

ARTICLE

April 2, 2012

Opportunities for Employee-Owned Professional Design Corporations

Anne-Mette Elkjaer Andersen
David O'Leary

New legislation makes it easier for some employee-owned professional engineering, architecture, landscape architecture and land surveying corporations to work on design projects in New York — but design businesses based outside New York are unlikely to benefit.

New York State has strict restrictions on the types of corporate and other legal entities that are allowed to practice professional engineering, architecture, landscape architecture and land surveying (the so-called "design professions") in New York. With the exception of a few so-called "grandfathered" corporations,¹ until recently only entities with 100 percent ownership and management by design professionals, i.e., licensed to perform the design professions, were permitted to offer and provide professional design services in New York.²

Traditionally, these rules have prevented not only publicly owned design corporations but also smaller professional design corporations with employees other than design professionals among their shareholders from providing professional design services in New York and prevented those already practicing in New York from having a more flexible management and employee ownership structure.

However, effective Jan. 1, 2012, the Business Corporation Law (BCL) and the Education Law have been amended to allow more flexibility for professional designers by allowing a new kind of design professional corporation to include non-professional employees among its shareholders without losing the ability to perform design services in New York.³ The change also allows these corporations to include among its shareholders employee stock ownership plans, which may provide tax benefits.

Ownership

The BCL authorizes a new type of New York corporation referred to as "design professional service corporation" (DPC).⁴ A DPC must be incorporated in New York after Jan. 1, 2012, to practice professional engineering, architecture, landscape architecture or land surveying, or any combination thereof. Pre-existing professional design corporations (and other professional design entities) wishing to take advantage of these new rules would need to form a



Anne-Mette Elkjaer Andersen
212.513.3224
anne-mette.andersen@hklaw.com



David O'Leary
312.715.5851
david.oleary@hklaw.com

DPC and then merge their pre-existing entity into the DPC, or otherwise transfer its professional activities and employees to the DPC.⁵

In addition to design professionals, a DPC will be allowed to include among its shareholders employee stock ownership plans (defined contribution plans established pursuant to Section 4975(e)(7) of the Internal Revenue Code, each an ESOP) and DPC employees who are not design professionals.⁶ Other types of shareholders, such as other corporate entities or non-employee individuals, are prohibited.⁷ For the same reason, shares may only be transferred to other eligible shareholders, i.e., design professionals or employees.⁸

Inclusion of non-design professional employees and ESOPs in the ownership of a DPC is subject to the conditions that:⁹

1. Greater than 75 percent of the outstanding shares are owned by design professionals.
2. An ESOP may not constitute part of the greater than 75 percent owned by design professionals.
3. The single largest shareholder is either (1) a design professional, or (2) an ESOP with greater than 75 percent of both its voting trustees and its committee members being design professionals.

The above restrictions would allow an ESOP to be a 24 percent owner of the DPC (regardless of the percentage of beneficiaries that are design professionals), but if the ESOP is the largest shareholder, then more than 75 percent of the ESOP's voting trustees and committee members would need to be design professionals.

The BCL defines "design professional" as "an individual licensed and registered pursuant to Title Eight of the Education Law to practice professional engineering, architecture, landscape architecture or land surveying."¹⁰ Title Eight of the Education Law only addresses licensing in New York State, and accordingly, design professionals licensed in states other than New York would not qualify as "design professionals" for a New York DPC, and the inclusion of them would be counted toward the cap of less than 25 percent for shareholders other than New York licensed design professionals.

The new rules are structured to permit former, current and future employees to benefit from share ownership, either directly or through an ESOP. Inactive ownership by investors will not be permitted.¹¹

Only persons with an actual employment history for the DPC can become shareholders. New York licensed design professionals must be, have been or will be (within a 30-day period) working for the DPC.¹² Other employees cannot become shareholders prior to employment. Upon retirement, New York licensed design professionals may remain shareholders, but other employees cannot remain direct shareholders upon retirement or termination — although there appears to be no restrictions on allowing them to continue to benefit from an ESOP. The DPC would be required to repurchase or redeem the shares held by non-design professional employee shareholders (and design professional employees licensed in states other than New York) within 30 days of termination, unless the shares are transferred to another employee.¹³

Because the definition of "design professionals"¹⁴ requires licensing in New York, design professionals licensed in other states would be treated as regular non-professional employees of a DPC. Therefore, professionals licensed outside New York would not be permitted to acquire stock before they become employees, nor could they remain stockholders upon termination or retirement, except through an ESOP.¹⁵

Shareholders of a DPC would be prohibited from entering into voting trust agreements, proxies and other types of agreements vesting voting power in another person, except with another shareholder of the DPC.¹⁶

