

Selling, Merging, or Closing Your Practice

An Overview of the Many Processes and Factors to Consider When Choosing a Course of Action

By George E. Christodoulo, PC¹

Privately-owned architecture firms of all sizes are increasingly faced, in light of the inability to successfully transition ownership and leadership internally, with considering an external sale or merger of the firm or the winding up and closure of the practice. Each of these alternatives has both advantages and challenges which must be carefully weighed in deciding a course of action.

Introduction

This paper will review the challenges facing privately owned architecture firms in today's consolidating competitive environment where the traditional internal ownership transition/leadership succession programs face numerous hurdles. This discussion will explore and compare the alternatives processes of sale/merger or firm closure facing the leadership of a firm and the factors to consider when determining a course of action. This paper is divided into five sections: 1) Challenges; 2) Alternative Courses of Action; 3) Sale or Merger; 4) Firm Closure and 5) Conclusion.

Challenges

Privately owned firms are the rule in the architecture sector, with thousands of such firms. No matter how young or old, how large or small or how diversified or specialized, each firm faces a competitive environment that continues to consolidate. In recent years there has been an increasing and sustained pace of mergers and acquisitions rivaling the heights of 2007. It appears that there is continued confidence on the part of institutional investors and savvy buyers who see the industry fundamentals as stabilizing and long-term trends as encouraging.

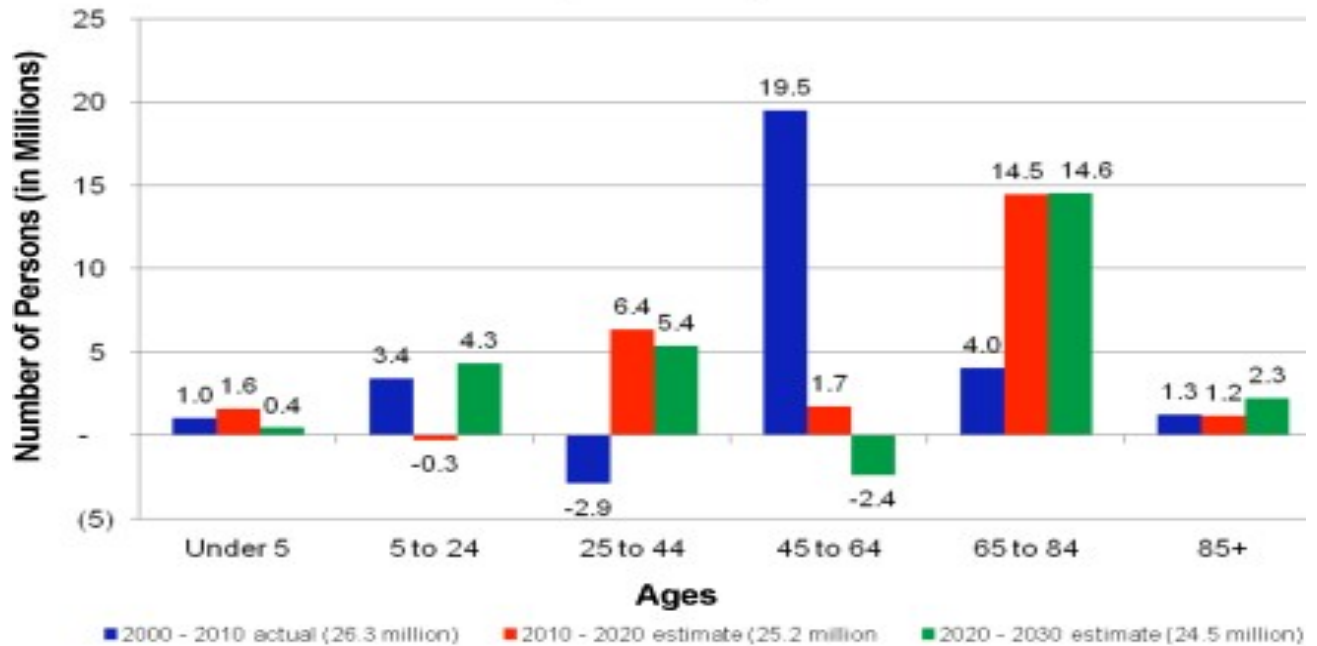
Some industry consulting and financial advisory firms which track such activity believe that the continuing needs of baby-boomer owners to free up their investments in their firms and the increasingly competitive environment will result in many firms seeking or accepting an

unsolicited external exit.² With both buyers and sellers seeking transactions, it may be that we will see a continued vibrant pace.³

