Case Study Number 7: An Evaluation of a Mid-sized Firm's Succession Plan

The Situation

Our client in this case was an $8.5 million firm with 6 equity partners and 2 non-equity partners. The firm approached us to assist them with evaluating their plan to remain independent because four of the total 8 partners would be leaving in 4 years or less. We were told that one equity partner was planning to retire in 2 years and 1 of the non-equity partners was planning to retire in about a year. One additional equity partner and the other non-equity partner were planning to retire in 4 years.

The two non-equity partners joined the firm as the result of acquisitions the firm made. Their compensation and buyouts were contractual and basically followed the structure of a Two Stage Deal [see link to Two Stage Deal Case Study #1].

We inquired about the firm's succession bench and the Managing Partner indicated he thought 3 managers that had over 9 years of experience each were good candidates to become partners.

Engagement Process

We requested operating and financial data on the firm as a whole and on each of the 8 partners and 3 managers. We obtained a copy of the firm's partnership agreement. After reviewing the data we interviewed the Managing Partner again to discuss our preliminary observations and some potential approaches to strengthen the succession plan.

We followed up with an interview of the other seven partners to gain their perspectives of the situation and to discuss some possible remedies.

Identified Issues

During the interviews the following issues were identified:

- Not all the partners were in agreement with the Managing Partner that the 3 managers were ready for promotion to partner status
- The firm had not admitted a new partner internally in 9 years; the partners did not know how to go about doing this
- There was no transition plan in place for dealing the client relationships of a retiring partner and this was a major concern for the partner group
- There was extreme concern the firm could not afford the buyouts of the two equity partners slated to retire soon; this concern was held by both those two partners and the younger partners

Summary of Current Partnership Agreement

The basic terms of the firm's partnership agreement were:

- Intangible value was allocated based on one times the firm's revenue for the past 12 months times a partner's equity ownership
- Accrual basis book value (including accounts receivable and work-in-process) was allocated

based on equity ownership
- Intangible value was to be paid over 10 years as retirement payments and included interest at 6% per annum
- Accrual basis book value was to be paid within one year of retirement
- There was no requirement to provide advance notice of retirement after a partner had 10 years of experience and achieved age 60

Our Evaluation and Recommendations

A summary of our recommendations in written report follows:
- We noted that adding 6% per annum interest to the payments effectively made the multiple 1.33 times revenue which is substantially above norms in the profession for owner agreements
- The requirement to pay accrual basis equity within one year of retirement could be satisfied only by the firm borrowing those funds or as the result of the partners making substantial capital contributions
- Without a notice period, and because there was also no requirement to execute a transition of a partner's duties, the firm had a substantial risk clients managed by a terminating partner might not transition properly and, as a result, leave the firm
- The current configuration of the terms would make admitting new partners very difficult
- We recommended the firm split the intangible value from the tangible value (accrual basis equity) by converting to a unit system [see link to article How to Admit New Partners; A Fresh New Approach]; this would not require any existing partners to give up existing value but would allow for a reasonable buy-in cost for new partners
- We recommended the interest be removed from the deferred payments for the intangible and reduced to the AFR rate for the tangible value; this would make the payments affordable
- We recommended the tangible value be paid over 5 years instead of 1 year
- We recommended a partner be required to provide 2 years of notice of intent to retire and execute a mutually agreeable transition plan; otherwise the payments for intangible value would become contingent on client retention
- We performed a financial analysis of the suggested new terms for partner retirements to demonstrate the buyouts were *financially* affordable
- We further pointed out the real issue was a lack of a business plan to provide adequate partner level resources i) to replace retiring partners and ii) to transition client relationships
- We recommended that a plan be instituted as soon as possible to promote the three managers to at least non-equity partner status so they could participate in the transition of client relationships from the two partners retiring soon

Follow-up Retreat

Following submission of our report, the partners and we agreed the best next step was for us to facilitate a partner retreat in order to further discuss the recommendations and develop a consensus amongst the group for changes to be made.

At the retreat a substantial amount of time was devoted to evaluating the 3 managers (who were not in attendance) for partner status. We were able to show that the reason there was a lack of agreement amongst the partners on the candidates readiness was because there was no template being used to evaluate their performance against. That template was built at the retreat and agreement was reached to promote all three to non-equity partner status. That would allow for transition of client relationships over the next two years from a partner to a partner. It also allowed each of the three candidates to prove their ability to function as a partner without the commitment of equity.

Because of the enormity of changes the firm needed to make over the next two years to execute this plan the retreat also featured an evaluation of "Plan B' which would be an upstream merger. On strictly a generic basis we assisted in the partners becoming aware of the types of firms that would be most relevant to them as a successor firm and the types of deal structures that would make the most sense. A plan for when to start pursuing that option was agreed to which was based on the firm's progress in executing the internal succession plan.