Benefits of ESOP Ownership

An ESOP is a special kind of retirement plan that gives employees an ownership stake in their company by investing primarily in shares of stock of the sponsoring employer. It is governed by the laws of private retirement savings plans, such as the Employee Retirement Income Security Act of

1974 (ERISA) and the Internal Revenue Code (the "Code"), and must meet most of the general participation and benefit requirements applicable to qualified retirement plans. The shares of stock of the sponsoring employer are owned by a trust managed by a board-appointed trustee, who may be an officer or other insider, or an external independent trustee. The ESOP can acquire shares on a "pay as you go" basis or can borrow funds to purchase shares from the plan sponsor or shareholder. The ESOP provides a way for non-professional design employees to share in the future growth of the DPC, and otherwise be given an incentive to work harder and more efficiently.

The use of an ESOP offers significant tax benefits to the DPC and its design professionals. For example, if the DPC is an "S" corporation partly owned by an ESOP, the ESOP's share of the DPC's income will be exempt from federal income taxes. Moreover, if the ESOP acquires shares from a design professional or from the DPC, those shares can be acquired on a pre-tax rather than an after-tax basis, thereby providing significant tax savings. Acquisition of shares on a pre-tax basis is only possible if the purchase is made by an ESOP.

An ESOP may also give shareholder design professionals a measure of liquidity, such as for retirement, death or other financial reasons. It may also facilitate a DPC's buyout of a design professional in a shareholder dispute. The ESOP provides a ready market for such shares as well as the possibility of a flexible payment schedule for the DPC and selling design professional. The ESOP can also be a financing vehicle by the DPC. If the DPC requires funds, the ESOP can simply purchase additional stock from the DPC (subject to the 25 percent ownership limitation).

The use of an ESOP instead of direct ownership by non-design professionals (and design professionals licensed outside New York) also has administrative benefits because it would eliminate the need for transfers of shares held by such employees each time an employee is terminated, resigns or otherwise leaves the DPC.

Management Requirements

Inclusion of non-design professionals in the management of a DPC is subject to the conditions that greater than 75 percent of the directors and officers (and without exception the chairman, president and CEO) are New York licensed design professionals.¹⁷

A DPC may wish to appoint a CFO with a business degree and a Chief Legal Officer (CLO) with a law degree. However, because more than 75 percent of the officers must be New York licensed design professionals, the DPC making such CFO and CLO appointments would need to appoint at least seven additional New York licensed design professionals as officers. In addition to the CEO, president and chairman, such design professionals could, for instance, be appointed as vice presidents or chief design officers.

While the new legislation would permit out-of-state licensed design professionals to be appointed to officer positions (other than chairman, president or CEO), such appointments, combined with other non-design professional appointments, would need to represent fewer than 25 percent of the officers, because the out-of-state design professionals do not qualify as design professionals under the law.¹⁸

Incorporation of DPC

A DPC's certificate of incorporation filed with the New York Secretary of State must outline the design profession(s) to be practiced by the DPC.¹⁹ It also must state the names and addresses of all individuals or ESOPs who will be the original shareholders, directors and officers, specify their ownership interests, and indicate the professions of those shareholders who are design professionals.²⁰ The corporate name of a DPC must end with "design professional corporation" or "D.P.C."²¹

Before filing the certificate of incorporation with the Secretary of State, it must be submitted to the Education Department of the State of New York, along with Education Department certificates evidencing the New York licensing of the owners, directors and officers who are design professionals and further certifying the owners, directors and officers meet the requirements of good moral

character set by the Education Department.²² The certification of good moral character is not expressly limited to the design professionals, but as a practical matter the Education Department would not have pertinent information about non-design professionals.

After the certificate of incorporation has been accepted and put on record by the New York Secretary of State, a certified copy must be submitted to the Education Department within 30 days.²³ The DPC must also apply for and obtain a "certificate of authorization" from the Education Department to provide the particular design services it was organized for, before it may offer such services to customers.²⁴

Once incorporated, the DPC must file a report with the Education Department every three years listing the names and addresses of each shareholder, director and officer and certify that it has been in compliance during the past three years with the restrictions on ownership and management.²⁵

Disqualification or Death

If a New York licensed design professional shareholder, director or officer of a DPC loses his professional license, all financial interest (other than as a creditor and other than deferred compensation and pension benefits) and employment with the DPC must be severed.²⁶ If a DPC shareholder dies or becomes disqualified, the DPC shall acquire or redeem his shares within six months, unless the individual has transferred the shares to another shareholder. A shareholder who is not fully redeemed for the price of the shares may be awarded reasonable attorney fees.²⁷

Mergers

Pre-existing professional service corporations may merge into a DPC.²⁸ This provision also permits so-called "grandfathered corporations" to merge into a DPC, but because ownership and management restrictions are stricter for DPCs than for grandfathered corporations, there are seemingly few incentives to do so. Only entities that are lawfully organized to provide design profession services in New York can merge into DPC.²⁹ Therefore, out-of-state professional service corporations would need to become authorized in New York before merging, and regular business corporations (wherever incorporated) could not merge with a DPC.