Privately owned firms of all sizes must transition ownership and leadership each generation if they wish to sustain themselves as independent entities. Internal ownership transitions, which have historically been the preferred method of intergenerational transfer within a firm, have become more difficult to consummate successfully given the uneven financial performances of many firms in recent years. Virtually all internal transitions are funded, in whole or in part, by bonuses and distributions from the firm. The performances of architecture firms from 2008 to 2011 have negatively impacted the amounts which can be bonused to younger owners to finance their purchase of shares and leadership succession and ownership transition was delayed. The market began a turnaround beginning in 2012 and continued strong performance will increase the likelihood of successful internal transition. Without such an infusion of profits, firms often find it impossible to finance the redemption of shares by older leaders and still allow the firm to have adequate capital to operate and grow. The second part of the challenge is the absence of the next generation of architects, who while talented professionals, do not necessarily have the inclination or entrepreneurial business instincts to lead a firm.

A recent article sets forth the alarm regarding a firm's ability to redeem shares based on an analysis of the growing number of baby boomers over the next two decades.⁴ The rate of change in population demographics will have a significant effect on value, liquidity and leadership succession. Over the next two decades, the population of those 65 to 84 years of age will increase by nearly 30 million people while the population of those 25 to 64 years of age will increase by a little over 11 million or nearly one-third as many as those reaching retirement, resulting in an abundance of sellers and a shortage of buyers. The concern is that the need to devote future cash flows for share redemptions may impact the ability to grow, pay competitive incentive compensation to staff and generate a return for owners. The chart below is a graphic illustration of these statistics.

Change in Population



U.S. Census Bureau, Population Division

Clearly, firms who wish to pursue an internal intergenerational transition will find that it is not without its challenges. More and more firms are incorporating ownership transition in their strategic planning engagements to address slow growth rates, lower profit margins, the demographics described above and obligations to previously separated shareholders in an attempt to formulate a realistic internal ownership transition program.⁵

•Firm Size

Firm size categorization, for purposes of this paper, is as follows:

Number of Employees

1 to 20
21 to 100
101 to 450
451+

Size

Small
Medium
Large
Extra Large

•Mid-Size, Large and Extra Large Firms

Large and Extra Large independent firms face profitability challenges from larger, well capitalized publicly-held firms which may bid aggressively for work to keep their staff busy and from smaller firms which may undercut their pricing due to lower overhead and

efficiencies in operations. Industry specialized valuation and financial advisory firms have been discussing the so-called vanishing mid-sized firm, characterizing such firms as to be too large to be small and too small to be large. However, a recent study argues that the midsize A/E firm is not dead or dying, but rather sustaining itself.⁶ Medium size firms often have solid profit, top partner salaries and top design award recognition. However, after the current generation of leadership it may be difficult to sustain such financial and design levels without an external transition as the internal talent may not measure up as leaders. With the right leadership, however, a medium size firm can attract clients and talent and it is a great size to practice architecture.

The factors that lead a firm to seek an external transaction are several:

1. Higher Valuations

External valuations are almost always higher than internal transition valuations, are paid more quickly and with less risk of nonpayment. Valuations of external sales are often based on a multiple of historical earnings and are appreciably higher than the book value of the firm. The multiple of earnings a buyer is willing to pay is generally higher for large and extra large firms than small and mid-size firms, since so few firms are so large. Brian Kenet, a Consulting Principal at EFCG, based on his experiences in advising in several of the largest architecture mergers and acquisitions, believes that buyers are willing to pay a higher multiple for larger firms since such firms are governed and operate in a corporate-like organizational structure not dependent on a small group of principals to generate project work. Valuations for internal sales are typically at book value or book value plus perhaps a small premium, but always lower than an external sale. The valuation in the case of a firm closure and liquidation is never more than the book value of the firm at the time of its closure and is almost always less since monetizing the balance sheet inevitably results in some slippage in collecting accounts receivable.

