

PARTNER/SHAREHOLDER AGREEMENTS – PART THREE

By BILL REEB, CPA, CITP

In part three of this topic, we are going to pick up on the departure/termination policies. While we listed these in the second column, I am including them here for your review. Those policies are:

Departure/Termination Policies:

- 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

Once again, we are not attempting to give legal advice; our focus with these policies is simply on the business issues that unfortunately many of our clients have suffered through. We break them out this way partially to eliminate duplication. It is very easy in a complex set of documents to cover the same issue twice. Then, when it comes time to make changes to the language, you will need to remember to make two changes. What often happens is that only one document or section is updated, so you end up with inconsistencies, and don't find them until the situation bites you.

It is not uncommon around the country to find CPA firms with multiple agreements within the owner group. There might be multiple versions of the agreement so that there is not one overarching agreement everyone has signed; and there might be different agreements (with each owner joining making a specific deal with the CPA firm). Just to tell you what you already know: both of these situations are bad and need to be fixed. The best time to deal with all of this is before an issue arises, while the issues are more about business and less personal in nature. The closer you get to one of the sections of the agreement kicking in, the more personal the discussions feel and the more emotional the conversations become. Thereby, pushing all sides to extreme positions, instead of finding the middle where they most likely belong. Just think about a divorce. By the time an agreement is finalized, both parties often resort to playing a game of "lose-lose" to ensure that the other party does not "win" anything from the settlement. This is exactly what we see when issues are not dealt with early because all of the owners want to avoid the possible conflict and hope it will just go away. Well, in 30 years of consulting, very, very rarely do we see issues go away; they usually take on a life of their own and get bigger the less that is said.

Let's take a tragic case for example. Consider the Shareholder Leaving Due to Total Disability Policy. This is an ugly situation to address, but given the number of us that are baby boomers, it is becoming more and more common. Think about cancer, a common horrible disease that can quickly consume our lives. What do firms do when this issue has not been addressed? They just keep paying the partner's salary or income until he/she gets better. The problem is that, with each paycheck written, the owners doing the work of the debilitated partner get a little more tired of putting in the extra hours of work and not taking anything extra home for it. Sure, in the beginning, this is not an issue because all the owners can think about is the struggle their friend and business associate is facing. But time wears thin in every instance. On the other side, the person with the cancer is deeply indebted to his/her partners for carrying the financial load at first. But at some point during that struggle, realizing that this battle will not be over soon and worrying about

the long-term financial needs of his or her family, the debilitated owner starts believing that the money being paid is reasonable for the past service given. Clearly, these views are going to clash sooner or later.

But it gets worse. With diseases like cancer, people come in and out of health. If you have an owner that is out six months coping with his/her disease, then back for four months, then out for three, then back in for five - how can you reasonably run a firm when your highest level people can't be counted on to be there and be productive? This is why we put a clause in this policy to that effect; if you come back after being disabled, then if that person is out for more than 12 of any 24 rotating months after that disability, the firm can retire that owner, pay them off accordingly, and start building the future business of the firm. Does this have to happen? No, policies are created to protect the firm. But if this is what the owners agreed to, then this is what the firm has said it plans to do if this situation arises. In the end, the shareholder agreement is created to protect the firm; to make sure that the firm can survive changing individuals that own it and maintain a going concern for those employees who have dedicated their lives to working for it. I am not saying these issues are pleasant to deal with; but trust me, as ugly as they are now, imagine dealing with them when you have finally gotten to the point of drawing a line in the sand against your partner who is sick and just trying to survive.

What about leaving and taking clients? This one is near and dear to every professional service business, whether you are a CPA, attorney, engineer, etc. We live on the relationships we build. But the firm is paying you the entire time you are doing this. Therefore, unless our goal is to incubate a bunch of spin-off businesses - by allowing people to work for the firm until they get a large enough client base to sustain them, then quit and start their own firm - we have to create policies that address this. To be clear, we stopped focusing on "non-compete" issues a long time ago, because in many states you can't hold someone back from making a living in their own profession. So, our belief is that you can quit the current firm and open up next door if you want, but if you take clients or staff, you will pay for them. We utilize some legal precedents our lawyers have found to support our position, but simply put, if you take a client you will end up paying about two times their annual revenues and if you take an employee of the firm you're leaving, two times their annual salary, (regardless of whether they work directly for you or not). This usually is framed over a two year period. The assumption is after two years, if the remaining owners have not built up the kind of relationship with a client that motivates the client to stay with their firm, then shame on the remaining owners. By the way, when someone is receiving retirement payments from the firm, then this protection timeframe is stretched for the duration of the payoff period.