A 30-day grace period is granted during which the restrictions on issuance, transfer and sale of shares of a DPC are suspended with respect to any issuance, transfer or sale of shares made pursuant to the merger, provided that no person who would not be eligible to be a shareholder (absent such grace period) will not be allowed to vote or receive any distribution.

Corporate and other entities that do not qualify to merge with DPCs may be able to transfer their design profession business to a DPC in an asset sale.

Outside New York

The new legislation does not provide for an out-of-state DPC equivalent to register and be granted similar privileges in New York. Accordingly, such mixed ownership out-of-state professional design corporations are not qualified to register in New York and cannot provide design services in New York. Out-of-state professional corporations must still comply with the requirement of 100 percent ownership by design professionals (who may be licensed in or outside New York).³⁰

Similarly, the new legislation does not offer any help for design firms with 25 percent or more of its shareholders licensed in other states than New York. Such design firms will only be able to register as out-of-state professional entities and provide design services in New York if all of the owners are licensed design professionals.

Accordingly, for design firms primarily owned by out-of-state design professionals, the wiser (and sometimes only) solution may be to remain incorporated outside New York, continue to exclude non-design professionals from ownership, and to register as an out-of-state, or foreign professional corporation, in New York. If a design firm desires to include other employees among its owners or have ESOPs, an affiliate entity meeting the New York requirements may be created for contracts to

be performed in New York, but in such cases the parties need to be very careful in planning a structure that does not violate the prohibitions in the Rules of the Board of Regents, which prohibit sharing fees received for professional services with non-professionals (other than employees).³¹

Conclusion

Allowing New York design firms to incentivize non-design professionals by giving them a minority interest in a DPC is a helpful new opportunity that seemingly will help design firms attract qualified employees. However, as the law currently stands, out-of-state professional corporations with a similar employee ownership program would not be allowed to qualify as an out-of-state professional corporation or DPC, even if they otherwise satisfy the requirements for foreign professional corporations in New York and therefore will need to remain 100 percent owned by design professionals, or create an affiliated entity that meets the DPC requirements, in order to provide design services in New York.

To take full advantage of this new opportunity, design firms should carefully consider the tax benefits, as well as the flexibility and control, of using an ESOP to own a portion of the shares of the DPC.

Anne-Mette Elkjaer Andersen is a partner with Holland & Knight in New York. **David O'Leary** is a senior counsel with Holland & Knight in Chicago.

Endnotes:

1. Corporations incorporated many years ago, which were permitted and continue to provide design services in New York pursuant to N.Y. Educ. Law §§7209(6), 7307(4), 7327(4) (2012).
2. N.Y. Bus. Corp. Law §§1501(f), 1507, 1508(a), 1525(d); N.Y. Ltd. Liab. Co. Law §1207, 1203(b), 1301(a). For a detailed explanation of the rules, see Anne-Mette Elkjaer Andersen, "The Illegal Practice of Engineering or Architecture by Companies in New York—a Compliance Guide, Part One and Part Two" (Bloomberg Law Reports, Oct. 4 and 20, 2010).
3. N.Y. Bus. Corp. Law §1501(e).
4. Id.
5. §1516.
6. §1507(b).
7. Id.
8. §1511.
9. §1507(b).
10. §1501(f).
11. §§1507(b), 1511(b).
12. §1507(b).
13. §1511(b).
14. §1501(f).
15. §§1501(f), 1511(b), 1503(b-1), 1507(b).
16. §1507(b).
17. Id.
18. §1501(f).
19. §1503(b-2)(i).
20. §§1503(b-2)(i), 1503(b-2)(ii), 1503(b-2)(iii).
21. §1512(b).

22. §§1503(b3), 1503(b4).
23. §1503(c).
24. N.Y. Educ. Law §7210(1).
25. §1514(b).
26. §§1509, 1510(a).
27. §1510(a).
28. §1516(a)(i).
29. §1516(b).
30. §1525(d).
31. N.Y. Comp. Codes R. & Regs. Tit. 8, §§29.1(a)(3), 29.3(a)(6).

www.hklaw.com
Holland & Knight LLP

Reprinted with permission from the April 2, 2012 edition of THE NEW YORK LAW JOURNAL. © 2012 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact 212.545.6111 or visit www.almreprints.com.