2. Ownership Transition Failure

Many firms are burdened with a disproportionate number of older owners/leaders who own a majority or significant portion of the firm and/or with obligations owing previously departed owners. There is a shortage of younger professionals who are prepared and inclined to take over the ownership of a firm, particularly when firms have not been able in recent years to generate strong profits to bonus younger owners to allow them to finance the purchase of shares. The demographic statistics, as previously discussed, indicate that the challenge of an internal transition is likely to become more acute in the future.

3. Leadership Succession Failure

Most firms have not adequately prepared the next generation to take over the management helm of firms, and in many cases there are not members of the next generation of management who wish or are inclined to take leadership positions.

4. Client Demands

Many clients are demanding that firms have increasingly broader service platforms and geographical reach to minimize the number of joint ventures, firms and subconsultants on each project. Mid-size, large firms and extra-large firms either do not have the resources and capital or the inclination to spend such resources and capital to face consolidating competition and growth pressures, either organically or through acquisitions.

5. Diminishing Financial Performance

Firms must contend with increasing corporate overhead and fixed costs, the need for more astute business management and larger competitors who are chasing smaller projects, which may result in lower profitability and tighter financial constraints.

6. Ongoing Employment

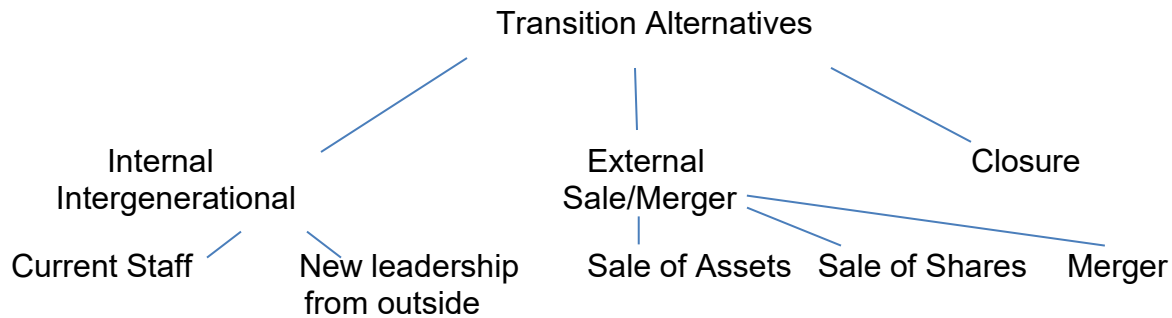
External transactions virtually always include continued employment for firm owners and staff and ongoing servicing of firm clients, which allows for a perpetuation of the firm or components of the firm in a larger context.

•Small-Size Firms

Firms below the mid-size level may prosper with lower overhead, nimbleness in operation and may focus on one discipline, market segment or geographic area. Often, such firms are owner/founder centric, with leaders attracting the firm's projects because of individual reputations since the firm is not viewed as an institution. Clearly, these firms are more likely to have an unsuccessful ownership transition and management succession program since there are far fewer candidates in the next generation to own and lead the firm and the specter of succeeding the owner/founder may be extremely difficult. For smaller firms, they must either find a buyer who is looking for a so-called "niche" or "tuck-in" acquisition or face the prospect of closing the firm since there is no realistic way to perpetuate the existence of the firm through internal transition. The same factors which apply to larger firms to seek an external exit are equally applicable to a small firm, and in some cases, even more applicable.

Alternative Courses of Action

The alternatives facing any size firm, assuming an internal ownership transition/management succession program with current staff is not feasible or is not proceeding at a realistic pace, are the hiring leadership from outside the firm, a sale or merger or closure of the firm.



