All in Agreement

Best Practices for Keeping Partner Agreements Current and Relevant

BY: MARK LOEHRKE

When it comes to updating partner agreements, the question of timing may have less to do with how often those documents are altered and more to do with the underlying reasons for revisiting them.

For example, while data from IPA's most recent firm administration survey shows that 38% of responding firms haven't updated their partner agreements within the last three years (a comparable figure to previous years), two longtime consultants to the profession say that such a span between updates isn't a problem – provided those firms have been regularly reviewing their agreements and keeping an eye out for major changes that might demand action.

The frequency of updates was just one of the topics related to partner agreements that **Russell Shapiro**, partner and transactional department chair at law firm **Levenfeld Pearlstein**, and **Terrence Putney**, managing director of **Whitman Transition Advisors LLC**, addressed in separate interviews with INSIDE Public Accounting Monthly. We have compiled their edited comments here.

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FREQUENCY OF UPDATES

RUSSELL SHAPIRO: That 38% doesn't surprise me for a couple of reasons. One is that firms often neglect to look at their agreements unless there's a problem. Second, you should definitely look at them periodically – every year or two – but you don't necessarily need to be revising them every three years.

Russell Shapiro

You generally see major revisions or overhauls every 10 years or so, and these often coincide with changes in leadership. In the interim, you'll often have updates or tweaks in response to changing market terms or things like that – these are generally in the range of every two to four years, and they tend to be more minor updates.

TERRENCE PUTNEY: I think three years is actually a pretty short window – that's probably more than necessary. That being said, I do think this is a problem area for most firms – they probably aren't updating their agreements as often as they should. It's not uncommon for me to work with firms that haven't looked at their agreements in 20 years or more.

It's probably worth taking a look every five or six years, but it doesn't need to be a regular routine. If a firm finds some things aren't working as well as they used to, they may want to update the agreement. For instance, maybe the ownership percentages that were used to value the firm at the outset don't make sense once a few new partners come into the group. An update is probably required in a case like that – the firm might need to move to an entirely different system.

KEY FOCUS AREAS

SHAPIRO: It depends on what's going on and what the firm needs. Some firms may need to update their governance models, while others may need to update their retirement provisions. Other firms may have issues around how they're keeping capital.

PUTNEY: Firms should make sure the incentives they're creating for the partners are the things they want them to focus on (see "Setting the Tone" above). Most firms under a certain size rely on their partners to help manage certain aspects of the firm, such as marketing or recruiting or financial management. If those are key roles for partners to play but you don't recognize the value of those roles in the partner agreement, why would you expect someone to focus on doing them and doing them well? There can be a disconnect.

Another key area is how to manage the transition of the firm. For example, it's pretty common these days for a partner agreement to require a partner to give two years' notice of their intention to retire or leave the firm for them to be paid their full amount at retirement – the idea is that the firm will use those two years to properly transition client relationships. But even though many agreements require two years, they might not say what happens if the partner doesn't give that notice and they don't say what's going to happen during

Terrence Putney

SETTING THE TONE

Veteran consultant Terrence Putney believes that the importance of keeping partner agreements current goes beyond just the nuts and bolts of retirement provisions and payouts – it goes to the heart of what the firm values and what it ultimately wants to be.

"The partner agreement sets the tone for how you want partners to behave – what the priorities are, what the incentives are, how you want them to operate," he says. "That's the real key to the agreement. For instance, if a partner agreement says I'm going to pay you when you leave based on the book of business you manage, it's clear that partners will focus on building their book of business. And that might lead to all kinds of things that might not be in the firm's best interest. It could lead to partners hoarding clients or partners keeping clients that they're not best suited to serve or partners focusing on their books to the detriment of everything else they should be doing to help build a successful firm. What do you want partners to focus on? What's important? The partner agreement lays those things out. It's a really important tool for managing partner performance and behavior."

