PARTNER/SHAREHOLDER AGREEMENTS – PART TWO

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In part two of this topic, we are going to start with a list of common policies that we cover with our firms, as well as some issues that are important to address. The SOP (standard operating policy) categories are:

Roles and Responsibilities:

- President/CEO Roles and Responsibilities
- Chairman of the Board of Directors Roles and Responsibilities
- Board of Directors Roles and Responsibilities

Voting Processes:

- Equity Interest Policy (percentage of ownership defined)
- Voting Interest Policy (one vote per owner)
- Electing or Dismissing the CEO/President Policy
- How Equity or Voting Interest Works When a Shareholder is Removed from the Calculation Policy

Retirement Policies:

- Maximum Payout of Deferred Compensation for Retired Shareholders Policy
- Transition Policy (re: Retiring Shareholder)
- Special Compensation Plan Policy
- Shareholder Buy-Sell Valuation Policy
- Sale of Interest and Deferred Compensation Policy

Departure/Termination Polices:

- Buy-Sell Policy for Shareholder Leaving Who Will NOT Be Taking Clients
- Buy-Sell Policy for Shareholder Leaving Who WILL Be Taking Clients
- Buy-Sell Policy for Shareholder Leaving Due to Death
- Buy-Sell Policy for Shareholder Partially Disabled
- Buy-Sell Policy for Shareholder Leaving Due to Total Disability
- Termination of a Shareholder Policy

Other Polices:

- Admission of Equity Shareholder Policy
- Share Purchase Policy
- Sale/Upstream Merger of the Entire Firm Policy
- Operational Policy
- Purchase Price of Other Companies Policy
- New Client and New Work Acceptance Policy
- Prime Interest Rate Policy
- Specific Operating Decisions

These policies and processes are designed so you only cover an issue once. This approach adds some complexity because you commonly have to refer to multiple SOPs in order to fully determine the resolution to a specific issue. If we did not take this approach, we would open up the likelihood that material would be covered numerous times in the various policies, even though each policy would have

imbedded in it the full content necessary to answer questions. This redundancy would create problems as we maintain our agreement as a living document, as we update one discussion on a specific topic in one SOP, and ignore another discussion of the same topic in a different SOP. Thus creating a conflict among the agreements that diminishes the value of organization.

For example, to determine the value of an owner's buyout by the way we have orchestrated this, you would consider the "Valuation" policy to ascertain vesting privileges: the "Sale of Interest" policy to compute the initial retirement benefit; the "Transition" policy to calculate any deductions from the benefit for non-compliance regarding client transition; the "Shareholder Leaving" policy to evaluate the conditions of the departure and its impact on the benefit; etc. In other words, it can be complicated. But the fact is – so is buying out an owner.

For instance, when does an owner deserve benefits? If you are a founding owner, then you will probably have the right to sell out your ownership at any time, any age. And this makes sense, because that person started the firm and, directly or indirectly, paid for each client. And what about new owners that bought into the CPA firm at full market price, shouldn't they be able to sell out anytime as well ? It gets more complicated, however, when people buy into the firm at book value (or are given ownership) and then sell their shares at market value at any time. And what about the added hurdle of a new owner buying in at whatever the price is, and paying that back through an instant pay raise granted by the firm to at least cover the purchase price?

With small firms, comprised of one or two owners, people typically just sell the book of clients they have brought in and managed. This makes sense. But as firms grow larger, new owners don't bring in all of their own clients, nor do they need to. With success comes a steady flow of opportunity created by the firm's reputation. The firm moves from having to find "hunters," who can find and acquire the clients, to "village builders," who can leverage the opportunity that is presented and grow what they have before them. Under the "village builder" model, we want new owners to be able to get in easy because what we, as existing owners, really desire is years of servitude. We don't want owners joining at age 38, working for 10 years, and selling out. We want them staying until they have attained a specific age, along with working for the firm as a partner for a minimum number of years. This allows firms to build a succession management process where new owners are put in place at different ages and skills to insure the firm will be able to continue for at least the next generation. In order to build this kind of process, it is common for founding owners to give up privileges to make it work.

As "villages" are created, they usually come with vesting schedules. We like to see them start at 60 and go to "mandatory sale of ownership" (MSO) age, which is usually 65 or the age at which a person is entitled to retirement benefits. We also recommend to our firms that the language dealing with the vesting schedule be written so that the early vesting rights are only available with at least two years' advance written notice. In other words, if you are 62 years old, early vesting rights start at 60, and you tell your partners you are retiring in six months, nothing is owed to you for retirement unless the firm, at its sole discretion, waives the notice requirement. On the other hand, that same 62-year old can give two year's notice at that time, retire at age 64 and receive the vesting schedule benefits for age 64. Way too often, we have seen firms put in terrible positions pertaining to sustainability, because multiple owners decided to bail out without adequate notice; thus forcing high dollar "sale of ownership" benefits, while providing the firm little-to-no-time to accommodate this critical talent loss.