Outside Leadership

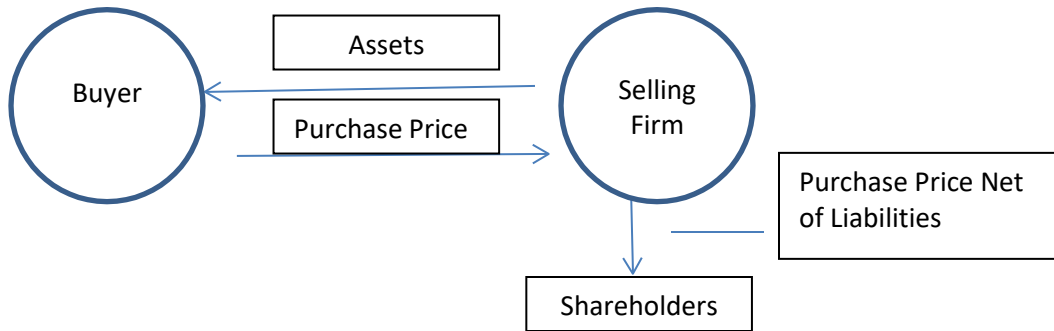
Assuming a firm is financially successful and can fund redemptions of senior owners, the firm may seek to attract leadership from outside the firm. While a possibility, the person will need to be culturally compatible with the firm and may require a period of time to earn the confidence and trust of both the current leadership and key staff members before ascending to leadership of the firm. This scenario may not be successful or attractive, given the difficulty in attracting such a person and the time needed to have that person rise to become the leader of the firm.

Sale or Merger

A sale or merger of a firm may be in one of several forms, including a taxable sale of assets or shares or a nontaxable sale of assets or shares, sometimes referred to as a tax-deferred transaction. A merger is the technical legal and financial name of many tax-deferred transactions. Each form of transaction dictates the tax impact to the seller, its owners and the buyer and the going forward culture and identity of the seller.

•Transaction Summaries

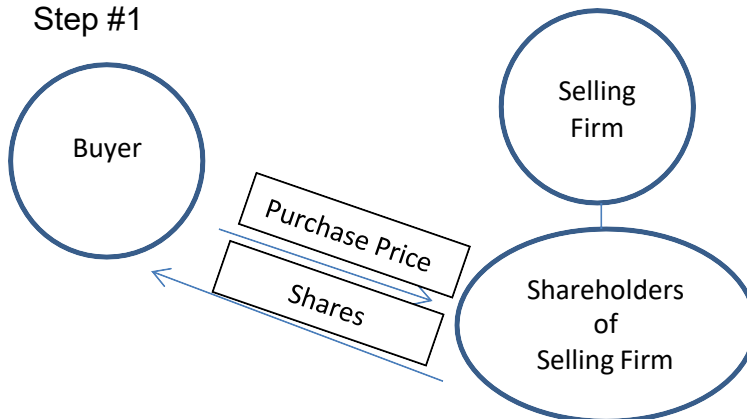
1. Sale of Assets



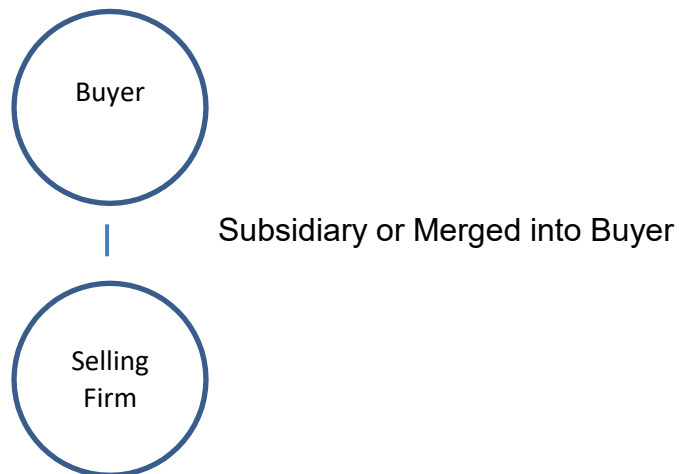
A sale of assets ultimately leads to the liquidation and dissolution of the selling firm, with the leadership and employees of the seller becoming part of the culture and staff of the buyer.

