Case Study Number 8: A Mid-sized Firm Addresses Its Owner Agreement in Anticipation of Pursuing Mergers

The Situation

We were asked by a $12.5 million, 8 partner firm to assist them in developing a strategy to grow through mergers. As a part of the upfront consulting we provide in these cases, we evaluate our client's readiness to undertake such a strategy. Part of that evaluation in this case was a summary review of the firm's owner agreement.

An acquiring firm's owner agreement is an important tool in mergers. By definition, in a merger some or all of the owners of the firm targeted for a combination will be signing onto the owner agreement of the successor firm. In this case, our client intended to be the successor firm. Sometimes in mergers of equals, an owner agreement new to both firms is negotiated. Based on the criteria for our client's search in this case that was not the intended outcome. If none of the owners of a targeted firm will be admitted as new owners of the successor firm, and therefore, not required to become a party to the owner agreement, the transaction is not technically a merger. In those cases, the transaction is an acquisition.

The terms of a successor firm's owner agreement that tend to be of most interest to partners that will be admitted as equity partners in a merger are:

- Governance
- Partner compensation
- Terms of retirement or other partner buyout scenarios
- Mandatory retirement age (if applicable)
- Capital requirements

Buyout Terms

The issues an owner agreement can pose with respect to terms for the payment of partner buyouts or retirement tend to be either agreement terms considered to be too low or terms that are too rich compared to the expectations of the merging partners. Obviously, if an owner agreement is viewed to provide an insufficient value to a retiring partner, merging partners may not be willing to sign on. This is especially the case for partners that are nearer to retirement age than younger ones. Surprisingly, the opposite can also be true. If the terms are considered too rich, and if the merging partners perceive themselves more as "buyers" than "sellers" in the deal, due to the expected transitions of senior partners of the acquiring firm, those potential new partners may be unwilling to take on the liability the agreement will create.

Our Evaluation

We evaluated our client's owner agreement and noted the following:

- The firm used the Equity Method for allocating value to partners that are being bought out
- The two senior partners in the firm owned collectively 60% of the firm's equity
- The senior partners were expected to retire in the next 5 years
- A significant motivation to pursue mergers was to strengthen the firm's succession bench due to these impending retirements
- The firm's intangible value in the agreement was based on 125% of firm revenues
- The payment period for retirements in the agreement was 7 years
- Capital accounts, which were based on accrual basis equity, were to be paid within one year of retirement

We performed a standard litmus test to determine if the retirement payments under the firm's owner agreement would be affordable. Affordability is determined by making sure that not only can the retirement payments be made without requiring external borrowing, capital infusions by the remaining partners, or a reduction in partner compensation for the remaining partners, but there should also be upside so the remaining partners don't feel they are running in place while they are paying for retired partner buyouts. The litmus test we use is as follows:

Retired partner total compensation including the cost of perks and benefits, *less*

Cost to replace a retired partner's labor, *less*

Annual cost of retirement payments, *equals*

Residual or upside

We also compared the firm's agreement to norms found in other firms in the accounting profession based on our own experience and surveys that have been made.

Our conclusions were:

- The firm's valuation of intangible value at 125% was substantially above the norms for the profession in today's market; the normal range is currently about 65% to 100% with the average at about 80%
- The payment term for the intangible value of 84 months was shorter than the average in the profession which is currently 10 years
- The payment term for accrual basis capital of one year compares unfavorably to an average in the profession of 3 to 5 years, or more
- As a result of the above terms, the overall plan did not meet the litmus test and would, therefore, not be considered affordable
- The unaffordability in this case was further exacerbated because of the use of the Equity Method for allocating value; because the senior partners' share of income was substantially less than their equity allocation, there wasn't enough capital created to fund their buyouts

We advised the firm that because their objective for a merger was to strengthen their succession bench, potential merging partners were unlikely to reach a conclusion that their firm presented a good long term opportunity due to unaffordable liability the firm would have to the senior partners in the near term.

Our Recommendations

Our recommendations to modify the owner agreement included:

- Reducing the valuation of the intangibles to 100% of revenue which, although on the high side of the normal range, at least put the value in line with profession norms
- Extending the payment period for the accrual basis capital to 5 years and the payment period for intangible value to 10 years
- We suggested the agreement be modified to allocate intangible value based on a Unit Method instead of the Equity Method (refer to the article *How to Admit New Partners: A Fresh Approach* under Resources/Articles/Owner Agreements on this website for more information on the Unit Method)

In order to minimize the negative impact these changes could have on the senior partners, we recommended the firm allocate the initial units (Unit Method) based on equity. However, future allocations based of growth should be made so as to limit the amount of additional value allocated to the senior partners. Allocation of units reacquired due to partner buyouts should consider a variety of criteria including performance.

Outcome

Initially we met with resistance from the senior partners because our recommended plan would have a negative effect on the value of their personal retirement buyouts. However, they also came to realize that the plan they had was probably not viable in that the firm couldn't afford it and their younger partners might resist executing it anyway. Plus, in an external merger they would almost assuredly not be offered terms from an acquiring firm even close to the terms in their current agreement. The senior partners of the firm eventually embraced our recommendations.

As we undertook developing merger opportunities for them we found the new agreement was embraced by the types of firms that would meet their strategic objective for strengthening their succession bench. We assisted them in successfully merging with a $3.5M firm with three partners in the age range of 40 to 52.

Certain facts and descriptions have been altered to protect the confidentiality of the parties involved in the above transaction.