Succession Planning: The Available Strategies and How They Work

By Joel Sinkin and Terrence Putney

With the aging of the Baby Boomers, succession planning remains an integral part of looking to the future. This article discusses how to manage partner transition within the firm. Strategies for partner succession employed by firms in the accounting profession these days generally fall in two categories:

- Internal succession plans, where the remaining partners and or high-level staff are promoted to partner status for the purpose of replacing retiring partners
- External succession solutions, which involve recruiting high-level professionals to replace retiring partners, or the possibility of a merger with another firm

Determining which of these two paths makes the most sense for your firm, and which you are prepared to pursue, is the most important step in formulating a workable succession plan.

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Determining whether you have the ability to do an internal succession plan

We are regularly asked to consult for firms that prefer to use an internal succession solution. Firms often feel this path leaves them more in control. However, this option may not be achievable if the firm does not have either the resources available to complete the plan successfully or processes in place to create those resources. The answer to this one question may reveal the answer to whether this is a realistic choice for your firm: "Can we replace the skills and capacity of partners that intend to retire in the next five years?" A firm may have the cleverest terms ever devised to deal with the financial aspects of partner retirement, but such a plan is not viable without the ability to replace retiring partners with new partners.

Let's start with the role and skill set. We often see firms promote managers with good rainmaking skills, as that is the most sought after aptitude for new partners. However, has any thought been given to the new partner's role at the firm? For instance, how will the new partner's rainmaking skills be used if he or she is a quality-control partner? Be sure you first replace the role, not just the body.

The second consideration is that of excess capacity. We don't mean people sitting around looking for something to do or excess space in place. When assisting firms with succession issues, one of the first steps that should be taken is a poll of the partner group to get a feel for how many partners expect to substantially reduce their time commitment to the firm, or outright retire, over the next five years. If the firm has already identified the high-level professionals, whether partner level or not, that have the ability to take over for the duties and expertise of the soon-to-be retiring partners, an internal succession plan can be workable. If not, the firm probably should start to consider an external succession plan.

What are the keys to a successful internal succession plan?

After determining the specific plan for replacing the retiring partner's role, the next most important issue is determining whether the clients that partner is responsible for are "brand loyal" or "partner loyal." Brand-loyal clients probably are not at risk of leaving the firm solely because a specific key person leaves the firm. Partner-loyal clients are at risk if the partner in charge of their relationship leaves the firm.

Brand-loyal clients take the least time to transition; partner-loyal take the most. If the firm's clients are deemed to be partner loyal, the firm should allow at least a two-year window to transition those relationships to the partner or staff person designated to eventually be in charge of that client. Because transitions are most effective when they are done in person as part of the normal service cycle, the actual timeframe required depends on the frequency of contact between the client and the partner. If the partner only physically meets with the client once a year, two years is only two meetings, and a successful transition may take longer than two years. If the partner has frequent contact with the client, the timeframe can be shortened.

To allow the firm time to manage the transition of the relationships and minimize the risk of loss of clients, we normally suggest a firm require two years' notice of intent to retire from its partners in order to receive locked-in buyout or retirement terms. (A common penalty for failing to comply with this requirement is tying partners' payouts to client retention, although other approaches, such as preset discounts, are fairly common as well.)

Once a notice of intent to retire has been received, a specific successor should be chosen for each client. Although, the firm may be able to reassign large groups of clients to one successor in the firm, the following items should be considered:

- *Expertise required to service the client.* The firms that are best positioned to deal with client-succession issues have identified successors for all major clients as "secondary partners" well in advance. Often, the clients have had the chance to work with the successor and know he or she is knowledgeable about the client's business.
- *Chemistry.* Clients are accustomed to a type of personality.The comfort clients have with the firm is often dependent on how much they like the style of the person in charge of their relationship.
- *Capacity.* Can the successor take on the additional workload? This may be a combination of the successor having: (1) preexisting capacity, (2) partners that can pass down some of their existing work to staff, which frees them up to take on the workload of the retiring partners, and (3) a plan to recruit additional talent to handle the increased workload.

What if you can't manage an internal succession?

If you can't manage an internal succession, you need to know the types of external succession plans that are available. There are three main types of external succession plans:

- Hiring or merging-in top-level talent as a means to instantly strengthen the internal succession team.
- Merging-into a larger firm that has the ability to manage the succession of retiring partners, in essence shifting the burden for succession to that firm.
- Merging with a similar size firm, again, in order to create more resources for partner succession.

Merging-in talent

Merging-in talent to build an internal succession team is a strategy that can work when the need is to only develop one or two additional partners to replace outgoing partners. If you are looking at replacing more than a couple of partners in the next five years or less, this is unlikely to be a successful strategy. If you try to recruit laterally or hire professionals that

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are near-term partner material, you are facing the daunting task of hitting it right on all cylinders. These professionals may be unproven commodities who never have had that role in any firm before. Even if they have a proven record as a partner, they still have to acclimate to your culture. If you need to replace multiple partners, you may be better off strengthening your internal succession team through a merger with a multi-partner younger firm.

However, keep in mind, there are many firms looking for this same multi-partner young firm. Many of these firms are also dealing with succession issues. You may pick up two or three 40-year-old partners, but also have to deal with one or two senior partners who are close to retirement. If you find a firm full of young partners, be prepared to create a very attractive opportunity for them. Most young partners who are strong enough will not wait 10 or 15 years for their chance to shine.