2. Sale of Shares

Step #1

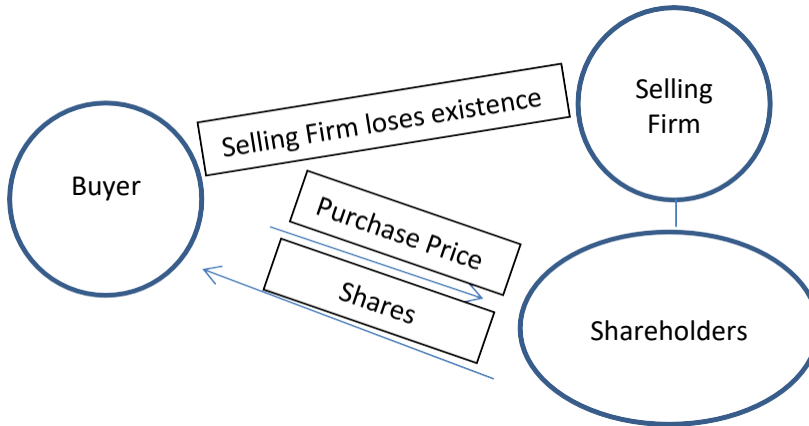


Step #2



A sale of shares is a more attractive alternative for the shareholders than a sale of assets since the taxation is at a lower rate and the culture and leadership of the seller may be more likely to continue in place.

3. Merger



Under a merger, the existence and identity of the seller terminates upon the merger.

In each of these transaction scenarios, the issues of the financial and taxation consequences to each party must be addressed and resolved. From the point of view of the seller and its shareholders, the topics of culture, leadership and autonomy should be fully reviewed and agreed upon so as to have an understanding of the impact to leaders, staff and clients.

For purposes of this paper, a sale or merger shall be used as interchangeable terms since the review of the process is similar, notwithstanding the form and consequences of the transaction.

•Process

The transaction process of a sale or merger can be set forth in general chronological steps, although often times certain steps are undertaken in simultaneous or parallel steps.

1. Transaction Readiness

Any firm contemplating an exit transaction should strongly consider making the firm transaction ready. The purpose of this exercise is to tidy up the business aspects of the firm before a potential buyer reviews such matters in the due diligence of seller. Such steps may include cleaning up the financial statements (for example, independent accountant review, eliminate loans to shareholders, get personal automobiles off the

books, resolve any open tax audits, write off very old accounts receivable, terminating underutilized staff at all levels, make sure income has not been recognized prior to being actually earned and accrue paid time off as a liability on the financial statements) and operational issues such as improperly classifying employees as independent contractors, operating profitability and being in compliance with software licenses. The failure to address such matters before discussions with buyers commence has, in my experience, led to difficult discussions with buyers after the due diligence has been completed and may result in a reduction of price, change in deal terms or even a termination of discussions.

2. Assemble an Internal Deal Team

Typically, the internal deal team consists of the President/CEO and the Chief Financial Officer. Senior leadership will be involved and it is important to centralize communication, negotiate the transaction with industry experienced advisors and be willing to make the deal a priority in their respective schedules.

3. External Deal Team

The external team includes a mergers and acquisitions attorney and a financial advisor/intermediary, in each case with industry specific experience. There are several firms who provide industry specific advisory services, including sourcing and searching for deal partners, valuing your firm and advising during the process. A corporate attorney with transaction experience within the industry, and a tax attorney or accountant, are important to make the transaction tax efficient to the seller. The financial adviser and deal attorney will assist the seller in understanding professional licensure rules and market terms regarding such matters as restrictive covenants, employment agreements and indemnification of buyers. The professional liability insurance agent will provide the seller with advice regarding insurance for the prior acts.

4. Financial Intermediary

The seller first interviews and then retains a financial intermediary, who may work on an initial fee and deal success (contingent fee) basis or on an hourly basis. Industry experience, a track record of transactions and an awareness of possible buyers for the practice is critical. Retaining an advisor with no prior experience in the architecture sector is not the proper choice.

5. Preparation of Confidential Memorandum

The firm and the financial intermediary will together prepare a Confidential Memorandum describing the firm, services, leaders, operations and locations, financial performance (in a redacted manner) and representative projects. The Confidential

Memorandum also makes the case why the firm is for sale and the benefits of acquiring the practice.

