Creating an
INTERNAL OWNERSHIP TRACK

Recruiting and developing a skilled team of advisors is one of the most difficult challenges facing the owners of a financial advisory business. It is, after all, the people who are one of the real assets of any business, and this is especially true in a professional services industry.

But recruiting and training a core team is actually only half the challenge. The other half is retaining key employees now and in the future — a future that may extend beyond the current owner's lifetime. How can advisory owners keep the talented people they have worked so hard to recruit, train, and develop? The answer may be contained in the question: make these key employees "owners" as well.

The advantage of creating an internal ownership path stems from its ability to turn key employees into active investors who see their investment's value grow through their own hard work. In addition, retaining and motivating key employees is a major step in preserving the value of the business in the event of short-term disasters such as the sudden death or disability of the founding or majority owner. Creating an internal ownership track is an integral part of managing and growing the value of a financial advisory practice.

Cast in this way, an internal ownership program becomes part of the overall "equity management" of a firm, a concept focused on helping investment professionals identify, grow, and realize the value of an advisory business while providing for the long-term care and retention of the client base. By creating ownership opportunities for the next generation, investment professionals create a stronger and more stable business model that can grow, with the client base, from one generation to the next, while growing the value and hence the reward for all of the "owners" of the company.

While the idea of "sharing" ownership with the next generation is often met with skepticism by founding owners, the advantages of an internal ownership program far outweigh the small dilution of a founding or majority owner's equity. While implementing such a plan may raise issues of loss of control, taxes, distributions, dividends, value and valuation approaches, minority discounts, gifting, expectations, and sometimes feelings of entitlement, each of these issues can be systematically dealt with in a carefully crafted plan. This paper provides a practical overview of internal ownership plans with the goal of helping business owners sort through the most troublesome of these issues and dispelling many common misconceptions.

FROM TOO SIMPLE TO TOO COMPLEX

Providing ownership to employees need not be a complex undertaking, but it does need to be set up and administered properly. At opposite ends of the spectrum are two approaches — gifting the stock (or membership interest in an LLC, hereafter referred to as "stock" for simplicity), or using an Employee Stock Ownership Plan (ESOP).

Many owners think the simplest, most effective approach is to simply gift a small or minority portion of stock to one or more key employees. While this approach can achieve, at least in part, the objective of moving an ownership interest to a key employee, there are a host of valuation and tax issues that accompany such transactions. The Internal Revenue Code (Section 102) makes a gift from an employer to an employee a taxable event in many, if not most, circumstances, and certainly when it comes to stock. Gifting, as a strategy, is unsustainable as a systematic program to provide ongoing incentives and a real path to ownership for employees. It also undermines the concept of having employees invest in their future.

At the other end of the spectrum is an ESOP – an employee benefit plan governed by ERISA (Employee Retirement Income Security Act) that provides a tax-advantaged mechanism for transferring ownership of a company to its employees. Using a leveraged ESOP, a bank lends money to the ESOP, which in turn buys stock from the company or from existing shareholders. The company makes annual tax-deductible contributions to the ESOP, which in turn pays the bank loan. Employees receive stock or cash when they retire or leave the company. The regulatory requirements for maintaining and administering an ESOP, coupled with the cost of setting up such a plan, make ESOPs impractical for all but the largest financial advisory firms.

So where is the middle ground? An internal stock ownership plan may provide the answer. This is a structured plan that allows employees to purchase stock (or LLC membership interests) at fair market value and on established but flexible terms. Owners can sell a portion of their ownership interest to one or more key employees over time, usually starting with a purchase and sale agreement, promissory note and stock pledge agreement as collateral.

BATTLING THE ELEMENTS

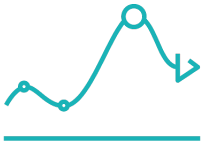
The objections to establishing an internal ownership track can be condensed into a relatively small list. For most owners, it is a combination of factors and misunderstood issues that sidetrack the process before it even begins. The following is a summary and explanation of the various elements underlying an internal ownership track for the average financial advisory business:

CONTROL

The issue of control is both real and emotional, but providing one or more key employees with an ownership opportunity is not about surrendering control. The goals under consideration in this paper can be easily accomplished with just 1% of the company's stock. And while majority owners typically control the company, governance and equity are separate concepts; the amount of ownership doesn't have to equal the amount of control.

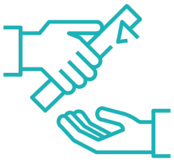
COMPENSATION

Like equity and control, ownership and compensation are separate issues. Compensation is for doing a job, while ownership – which includes the privilege of sharing in company profits – is about investing in the future, building value, and creating or contributing to the company's ability to continue beyond the lifespan of its founding owner. It takes years for employees to hone their skills, learn and implement the company's vision, and earn the right to be an owner.



RISK

Ownership involves risk. This is not an opportunity to acquire passively owned, liquid, publicly traded stock. Many employees see nothing but positive growth numbers for business year after year, and well into the foreseeable future, but a small business, lack of control, and lack of marketability for minority shareholders still equal a risk. Just as you tell your clients, every investment carries with it a risk.



GIFTING

The issue of gifting stock is deceptively complex. An owner can give stock to an employee, but it is just like giving the employee cash — it is a taxable event and taxes must be paid by the employee on the fair market value received. Shares of stock in a privately owned small business should not be used as a reward. Instead, create the opportunity. Let your employees decide if they're willing to write the check and make an investment in their own futures.

VALUE/VALUATION

Begin every ownership discussion with the concept of “fair market value” and obtain a neutral, third-party valuation to aid this part of the process. Both sides will benefit from an objective opinion of value at the start, and once a year thereafter so that value and equity can be monitored. And, since price and value are related but different, you may decide to apply a minority discount to the fair market value for internal share purchases.

