Case Study Number 5: A Small Firm Admits a New Partner

The Situation

Our client in this case was a $1.7 million firm with 2 equity partner. The firm approached us to assist them with developing a plan to admit a new partner to the firm. The partners did not have a partnership agreement and the discussions they had to date with the partner candidate, Rebecca, had been disappointing. She was balking at the cost they proposed and a confidant had advised her not to sign on and invest without a partnership agreement in place.

The two existing partners were 60 and 55 years of age. Rebecca, who was 39 at the time, was seen as a key to their long term succession.

In our initial evaluation of the situation we determined the following:

- Rebecca was managing about $250,000 in a book of business.
- The initial offer that had been made to Rebecca was to acquire a 10% interest in the firm for $200,000. They arrived at the figure using 10% of the firm's AR and WIP plus 10% of the firms' annual fees. Both partners said they had bought into an accounting firm years ago on that basis that they had subsequently left to form this firm.
- Rebecca rejected the offer as too expensive and she did not understand what she would be receiving in exchange for investment. The partners weren't able to explain that to us either, let alone her.

Engagement Process

We requested operating and financial data on the firm as a whole and on each of the 2 partners and Rebecca. After reviewing the data we interviewed all three of the parties individually to discuss our preliminary observations and some potential approaches for how to admit Rebecca and the structure of the firm's partnership agreement.

Identified Issues

During the interviews the following issues were identified:

- The two equity partners had a very loose arrangement on how their compensation was determined each year. They'd sit down at the end of the year and negotiate a split on top of a $150,000 draw each was taking.
- Rebecca concerns were: 1) she did not dispute that a 10% interest in the firm was probably worth $200,000, 2) however, she was not willing to borrow and empty savings to make a the required investment, and 3) the partners could not adequately describe how her compensation would change to justify the investment.
- The partners were sympathetic to Rebecca's plight but unwilling to "give away" part of their interest in the firm to make it more affordable.
- The partners agreed with us that they were sitting on a ticking time bomb by not having a partnership agreement in place. Any number of events could occur (death, disability, divorce, or any form of termination of a partner's interest) that would require a set of terms to resolve a partner's interest in the firm. No agreement meant no control over the process.

Our Evaluation and Recommendations

A summary of our recommendations in a written report follows:

- We made the case that equity in the firm was the result of how that would be defined in the partnership agreement. Equity normally meant voting control. But how equity is used to allocate value does not have to be linear. A partner could own 10% of the equity but have a different amount of overall value allocated to them.
- If we divided the overall value in the firm into two pools, tangible and intangible, we could sell Rebecca 10% of the tangible pool for about $30,000. Then if did not require her to buy any of the intangible asset pool (which is the goodwill portion defined by volume), we could hold down the investment. That portion of her value could be earned over time as she shared in the firm's incremental growth and as partners were bought out down the road. She would have an important role in both of those outcomes and in essence would earn value through sweat equity.
- A more detailed evaluation of this solution is described in the following Journal of Accountancy article: How to Admit New Partners: A Fresh Approach [provide link]
- This concept of determining the allocation of value led to our recommendations for the structure of the firm's partnership agreement. In addition to determining how to set value and allocate it to the partners the most relevant terms for the agreement we provided recommendations to the partners included:
    - Payment terms
    - Tax treatment
    - Tying adequate notice to a strong transition of partner duties and client relationships
    - Dealing with death, disability, involuntary and voluntary terminations, and retirement
    - Governance
    - Vesting (in this case for Rebecca)
    - Restrictive covenants on competition
    - Caps on maximum partner retirement payments to protect the firm financially
- We also assisted the firm in developing a more structured approach to partner compensation.

Outcome

Rebecca was successfully admitted to the firm as a partner. We understand another partner candidate has been identified. The terms for that persons' admission are set and the partners have told us they are confident the same approach will work again.