6. Potential Interested Parties

The firm and the financial intermediary together will prepare and finalize a list of prospective buyers. The seller will be able to pinpoint certain criteria it believes are important in a buyer (size, location, competitor, private or publicly owned, etc.) and cull the list. The intermediary will then contact these firms with a short description of the seller in a manner that preserves anonymity as to the identification of the seller.

7. Confidentiality Agreement

A potential buying firm which indicates an interest in exploring a transaction will then sign a Confidentiality Agreement (Nondisclosure Agreement). Thereafter, the buying party will receive the Confidential Memorandum for review.

8. Initial Meetings and Discussions

A buying firm which has reviewed the Confidential Memorandum and is interested in pursuing discussions will then have meetings and discussions with the seller deal team in a manner that preserves confidentiality within the seller organization. These meetings may include the financial intermediary and the transaction attorney for seller.

9. Memorandum of Understanding/Letter of Intent or Termsheet

At some point when discussions progress, the seller together, with the assistance of the financial intermediary respond to the buyer's draft of a Termsheet or Memorandum of Understanding setting forth the understandings initially reached by the parties. This document then is followed by a Termsheet or Letter of Intent prepared by the transaction attorneys in a more formal form. This document clarifies and memorializes the parties understanding of the material key transaction points, identifies the points of the transaction which must be agreed upon, sets forth a proposed timetable and enumerates binding and nonbinding terms. Typical binding terms include a provision that the seller cannot negotiate with any other party for a specified period, each party bears its own expenses, nondisclosure of discussions, allowing buyer access to seller's records and information, prohibition of any public announcement and how the agreement is terminated. This document is critically important to the seller since it is agreeing to cease further discussions with other suitors and to commit to the expenditure of funds and time going forward with one buyer. The importance of these documents is to give the seller and its senior leadership confidence to go forward and to eventually inform employees, clients and ultimately the public of the impending transaction at the appropriate time.

10. Due Diligence

Upon the signing of the Memorandum of Understanding/Letter of Intent, the buyer will present the seller with a Due Diligence Information Request, which will include qualitative, quantitative and legal matters. The goal here is simple - the buyer wants to find out everything it can about the seller through written documents, discussions and interviews with senior leaders. Most often the written information is scanned and loaded onto an FTP website which is accessible to the buyer, seller and their respective advisors. Face to face meetings with respect to nonwritten materials re also held. The results of the due diligence often lead to further discussions and alterations to the transaction as agreed, based on any concerns or information uncovered or of a concern to buyer.

11. Definitive Documents

The definitive documents include the Purchase or Merger Agreement and the Schedules thereto, Employment Agreements and Non-Competition Agreements.

Purchase or Merger Agreement

This is the transaction document setting forth the transaction structure, the consideration (cash, promissory notes, earnout, buyer's stock), representations and warranties of buyer and seller, indemnification provisions, and the assignments and consents thereto required to complete the transaction. The schedules to the agreement represent the seller's disclosures regarding its business and operations and it is critical that the schedules be complete and accurate, as they are the basis upon which the buyer may bring an indemnity claim against the seller and its shareholders.

Employment/Non-Competition Agreements

This is typically one document but may be divided into two documents. The employment provisions spell out the position offered for employment, compensation, benefits, term of agreement, termination of employment for cause, not for cause, death, disability or end of term. The restrictive covenants include noncompetition, non-solicitation of clients, non-solicitation of employees and confidential information. In the case of both the Purchase or Merger Agreement and the Employment/Non-Competition Agreements, the initial drafts are generated by the buyer with the seller and its attorney then negotiating the final versions.

12. Approval of Transaction

Typically, the transaction must be approved by the Board of Directors of the buyer, the Board of Directors of the seller and the shareholders of the seller.

13. Closing

When the documents are all approved and signed, the closing takes place. Simultaneously or immediately thereafter, a communication plan to employees of both the seller and buyer, clients and the public is implemented. Certain operational matters are integrated, including benefits, payroll, retirement plans, and insurances. Third party consents for assignment of leases and contracts, professional licensure matters and professional liability tail insurance for the seller's prior acts are among the other topics which must be addressed to complete the transaction.

•Factors to Consider

In determining a course of action to either sell or merge, there are a multitude of issues and topics to consider. The following are among the most important such matters:

1. Compatible Cultures

Are the cultures of the buyer and seller compatible?