Now that two years' notice is given, we can mandate a client transition process. Once the partner is within the notice period, they are automatically on a "special partner compensation plan," which simply means that the firm can and should be creating a compensation package that motivates that owner to step back from all client relationships, start working more in the background, provide more training and mentoring, start working more as a firm ambassador finding new business opportunities in the community, and transitioning referral sources, etc. The problem with the way most firms operate is that they , under the typical line partner compensation system, motivate the selling partner to increase his/her hours of production, stay involved with clients to find more business opportunities and undermine the transition process in order to keep annual pay at a reasonable level. We counter this by taking them out of the line partner pay system, focusing their efforts on more appropriate activities, and maintaining their pay at a fairly comparable level for these last two years (assuming full working hours). Once in transition mode, the partner continues to work normal hours but is being directed to work on activities more in line with the kind of effort we would expect, if the firm decides to make him/her an offer for continued work after MSO.

With vesting, notice, and a special compensation package, we can layer on a transition requirement. Simply put, we will make a list of every client and referral source the partner manages, assign specific activities to be accomplished with each relationship for each year of the transition, assuming these specific tasks are accomplished, the selling partner will receive his/her full benefit. For those clients or referral sources that are improperly transitioned, penalties can be applied based on specific circumstances.

If penalties occur the retirement benefit will be reduced. A couple of key issues go along with this. The first is, determination of accomplishment of the transition plan needs to be in the hands of one person – we recommend the managing partner (MP) for this role. While the board can override the MP, we advise that this is only done if the MP is grossly unfair in applying the standards of transition to the selling owner. And if this is the case, we would suggest that the board broaden their discussion to include removing the managing partner for such an egregious disregard of board policy. The point is, the transition process should be between the selling owner and the MP, you can't foster an environment of accountability if other partners are randomly inserted into this procedure. This interference will generate unnecessary chaos and confusion.

One other overarching concept we suggest is that the selling owner needs to walk the line of diminishing technical competence with his/her clients during this two year transition period. In the beginning, the selling partner might introduce the new relationship partner to a client. Six months later, for example, the selling partner no longer takes the lead in meetings with that client. A year into the plan, the selling owner no longer speaks up in meetings and when called by that client, always defers to the new client service partner rather than directly answering questions. The transition process has to clearly send the message that the new partner being transitioned in is an upgrade in talent and that person has been assigned because he/she is someone that can provide a great level of service. Simply put, if this isn't the message, why would any client ever be satisfied with this forced change of a long standing, trusted relationship? If the selling owner can't find the wherewithal to accomplish this, then while this is not the preferable situation, it is okay because the selling owner will put his/her entire retirement benefit – and possibly even his/her invested capital – at risk for this noncompliance.

The last policy under the retirement section listed above is "maximum payout." This policy creates a process by which the retired partners can't consume a burdening amount of the net income before partner pay. This is the "don't kill the golden goose" policy. Commonly set around 12 to15 percent of net income before partner pay, should the total of retired partner benefits exceed this percentage on an annual basis.

The policy will automatically stretch the repayment period of those benefits to insure a reasonable balance between current partner income and retired partner benefits outflow. However, we add the additional caveat that once the ceiling is reached, the policy calls for the maximum payout percentage to continue until the retired partners are back on the initial payment schedule, or are paid off.

In the end, the policies we recommend are all about protecting the firm so that it can survive and thrive, and minimize the probability that a retiring owner can pillage on his/her way out the door. On this note, we will pick up with the section on partner departure/termination next time.

In the meantime, if you want to get into the nitty-gritty of what each of these policies look like, we have created a 3.5 hour computer-based training CPE course (NASBA approved both Registry and QAS) that can be found on the Texas Society of CPAs Practice Management Institute Learning Management System (https://successioninstitute-tscpa.prosperitylms.com).

We introduce each set of policies with a video and then you peruse them one by one. The course has a much higher price tag than traditional CPE because included with the purchase and completion is not only the CPE credit, but also a downloadable set of the policies in Microsoft Word ™ for you to use and change, one hour of consultation with our organization (Succession Institute), as well as one hour of consultation with our attorney (who drafted these agreements as we have included a PC, LLC, LLP version of the agreement).