Equity -- Allocation and Reallocation
Part 2
By Bill Reeb, CPA

In my last column, we concluded by saying, “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.”

To take our next step, we will continue to use scenarios to drive home various points. Let’s say we have a five-partner firm. The ownership and age is as follows:

Partner	Equity	Age
Senior Partner 1 (SP1)	35%	65
Senior Partner 2 (SP2)	35%	63
Junior Partner 1 (JP1)	15%	53
Junior Partner 2 (JP2)	10%	48
Junior Partner 3 (JP3)	5%	42

First of all, many firms would die for this kind of age split as – unfortunately -- many firms have partners much closer in age than this 23-year range example. But continuing on, let’s say the SP1 wants to retire at the end of this year. If this would occur as it does in many firms, we would be scrambling for additional partners. But for the sake of this discussion, let’s say we just added JP3 last year and we will add JJP1 immediately after SP1’s retirement with an ownership interest of 5 percent. So, if this were to occur without unusual intervention, the new ownership percentages would look something like this a year later:

Partner	Equity	Age
Senior Partner 2 (SP2)	51%	64
Junior Partner 1 (JP1)	22%	54
Junior Partner 2 (JP2)	14%	49
Junior Partner 3 (JP3)	8%	43
Junior Junior Partner 1 (JJP1)	5%	44

The retirement of SP1 puts total control of the firm in the hands of SP2. This might be good … it also could be terrible. If SP2 was the more technical partner, then there is a reasonable chance that the emphasis will shift to a strong “Eat What You Kill” firm centered on books of business and personal charge hours. If SP2 was the marketing partner, you can count on JP1 through JJP1 defaulting to worker bee positions on SP2’s clients so that SP2 can go out and find more business. Neither of these situations will build a viable organization over the long term.

It is also probable that because SP1 and SP2 started the firm, they will still remember the days when there was no money to pay their salaries, when they weren’t sure this venture would even make it, when hiring someone meant that they had to defer their pay for a month or so, etc. So they likely learned early about what they had to do, like it or not, to put food on the table. As long as either one are still active in the business, those thoughts will be strong influencers of the way the business is managed. So the business may continue to prosper and thrive as SP2 might not only a benevolent leader, but a visionary one as well.

On the other hand, you always have to look at what the model produces. You can’t ignore the fact that the system is currently poised for abuse to occur. Why? Because SP2 has total

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control over the firm. So don't be surprised if a long-range management philosophy regarding building the firm, investing in process, utilizing better technology, developing people, etc. is nonexistent. SP2 will often focus the firm on maximizing take-home pay during the few years he/she wants to continue to work. Also, just based on our experience, don't expect SP2 to retire like everyone thought – as a matter of fact, you can count on SP2 extending his or her tenure. What we often find is that "absolute power corrupts absolutely."

You might be thinking … "we have a mandatory retirement clause so this would not be the case for us." Good for you … I think everyone should have one. But because of sloppy equity distribution, SP2 might be in a position to change that agreement because of his/her 51 percent equity ownership. As well, because SP2 probably controls that vast majority of the firm's book of business, even if the threshold to change mandatory retirement is above 51 percent, SP2 can put pressure on the other partners to make the desired accommodations if the rest of the partners ever want to see a voluntary transition of any client relationships to them.

Continuing on, let's say SP2 retires two years later at age 66. Here is what we are likely to encounter, assuming once again that one new partner at 5 percent ownership is added:

Partner	Equity	Age
Junior Partner 1 (JP1)	43%	56
Junior Partner 2 (JP2)	28%	51
Junior Partner 3 (JP3)	15%	45
Junior Junior Partner 1 (JJP1)	9%	46
Junior Junior Partner 2 (JJP2)	5%	39

This stage is usually when the crap hits the fan in many organizations. Why? Because the issue we never talked about is that JP1 was really someone who is a good technical worker, someone we didn't want to lose, so we made him/her a partner just so he or she would stay with the firm. Now JP1 is a voting force to be reckoned with. If JP1 is not entrepreneurial, or is not someone that will constantly push him/herself and others to operate outside of their comfort zone, the odds are that the firm will become an "order taking" firm (one where there is a pervasive attitude that you only do the work clients call you up and ask you to do, and avoid being proactive trying to find ways to help them). While this firm will probably be profitable for years, each year it is likely to slip a little more in its profitability unless the partners just continue to crank out more and more work hours to compensate. Here is an outcome that is common in this situation:

1. Revenues will stagnate or decline because the firm is not actively bringing in more business than will naturally fall out. Through no fault of anyone at the firm, clients leave, whether that is because of poor service, needing additional services not offered, the clients retiring or selling their businesses, death, etc.
2. Because of a flattening of revenues and the lack of proactive service to clients, key people, usually the more senior staff in the firm, will likely perceive that they need to move on to another organization where opportunities are expanding rather than contracting.
3. As key people leave, a greater gap in talent is created between the partners and staff. This forces the partners to work more hours to make the same amount of money.
4. Because partners are not proactive about serving clients and constantly trying to find additional ways to serve them, fees and realization tend to suffer as "order taker partners" tend to utilize discount pricing as their client retention strategy rather than being willing to charge standard fees and providing value-added services.

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5. Because the partners are not spending a lot of time developing people (because they are so busy doing the work) and the day-to-day focus is not on building the future capability of the firm, partners start creating silos around their clients and the firm becomes a bunch of solo practitioners sharing office space.

And the story continues. However, it rarely ends well. "Order taker partners" should NEVER be put in charge of running a firm or having too much influence over strategy and performance. This is why equity reallocation is so important to the long term success of an organization.

Just consider our example above. If this were like so many of the firms we see, one of the junior partners would be a much better candidate for maintaining some entrepreneurial aspect of this business than the others. Staying with our example, let's say that JP2 shows a great deal of promise, but so does JP3. Rather than allowing all the "equity ownership" to fall where it may (default to being distributed pro-rata), it becomes prudent for SP1 and SP2 to have a plan which provides for the ownership being spread to those people best suited to take the firm to the next level. Or another way to put it: SP1 and SP2 need to make sure, before they retire, that 1) a system of governance is installed that can last beyond their control, 2) the equity split is done in a way that doesn't give "order taker partners" too much influence in the strategy, 3) they create an operating environment that sets performance expectations and holding everyone accountable and 4) voting thresholds are set for operational policies, processes and procedures at a level where the vocal minority of ownership interests can't run the firm through veto power.

In my next column, I am going to go through a process we follow with firms as to how to reallocate equity. It can be painful and often creates conflict. But our belief is that conflict now is much better and less painful than allowing the firm to shift power into the hands of partners that:

1. Can't see the firm as more important than themselves.
2. Constantly protect their own self-interest at the expense of others.
3. Don't understand that every partner, and staff member, has to be accountable. And that you can't have accountability unless there is a formal governance structure which will eliminate the "I am a partner and will do whatever I want" performance expectation.
4. Think that because they are now a partner, they never have to change again or push themselves to learn or work in new ways.
5. Can't see the importance of investing in their firm and their people to maintain a profitable organization.
6. See the creation of an "order taking firm" as an easy way to finish out their career in a minimally demanding environment, and so on.

Next time, we will begin to take a closer look at the kinds of questions we ask during our interview process, the competency tools we use, the data we analyze, and other techniques to help firms decide the best way to position their firm for the future.

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