2. Name

Will the name of the selling firm continue, be modified to be used in tandem with the buyer's name or will the name of seller disappear? Is there an agreed upon transition timeline for any name change?

3. Prior Acts Professional Liability Insurance

Is the seller required to purchase so-called tail or prior acts professional liability insurance for claims against seller relating to the period prior to the closing but which arise after the completion of the transaction? Is buyer willing to insure such prior acts under buyer's continuing professional liability insurance? Is seller required to pay for the insurance coverage out of the purchase price or is the coverage being borne by the buyer?

4. Personal Property of Seller Shareholders

Often the shareholders of seller wish to retain ownership of personal items in their respective offices, sketches of projects and a portfolio of projects (often a duplicate of the portfolios purchased by buyer).

5. Motivations

What is the buyer's motivation to buy?

What is the seller's motivation to sell?

6. Deal Structure

What are the tax ramifications of the transaction structure to each of the parties?

7. Retention and Future Employment of Seller's Employees

Are there retention agreements in place to motivate the employees of seller to remain with the buyer? Are the restrictive covenants of the buyer understood such that each principal of seller is aware of the limitations in his activities? Are the terms of future employment clear with well-defined roles? After the closing, the only document binding the employees of the seller and the buyer is the Employment Agreement, which addresses future roles, compensation and termination provisions.

8. Liability/Indemnities

Are the post closing indemnities of seller for liabilities relating to the period prior to the closing understood? Typically, the buyer will look to the seller and its shareholders personally for indemnification for a period of 2 to 3 years after the closing for undisclosed or unknown liabilities of seller which were not assumed by buyer.

9. Post Closing Operations

Is it clearly understood whether seller will continue to operate as an autonomous unit or will seller's operations be integrated into buyer?

10. Future Role of Seller's Management

What are the future employment roles of the senior managers of seller? What are their responsibilities and authority in operations and future strategy?

11. Communications Plan

How will the transaction be presented to the various interested parties - employees, clients, professional associations, public at large? What is the branding strategy that keeps the legacy of the seller yet touts the expanded expertise and services of both the buyer and seller?

12. Transaction Costs and Expenses

What are the costs and expenses being borne by the seller for legal, accounting, financial and tax advisory services?

13. Comparison with Internal Ownership/Management Transition and Succession and Closure

How does the transaction to sell compare overall to an internal ownership transition/management succession program? How does the transaction to sell compare with a closure of the firm? The answers to the comparison of alternatives are firm specific and depend on a number of objectives and priorities of the owners.

Firm Closure

The owners of a firm often believe that if neither an internal transition nor a sale/merger can be consummated successfully, they will simply close the firm. The disadvantages to a firm closure are that the net proceeds to the owners are lower than an external sale or an internal transition, plus there is no continued employment for owners and staff and clients must seek other firms for architectural services. A more in-depth review of the process and factors to consider shows that such an alternative is not without its substantial challenges and disadvantages and thus is rarely viewed as a viable, planned course of action.

•Process

There are several steps in the closure process:

1. Owners Agreement

The owners of the firm must first reach agreement to wind up and close the firm and ultimately liquidate and dissolve the firm.

2. Closure Team

The firm must establish a closure team consisting of a firm leader and outside advisors (attorney, accountant, professional liability insurance agent, human resources consultant) to address the steps, costs and timeline to close the firm.

3. Schedule of Closure

The closure team must develop a schedule of events and tasks and a plan to implement the process successfully. The schedule should provide for contingencies in timeframe, expenses and third party matters, all of which are necessarily difficult to determine in advance with precision.

4. Client Contracts

The most valuable assets of a firm are its current contracts to provide

services and proposals for future work and the staff to complete such contracts. However, since a firm cannot synchronize the end of all such contracts at the same time to coincide with the closing of the firm, the completion of all current contracts now becomes a liability since the firm is contractually obligated to perform such services. Therefore, the firm may need to find another firm to complete the contractual services and obtain the consent of the clients to an assignment of the contracts to the new firm, which is not a simple task, or keep staff on to complete the contracts.

