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Partnership Agreements – The Good, Bad And Ugly

Has it been awhile since you admitted a partner or lost one to retirement? Not interested in merging up or acquiring a firm? If so, there's a chance your partnership agreement needs an update.

Joel Sinkin of **Accounting Transition Advisors** says out-of-date partnership agreements are "unbelievably pervasive" in the industry. A specialist in mergers, acquisitions and succession planning, Sinkin is involved in 40 to 60 deals a year, and in each case, changes need to be made to the partnership agreement (known as a shareholder agreement if the firm is a PC or operating agreement if it's an LLC).

Sinkin finds that smaller firms with two to four partners may operate without any partnership agreement. Mid-size firms usually have an agreement but often it's old. "It's an 'out of sight, out of mind' issue for a lot of firms," he says.

He has some straight talk for firms of all sizes. "Read your bloody agreement once or twice a year." Don't wait for a crisis. Poorly thought-out agreements can kill a merger. If a firm needs to improve its partnership agreement to complete a deal, the acquiring firm may get impatient and look elsewhere. "There's a reason people say time kills all deals," he says.

For this and many other reasons, it's smart to keep your partnership agreements fresh. Sinkin and **Neal Spencer**, **BKD's** CEO, agreed to talk to IPA about their experiences with changing a document considered to be the "Bible" of the firm.

Spencer stepped into the role of CEO at Springfield, Mo.-based BKD four years ago. As leader of the Top 10 firm, one of his first projects was to update the agreement which had been altered in a piecemeal fashion 12 times since 1978, but had not been given a comprehensive overhaul.

Keeping in mind that change can create anxiety, Spencer outlined a process that began in January of 2009 and ended in June of 2010. His watchwords were 'slow' and 'steady'. He began with a seven-page memo seeking partner input on about a dozen strategic issues. The 250 partners were required to attend one of 12 town hall-style meetings designed to discuss issues, concerns and questions. Spencer stayed away during the meetings. "We wanted our partners to feel that they could be very open in their comments. You don't need the CEO sitting in [t]here, causing people to not say what was on their minds." Partners were also given the opportunity to submit written comments.

From there, a small working group of firm leaders went through all the comments and developed a draft. The initial process took about 12 months, after which the product was then presented to the 35 or so office MPs who hashed over it for a day and a half. Another round of town hall partner meetings were held – this time with Spencer in attendance – and concerns and comments were again considered and further changes were made. In the end, the vote was very lopsided in favor of the agreement, Spencer said.

As with most management issues, open dialogue is the key to success. Build trust before you dive into an emotional issue like changing the partnership agreement. "Don't be defensive," Spencer says, "Partners will say things that will [clearly] offend you, but don't act offended."

This type of process – comprehensive, thoughtful and considerate of all viewpoints – can go a long way toward addressing the myriad scenarios that should be addressed, but even the smartest accounting professional can't think of everything, Sinkin says. What if a partner walks out with no notice? What if the firm leader suddenly dies? What if a partner just doesn't want to be there anymore?

SINKIN IDENTIFIES A FEW COMMON PROBLEM AREAS…

Valuing Buyouts – "A lot of buyout agreements are woefully out of step with the times," Sinkin says. In the past, many were based on equity; now many are based on compensation. He recently reviewed a partnership agreement with a buyout clause that was so generous the firm stood to lose a tremendous amount of money.

Accountability – Firms should have accountability provisions built into their agreements so when an issue comes up – such as an older partner wanting to reduce his time commitment yet not his pay – problems don't arise with the younger partners. Agreements must consider the different types of partnership roles and the compensation that should go along with them.

Partner Compensation – Far too many firms operate under outdated compensation models. It's a good idea to be fairly concrete regarding compensation in the agreement, Sinkin says, but he's found the bigger the firm, the more subjective the compensation arrangements. He's seen, for example, operating agreements that call for compensation to be based fully on a one-third vote of a compensation committee. "That's not unusual. That's one committee I'd never want to be on." He adds, "You need **some** subjectivity, but the more things that have subjectivity, the more likely you'll have some malcontents."

Lessons Learned

Spencer discussed some of the key issues that arose during the process at BKD. He took a different track than Sinkin, in that BKD did not go into great detail regarding compensation issues in their agreement, favoring a fairly subjective system, he said. One overarching concern was ensuring the agreement be slanted toward the overall protection of the firm, while still balancing the rights of individual partners. He also wanted to ensure it remained a governance document by keeping policies out of it. “Having too much detail can be a bad thing because then you don’t have the flexibility you need as you try to deal with certain issues,” he tells IPA.

Here are some *clauses* that Sinkin has seen work well for some firms:

1. **A limit on how many partners can retire within a 12-month period.** For example, a firm with 50 partners could probably handle four retirements in a year, but an eight-partner firm probably couldn’t handle more than one. “Put in a timeframe that everyone thinks is fair.”
2. **A cap on how much can be paid out to retiring partners**. One option to consider is a cap on how much can be paid out to retiring partners. Such a cap is a recommended option to address possible market trends. Consider a firm that has a large real estate practice. Such a firm may have a partnership agreement that allows a real estate partner to retire and receive income, but measures that income based on current revenue projections rather than past performance.
3. **Minimum notice requirement for retirements.** Two years may be reasonable in firms with clients that are particularly loyal to partners.

Both Sinkin and Spencer advise caution when dealing with attorneys, who should appropriately review partnership agreements. Sinkin urges firms to make sure an attorney is experienced in working with CPA firm partnership agreements due to the unique scenarios.

Spencer says attorneys tend to frown upon a non-compete provision, but he believes it is important and strengthened in BKD’s revised agreement. Don’t let attorneys dictate what the agreement should say, he says. “If you let an attorney take your partnership agreement and run with it and rewrite it, you will not be happy with it at the end of the day.”

Some firms struggle greatly with partnership agreements, Sinkin says, particularly when two generations of partners are considering what’s fair to all involved. The firm’s founding baby boomer partners are looking to slow down and get out; the up-and-coming partners don’t want to pay too much to the retirees, who are predicted to start retiring in droves.

The key is to do the updating and changing **before** the firm needs to merge or add partners. Education is a simple way to avoid problems. Read benchmarking data or ask other firms for advice. “A lot of MPs don’t know what they don’t know,” Spencer concludes. ■**IPA**