What if you are not taking clients? Well, we still need to understand what we might owe you, how we are going to pay you, interest or no interest, your capital/equity or deferred compensation or both, etc. But we also need some rules to guide the departing owner as well. For example, while most will find it hard to believe, I can't tell you how many times an ex-owner was being paid a retirement payment as he/she was constantly, publically criticizing and berating the remaining partners of the firm. Insane, I know; but by the time someone leaves, a planned friendly departure often turns into hurt feelings and people let that anger show through. So, you need to make sure your agreement addresses this. The same is true of discreditable acts - while an owner may be retired, as long as he/she is an ambassador of the firm (especially while receiving retirement payments), there has to be some accountability for their behavior. That is why we build in the right to "stop payment" until the situation in question can be mediated or litigated. We fully understand that issues like these have to be settled as to damages, but we want the right to call the situation to a head and address it (and stopping the retirement payment until it is resolved does just that).

Leaving due to death is rather easily resolved. Almost every firm wants to pay an owner's estate as if the deceased owner were fully vested and had reached his/her maximum retirement benefit. However, we usually recommend discounting that amount. While we agree that the first calculation should be as stated above, we like discounting that amount somewhat, usually between 25 percent and 50 percent, depending on a number of factors. The reason is simple, when an owner dies unexpectedly, which is almost always the case, the firm is not prepared to replace him or her. The firm, because of the death, will have to find a way to cover a difficult loss in technical expertise, pure raw working hours, and client relationships. This is quite a difficult task alone, but when you add the fact that the surviving owners care about each other and each other's families, production for about six months goes in the tank as well. In the end, the discount from the full retirement benefit is not being kept in the firm because of greed, but rather to pay for extra talent the firm has to find in short order, as well as lessen the cash outflow burden because of the damage created by such a critical loss.

This finally takes us to termination of an owner. In reality, this one is pretty easy once you have decided how to pay people and hold them accountable, depending on the circumstances of their departure. But the fact is, many firms have too high a voting threshold to fire an owner. We recommend that a super-majority of votes be required to fire an owner, excluding of course, the votes of the owner being terminated. Too many firms have thresholds requiring 100 percent of the remaining votes to terminate, which we have never seen occur unless someone was convicted of a felony. And even a threshold of 80 percent to 90 percent is a hurdle that is almost impossible to overcome. We are not suggesting that owners should be easy to fire. But the way we look at it is that, if 66 and 2/3 percent of your partners want you gone, it is time to end this relationship because things are only going to get worse. As a matter of fact, we have experienced that deterioration with some of our clients. Factions occur, with one side pitted against the other. In this type of situation, all of the decisions are made in an effort to protect one side or the other, with neither side thinking about the long-term viability of the firm. And you can bet that all accountability is lost by this time because the focus is about maintaining alliances, not about running a quality firm. We can't say this strongly enough: If you want to build a healthy firm, you have to be able to let an owner go. We make people owners because of what they did, but we also have to be able to undo that situation because of what they do!!! Don't make the mistake of creating owners for life regardless of their contribution. When you have a reasonable threshold for terminating an owner, you will also create a reasonable owner group because they all know that they have to continually perform to remain a member of this exclusive club.

We hope the points we have raised about Partner/Shareholder Agreements have been helpful. While there are many more issues that we commonly address, those covered in this column (and the past 2 columns) should hit most of the high points for you. Consider adopting our SOP approach to owner agreements in order to make it easier for you to constantly review and update the individual policies. While this approach will likely save you some attorney's fees long-term because you don't have to redo the entire agreement for a simple change to a single policy, the more significant issue is that your owner agreement will stay in sync with how you operate and the current beliefs of the owner group. As a final note: take the time to go back now and look over your current agreement and make sure you have adequately covered the issues we have addressed. If you haven't, then fix these issues before they cost the firm far more than just time and money.