5. Leases

Most firms have both office leases and leases for equipment. In a vast majority of cases, the lessors will not allow the firm and its personal guarantors, if any, to simply walk away from such obligations. Therefore, the firm must resolve its liabilities by settlement with its lessors, if possible.

6. Other Contracts

Other contracts, such as for reproduction services, must be addressed and resolved.

7. Employee Notification

The firm must comply with any and all state and federal notice requirements such as the WARN Act in notifying employees of the firm's closure. The biggest challenge may be to retain staff as long as desired to complete contracts since most staff will likely be seeking alternative employment and very well may leave prior to the date of closure. The firm may have to implement a policy of paying retention bonuses to incent staff to stay until a certain date.

8. Final Payment to Employees

The firm must pay employees in cash, within the time periods prescribed by the applicable state and federal laws, all accrued wages and accrued paid time off plus severance, if applicable, after termination.

9. Bank Financing

If the firm has outstanding bank debt, the firm and its owners, who are often personal guarantors of such debt, must address the payment of such debt.

10. Accounts Receivable, Work in Process, Accounts Payable

Work in Process must be billed and accounts receivable collected. The collection of amounts owed in the context of a closing firm is often more difficult than in the

context of an ongoing firm. Subconsultants and other accounts payable must be addressed and settled.

11. Tax Returns/Final Accounting

The firm will need to prepare financial statements and final tax returns. Any state or federal states owed must be paid with such taxes.

12. Bank Accounts

Bank accounts held by the firm will require closure.

13. Business Licenses/Permits/Professional Licenses

All licenses and permits will require cancellation or be allowed to lapse.

14. Articles of Dissolution/Final Distributions to Owners

After the assets have been marshaled and liabilities paid, final distributions to owners can be made and Articles of Dissolution filed.

15. Post-Dissolution Matters

The firm and its owners should purchase professional liability tail insurance as required by contracts completed by the firm and to insure against claims arising after closing for prior acts before closing. The owners should store and retain business records for seven years after closure of the firm.

•Factors to Consider

Before embarking on the closure of a firm, the following are among the issues that must be considered:

1. Timetable

The process requires a concerted and focused effort by a team over a period of several months.

2. Budget

The costs and expenses of closure must be anticipated and adequate funds segregated to fund the process.

3. Net Proceeds

It is likely that the closure of the firm may result in some portion of the net

book value being returned to the owners, but in some cases the costs may approach, or even exceed the proceeds from liquidation, particularly if collecting accounts receivable becomes problematic.

4. Comparison with Internal Ownership/Transition/Management Succession and the Sale/Merger of the Firm

How does firm closure compare overall to an internal ownership transition/management succession program? How does firm closure compare to the sale/merger transaction alternative? Again, the factors in weighing and comparing alternatives must be applied to the specific firm situation against the backdrop of the objectives of the owners.

Conclusion

Privately owned architecture firms face the generational challenge of either embarking on an internal ownership transition/leadership succession program or the external sale or merger of the firm. There are financial, cultural and professional career satisfaction parameters which are to be considered and weighed in deciding upon a course of action. An external sale/merger yields the highest financial return to owners with continued employment for staff and the closure of the firm yields the lowest financial return to the owners with no continued employment. An internal transition/succession more likely perpetuates the firm culture when compared to an external exit and while the proceeds to owners are less than an external sale and more than a closure, there is continued employment for owners and for staff who wish to continue. The most important trade-off facing a design firm is ceding control of the firm and design decisions in exchange for the payment of the purchase price. In the circumstance where neither an external sale nor an internal transition is a viable course of action, the closure of the firm serves as the default choice where the owners are unable to continue the firm in existence.

There is no right answer as to which course of action is best and the decision as to how to proceed is up to each firm and its owners in the context of its circumstances and the variables that matter most to them. It is critical for the leaders of a firm to constantly revisit the firm's strategic plan and the owners' plan for transition and leadership succession (internally or externally). Waiting too long to plan or act will likely result in neither an internal transition nor an external exit and therefore the default alternative of closure will ensue. For all reasons set forth above, a closure has few advantages and numerous disadvantages and should be avoided if at all possible.

Endnotes

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