Continuity.** Many architects who have developed viable practices choose to have them continue beyond their own tenure in the firm, whether to ensure continued service to valued clients, a continued workplace for valued employees, or simply to have the "child" they created and which bears their name continue into the future.

## **WHAT OWNERSHIP TRANSFER OPTIONS FOSTER SUCCESSFUL SUCCESSION?**

### **Internal transition**

Internal transition involves a selling owner's transfer of some or all of his ownership interest in the firm to another owner, or to a person in the firm chosen to become an owner.

The advantages of internal transfer include a) the opportunity to continue the firm as an ongoing entity, b) readily available buyers who have become enculturated in the firm's way of working, c) a reasonable financial return, usually in the range of 1.00 to 1.50 times accrual basis net worth, d) maintenance of effective control until the point that one's position is reduced to less than 50%, and e) probable maintenance of personal compensation and perks, subject to the establishment of a compensation and benefit arrangement that includes and is acceptable to the new owners.

The disadvantages of internal transfer include a) unavailability of suitable internal candidates, b) the need to begin sharing information and control, and c) the need to involve, foster the success of, and ultimately rely upon the contributions of others for the success of the firm, particularly regarding the ability to secure new work.

## **Recruitment of a leader from outside the firm**

When the firm does not have potential leaders in place, or the current owners do not see that potential, one alternative is to recruit such a person or persons from outside the firm.

The advantages of bringing in a leader from outside include a) the opportunity to continue the firm, if the transfer is successful, and b) potential redirection/rejuvenation. The disadvantages include a) the risk associated with the need to deal with unknown qualities, b) the need to share information and firm governance almost immediately, c) the likely high levels of salary and perks that may be required to attract such a person, and d) the possible need to redirect the firm's marketing and project execution to accommodate the interests of the next leader(s).

There will likely be a need to provide compensation and benefits at the market-rate levels sufficient to attract and retain such a person. With a successful new leader in place, the current owner can reasonably expect to receive at least 100% of accrual basis book value, and possibly more for his ownership interest in the firm.

## **Merger with another firm**

If qualified candidates for ownership are either unavailable, or the conditions surrounding such a transfer are perceived to be excessively risky, the owner(s) may consider merging with another entity. In a "merger of interests" no cash is exchanged at the time of the merger. However, an owner interested in retiring, creates the opportunity to redeem his financial interest in the merged company at a later date, probably at 100% of accrual basis book value.

Such a relationship has the advantages of a) providing for continuity of the firm, albeit in a new configuration, b) permitting the owner's eventual retirement and return of capital, and c) probably maintaining control of his own work. However, it would require the owner to a) begin working at a partner level in a basically unknown and untested relationship, b) begin sharing information, governance and control, and c) compromise on many issues, particularly those related to finances and marketing without the certainty of eventual success.

## **Acquisition**

Where the need for securing or maximizing financial return is paramount, other options are deemed inappropriate or unlikely to be unsuccessful, or other issues unrelated to ownership become important (e.g., market expansion), owners may consider the possibility of selling their firms to another firm.

The advantages of acquisition by others include a) assurance of the firm's continuity, albeit in a different form, and b) the probability of higher personal return on equity, possibly in the range of 150 to 250% of accrual basis book value. The disadvantages, however, are significant and include a) immediate relinquishing of the control of the firm to others, b) living within the acquirer's financial and cultural frame while employed.

## **Liquidation**

Although this liquidation is an option, it is not an option that fosters successful succession. Nevertheless, failing any other reasonable way to plan for the continuity of the firm through ownership transfer, an owner can realize a portion of his investment by liquidating the firm.

The advantages of liquidation include a) the right and the responsibility to maintain control up to the point of liquidation, and b) maintenance of compensation and perks, within the economic capabilities of the firm. Disadvantages include a) the probability of staff defections along the way and b) the significant negative impact on value: liquidating owners usually recover somewhere between 75 and 90% of the company's accrual basis book value. Additionally, absent an ongoing concern to provide for follow-on insurance coverage, the owner will need to consider purchasing a liability insurance "tail" or assuming the risk of potential uninsured and unfunded claims.

## **WHAT DO FIRMS NEED FROM THEIR (NEW) OWNERS?**

Architectural firms need certain contributions from owners that they cannot reasonably expect to be provided by non-owners. Because they are of utmost importance to the success of the firm, and must be provided by the owners, they can be thought of as ownership responsibilities. They are: capital, marketing, management, quality and leadership.

**Capital.** The owners are responsible for providing the capital necessary to initiate and operate the firm. Start-up capital is required at firm initiation for organizational expenses and initial operating expenses that are incurred and must be paid for before payment is received for services performed. Once up and running, the firm may require more capital to fund growth and to pay for ordinary operating expenses when collections fail to meet current needs.

**Marketing.** It is the owners' responsibility to secure the clients and projects that permit the firm to conduct its business of providing professional services. Although others may support the marketing and sales effort, ultimately it is the owners' responsibility to "feed the firm." Since the ability to market and sell is recognized as an important personal characteristic or learned ability, in some firms it is the single most important criterion for ownership. Since the firm can only do that which it

gets/sells, marketing is the lifeblood of the firm. Those who can do it successfully are understood to be making a significant contribution to the firm's success and are frequently compensated accordingly.

**Management.** The firm must be managed at the top. The owners must manage it to ensure that it exists tomorrow to fulfill tomorrow the promises to its clients that it made yesterday. They must manage it so that it produces a profit sufficient to ensure the firm's bankability, competitiveness in the marketplace and continuity. They must manage it to provide a financial return at whatever level they deem appropriate for their effort, investment and risk.

**Quality.** The owners must establish the level of quality that, literally and figuratively, will stand for and represent them - design quality, technical quality and quality of service. The firm's completed projects will stand in the marketplace as proof of what the firm is capable of producing, a determination that cannot be left to non-owners. The firm's reputation regarding its relationship to its clients and others is of equal importance. Although implementation, review and control of quality may be delegated to others, it is the right and responsibility of the owners to establish the level of quality that must be achieved.

**Leadership.** The owners must lead. They must provide the inspiration, direction and motivation necessary to move the firm towards the achievement of their vision for it. They do it by creating a vision and communicating it, and by performing, setting examples, motivating, encouraging, mentoring and rewarding others so that they will perform in ways that move the firm towards the vision the owners have for it.

In turn, owners need certain things from the firm and from each other. From the firm owners need recognition, internally and externally; participation in decisions affecting the firm's and the individual's future; control over one's work and how one does it; principal-level compensation, benefits and perks; and equity growth. From each other owners need shared values; professional respect; trust; compatibility and commitment.

## **WHAT SHOULD PROFESSIONALS, YOUNG OR OLD, DO ABOUT SUCCESSION?**

These understandings are crucial:

1. Whether or not to have the firm succeed one's own involvement is a personal choice, with important consequences for either path.
2. If succession is the choice, for any or all of the good reasons that apply, it must be planned.
3. Growth generally requires expanding leadership at the top, as well as staffing at the bottom.

4. Since the best opportunities to transfer ownership are internal, the owners must take care to develop their future successors.
5. The owners must understand what the firm needs from its owners and establish criteria that ensure the firm will get what it needs from the ownership group.
6. Employees who see themselves as potential owners should understand the responsibilities of ownership (i.e., what they will have to do as owners), and the criteria that the current owners will apply to the consideration.