TIMING

The opportunity to be an owner should be part of a formal, written business model or plan, with the opportunity occurring, for qualified employees, after an established level of tenure (such as five to seven years) has been reached, and a certain level of proficiency (such as production) has been demonstrated. Founding owners invest, work, and wait for their payoff. The same should hold true for the next generation. Note that it is an opportunity only. Not every tenured employee may be a candidate for ownership.

CONTINUITY PLANNING

In addition to the growth aspects, an internal ownership track is an excellent protection measure against the founding or majority owner’s sudden death or temporary or permanent disability. If key employees have even just a 1% or 2% ownership stake (a value of $10,000 or more in an advisory firm valued at $1 million, for example) that they paid for themselves, it becomes their value, and their investment that they work to protect. In addition, the clients come to know the key employee as a principal rather than as a staff member. The size, value, and complexity of an advisory practice, as well as the skills and business acumen of the employee, often dictate whether the ownership track leads to a controlling, succeeding interest or not.

STEPS TO ESTABLISH AN INTERNAL STOCK OWNERSHIP PLAN

The hardest step in establishing an internal stock ownership plan may be the first one — making the decision to share ownership, even nominally, with one's employees. The issues discussed previously have many emotional aspects as well as practical, tax, and legal elements. Taking time to learn about creating a formal plan and how it works can alleviate most of these concerns for owners. Once the decision has been reached to proceed, the implementation is relatively straightforward.

STEP 1: USING THE PROPER ENTITY STRUCTURE

Many RIAs are already structured as an entity — usually an S-corporation or an LLC. Either of these entity structures works with an internal stock ownership plan, although the owner's goals and preferences will determine which is the best fit. Sole proprietorship models can set up such an entity structure with the assistance of FP Transitions, as part of our comprehensive approach, or with the help of local legal counsel or a CPA.

An investment professional who operates as a corporation or LLC will contractually establish the client relationship through the entity, as opposed to the individual professional advisor. A client, for example, will sign an Investment Advisory Agreement with ABC Wealth Management, Inc., rather than with Bob Jones, the sole owner of the company. In the event of the owner's retirement, death, or disability, the contractual relationship can be maintained without interruption through the surviving and continuing shareholders of the advisory business.

Setting up an entity underscores the basic idea that while people don't live forever, an entity can, or at least for more than one generation. In contrast, a sole proprietorship can only transfer assets, making it impossible (or at least very difficult) to share ownership in the same company.

STEP 2: DETERMINING THE VALUE OF THE BUSINESS

Before a plan is established to share ownership, the value of "what" is being shared needs to be determined. FP Transitions can help you select the right approach to valuation for your situation. With an objective valuation for reference, the owners can decide how much of the company may be offered to the employees and what will be the nominal share value. Although not required, a minority discount can be used, if applicable, to reduce the price of the ownership opportunity. In terms of minority discounts to the fair market value, the range is generally between 5% and 30%. A fair and reasonable discount is typically determined in consultation with tax counsel and after considering the circumstances of the transaction.

STEP 3: PLAN DOCUMENTS

The entity's corporate governance documents will be created or updated to reflect the new ownership of the firm. In a Corporation this will include the Bylaws which govern the operation of the company. It provides parameters to the directors and shareholders regarding their respective rights, duties, and authority and covers a range of topics such as the management of the company, voting thresholds, and distribution of profits. The Shareholders Agreement is the buy-sell agreement among the shareholders of the corporation. It provides processes for onboarding new owners and how to handle the withdrawal of an owner, whether through termination of employment, retirement, disability, or death.

Agreements to document a sale of equity can include a Purchase and Sale Agreement which memorializes the terms of the sale between the seller and the buyer. A Promissory Note outlines the terms according to which the buyer is to pay the seller for the shares purchased in the transaction. And, the buyer will pledge to the seller a first, secured interest in the shares purchased from the seller as collateral for the performance of the promissory note through a Pledge Agreement.

STEP 4: FINANCING THE SALE

Putting in place a mechanism for helping employees purchase and pay for an ownership interest is important in creating a functional plan. There are basically three commonly used methods for an employee to pay for ownership or shares of stock in an advisory business:

1. Seller financing: Most internal ownership tracks rely on company financing in the form of a promissory note.
2. Bank financing: This is becoming increasingly available for employee buy-ins, and is often used in the employee's second or third share purchase.
3. Cash: The employee can pay for stock with their existing funds at the time of purchase.

Nonnegotiable promissory notes are typically the preferred method of seller or company financing. Interest rates tend to range from 5% to 10%, with monthly or quarterly payments over a period of three to 10 years. Collateral usually consists only of a stock pledge of the acquired stock, but may also involve a personal guaranty for sums in excess of $50,000.

Some owners provide both the financing and the means to purchase by way of a salary increase or an annual bonus. But most importantly, the choice to invest, and to embark on a career with a given business, remains with the employee. Once the opportunity is given, and the choice to invest is made, the key ingredients will be in place to help power the business to the next level.

SUMMARY

Providing the next generation with an opportunity to be owners, even in a very small way, can have a profound and lasting impact on the success of a financial advisory business. Providing an ownership path to key employees not only more effectively retains those employees, it can often increase productivity, especially when equity value is monitored on an annual basis.

In addition, employees who become owners provide an excellent means of protecting the practice from the sudden death or disability of the majority owner while creating the possibility of a long-term succession plan. While people don't live forever, a business can, if each succeeding generation plans appropriately and recognizes that its work can be extended to many future generations. This is a great benefit to share with clients and their families as the business grows and endures over time.

In fact, combining the talent and energy from multiple generations of advisors is the first step to running a real business.