

Equity -- Allocation and Reallocation

By Bill Reeb, CPA

In my next series of columns, I want to address the issue of equity – how it is commonly allocated to begin with, and then making adjustments to it over time.

For many firms, the idea in the beginning is that “all the partners are the same, so their ownership should be the same.” When the firm starts out with only a shingle, this is a very fair premise since the firm is basically starting from scratch and because everyone is at risk in this new venture. So, for the sake of this column, let's start out with a two partner firm and build from there, talking through the common issues that arise in the area of distributing equity ownership.

The most common approach would be for the two partners to split the ownership 50/50. The reason why this often works so well is because the two people that join together often are brought together because of their complementary skills. For example, one might be very technically competent and the other more marketing savvy. Together they make a great team -- one, without the other, is less effective. These partners will often divide up the work. One might hate the administrative issues that constantly arise (typically, the one with the marketing savvy), while the other hates going out in the evenings to network and socialize (usually the technical guru). Once again, this can be a marriage made in heaven ... both people get to swap out chores they genuinely dislike for more of what they are comfortable with and enjoy doing.

As I said above, 50/50 ownership is common. Personally, I don't think this split is really the best approach, but since it is the more common approach, I want to at least paint a fair picture of it. My reason for disliking this split is simple. If both partners disagree, the firm is at a stalemate. The only governance that can really take place is maintaining the status quo. Logically, since I have seen this type of stalemate situation evolve far too many times to count, I try to avoid this set-up like the plague.

On the other hand, the common counter argument to my concern for a 50-50 split is simple -- if we both don't agree, then maybe we really shouldn't be doing it anyway. And for the most part, this can be true. In reality, in a two partner firm, one partner commonly defers to the other partner for decisions in their specialty area or their area of firm responsibilities. For example, in the case I am describing above, if the issue in debate is really about the growth of the firm and attracting clients, then the technical partner will usually defer to the marketing partner. And the reverse normally is true if the issue is about compliance with a technical matter. However, I don't want to diminish the probability that, just as with marriages, this level of respect and trust can quickly deteriorate. And for that reason, I like the idea of one partner owning 51 percent with the other owning 49 percent -- allowing the firm to move forward even when there is a harsh disagreement.

The firm can easily mitigate the damage to the minority shareholder or partner by putting in standard operating procedures and processes that define how the minority shareholder can withdraw in a way that limits the damage to him/her, and on many issues, the firm can set a voting threshold above 51 percent so that it really does take both partners to agree. But for day-to-day operating decisions, you need to establish a voting process that allows the firm to continue despite strong disputes.

Okay, I have to admit I started with an easy example and decided to build on it. So now, let's assume that the two partners want to add a third partner. In this situation, it is common if those two partners have had a good working relationship and the third partner is added early in the growth stages of the firm for the new partner to be granted one-third of the company. This is especially true if the new partner comes in with an existing book of business comparable to the other two partners' books. However, if the company is long past its initial growth stages and the partner being added has grown up working in the firm, the likelihood is that the newest partner will only receive or have access to a small portion of the equity -- often somewhere between 3 percent and 20 percent, with the most common amounts falling in the lower end of this range.

On the face of this, there is nothing wrong with any of the splits described above. The real question is always about future performance. And if the firm equity was split 50/50 before, I would maintain that the firm might be in a healthier position now with a third partner because there is at least a way to break a tie between the two founding partners.

Now for the bad news. In our experience, having three partners is not 50 percent harder than having two partners, but rather, much more (four to five times) difficult. Getting three people to think alike, have similar values, being comfortable operating in the same way, being willing to defer to each other's strengths, etc. is far rarer to find with three partners than with two partners. So the question is ... how **do** you hold the three partners accountable to each other? When there are only two partners and they both own about the same amount of the firm, if there is a major dispute the answer is likely that they each will take their share of the marbles and go home. With three partners, this situation is far more complicated to deal with, regardless of the range of ownership that is allocated among them. The reason this is so different is because the firm, rather than just split up into two separate businesses, will likely continue -- but with one less partner. So now you have to have a process to formally deal with dismissing a partner, a process few people are willing to articulate on the front end when the hope that the new relationship will bring exceptional value is clouding all rational judgment.

As I said, the range of equity splits described above are not the problem ... performance is. If the new partner performs on a par with the other two partners, getting a third of the company upon entry seems fair. But what happens when the new person joining significantly oversold what he or she was bringing to the table to get their one-third ownership? Or even more difficult, what happens when the new partner performs so well that it becomes clear that one of the founding partners is, metaphorically speaking, mounting the other two partners and riding them like a mule? I know what your answer is ... "This is not a problem ... we will deal with this issue in the compensation plan."

Just for the record, we can show you firm after firm that has advocated this action that currently has a very similar situation (and with any number of partners), and quite frankly either does not, will not, or cannot, address this situation through compensation. Even if the firm can address the situation through compensation, it is just one issue. You can not overlook the constant damage that a firm experiences when a partner has voting privileges well beyond his or her contribution to the firm's success. For a firm to maneuver, change and thrive in a dynamic profession and economy, it has to be run by owners who are striving for success, not those hunkering down, locking their doors and trying to hold change at bay through denial of the current environment.

When you complicate the above scenario by adding a fourth, fifth, sixth, seventh, and more partners, this issue of judging fair performance, fair ownership, fair voting rights, fair value upon retirement and fair compensation through the years become even more of an issue. If we still are not painting a bleak enough picture, consider the firm that is very well managed and very profitable. When a senior owner retires and a large block of stock is to be transferred to the remaining owners, the odds of damage caused by that distribution are even greater than what we have described above. Why? Because rarely will the founding fathers give up their ability to control the firm while they are still working, whether that is accomplished through the control of equity or through governance structures like executive committees.

The founding fathers often are permanent members of the executive committee, which is chartered via partner agreement, and the founding partners want it that way so they can continue to run the firm. But when that founding father finally leaves and his or her block of stock is redistributed to other owners, often times not only does that executive committee structure start to fail, but partners who have been marginal performers can end up inheriting or gaining disproportionate (disproportionate to the value that they bring to the firm through their involvement) access to voting rights that will forever change this firm's future viability and stability.

Now that we have given this topic some context in this series of columns, we will take a more in-depth look at the common pitfalls we find with ownership distribution, issues to avoid in ownership distribution and finally, processes to help you constantly redistribute equity so that you are holding your partners accountable for their responsibility to take care of the firm rather than holding it hostage or coasting on their efforts from 20 years ago.

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