Up-front considerations. When you consider any merger, focus on the following up front:

1. If, after meeting the other group of partners, you don't like them well enough to have lunch regularly, don't go any further. If you are uncomfortable with them, why would your staff, other partners and clients be comfortable with them? Make sure the soft side of the culture fits, that is, values, personality and style.
2. Make sure the basic hard issues that define culture, such as billing rates, productivity goals, service mix, specialties and partner-compensation issues, are compatible.
3. Remember, you are pursuing this merger to address your succession issues. They should have the excess capacity to replace your retirement-minded partners. Even though their existing partners are, hopefully, already busy, by utilizing your infrastructure, they can pass work down to lower-level staff and also avoid some of their administrative duties. If the partners in the other firm don't have the capacity to replace your partners, you have not accomplished your mission.

Merging with a similar-sized firm

Merging with a similar-size firm has the advantage of creating a larger infrastructure. The resulting internal succession team will often be stronger if the other firm's succession issues are not significant. However, these mergers are the hardest to pull off. Both firms tend to push for their own culture to survive. There can only be one resulting partnership agreement, one approach to partner compensation, one managing partner, one firm name and so on. It isn't always obvious which firm's existing approach should survive as it is when the two firms are of disparate size. Otherwise, the same issues of capacity and role replacement pertain.

Merging-into a larger firm

The most frequent merger-based solution to solve succession issues is merging-into a larger firm. This is because:

- Larger firms typically have the ability to offer the partners seeking a long-term position an attractive professional and financial future.
- The relative financial strength of a larger firm alleviates the pressure partner retirement payments can cause.
- A larger firm is likely to offer a more diverse service mix, which benefits the clients.
- Capacity is not as much of an issue, as there are a lot more staff resources already available.

There are a several issues that typically always have to be overcome in this type of merger, including:

Culture. Normally, the culture of the larger firm survives. This applies to the partnership agreement, partner compensation, service methodologies, name and so forth. That culture needs to be comfortable for the smaller firm seeking a succession solution for the merger to succeed, as the smaller firm will likely have to adapt.

Equity. Some firms merging-into a larger firm have a few minority equity partners who just don't have a big enough stake to become equity partners in the larger firm. For example, we are working with a $5 million firm pursuing a merger into a $20 million firm. The $5 million firm has three senior equity partners owning 30 percent of the equity each. Two recently promoted partners only have five percent equity each. The larger firm generally has equal equity ownership in its partner group. Because the smaller firm still has $1 million of billings per partner, the larger firm feels there is room for five equity partners. But either the senior partners are going to have to accept a lower "value" for their equity (which will now be defined by the larger

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firm's partnership agreement), or the larger firm is going to be allocating more value than the smaller firm is bringing to the table as they assimilate the five partners into their systems. In this case, we are settling this issue by substantially equalizing the five partners in the smaller firm by having the minority partners acquire additional equity from the senior partners outside the merger.

Varying agendas. Most situations rarely require succession for all partners. (Note: firms that have waited until virtually all their partners are nearing retirement will not have an easy time finding an upstream merger these days.) More typically, one partner wants to retire in the very short term, one or two in three to five years and the majority in 10 or more years. In these situations, there are three different agendas, and the best approach might be three different solutions. For instance:

- The partner seeking immediate retirement might immediately go into a buyout arrangement and stay on with a *per diem*-type compensation plan. The buyout terms might be what they would have received in their prior firm with the liability assumed by the successor firm.
- The partners seeking retirement in three to five years may not come in as equity partners, but rather in a contractual role similar to a nonequity partner, but held out to the outside world exactly the same as equity partners (to protect their ability to retain their clients). We often use the concepts of our "Two Stage Deal" for these situations (see JOURNAL OF ACCOUNTANCY, March 2006 or *www.transitionadvisors.com* for a complete article on this concept). Their buyout/retirement may be either: (1) what they would have received from their prior firm with the liability assumed by the successor firm, or (2) what the successor firm pays its equity partners. Their compensation might be based on a formula that is tied to the billings of their client base and the labor costs to produce the same. They are put in a status quo mode that is designed to maintain their current level of income and create as much certainty as possible for their remaining years working full time
- The remaining partners come in as equity partners and assimilate as quickly as possible to the successor firm's partner programs.

One of the advantages of the previously discussed approach is several of the equity partners in the smaller firm come in as something other than equity partners, which helps the successor firm with its partner leverage ratio.

A prime consideration you should have when the topic of equity comes up is to understand what equity really means in the successor firm. Many partners don't realize how little equity impacts anything tangible. Many regional and national firms now place little emphasis on the amount of equity for income allocations and retirement buyouts. For instance, the vast majority of firms in excess of $25 million in fees these days use compensation-based retirement plans, and all partners own the same amount of capital in the firm. In many cases, the same benefits can be bestowed on a partner without legal equity through a contract as is given an equity partner that is a party to the partnership agreement. And by avoiding becoming an equity partner, the successor firm has the freedom to structure a compensation and retirement plan for an incoming partner close to retirement that is not restricted by the firm's partnership agreement. We will discuss compensation issues further in a future article.

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