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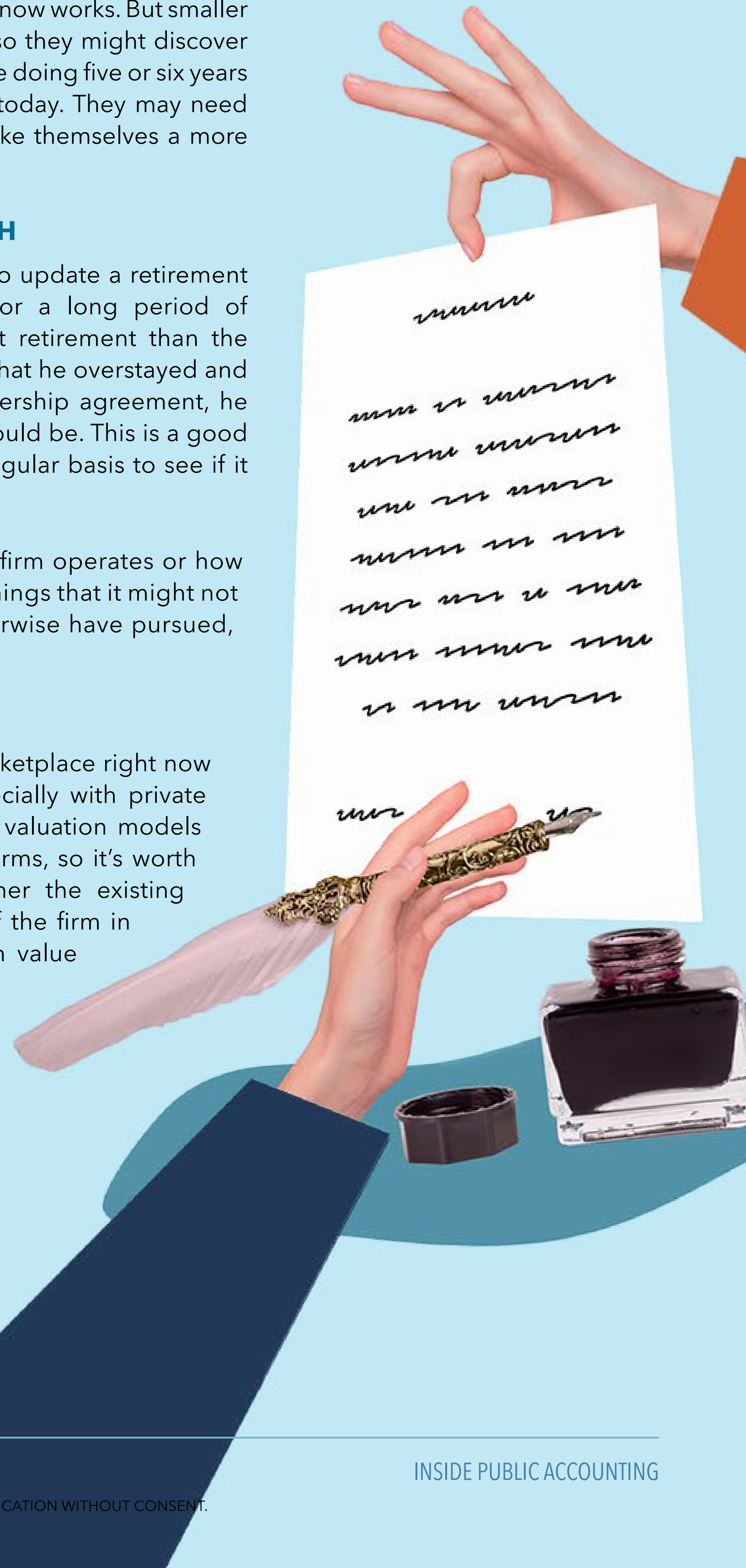
those two years. What's the formal transition plan and what is the penalty for failing to complete it?

Another issue I see more and more these days is that firms may need to update their agreements to address how they admit new partners – especially if they find they're getting some pushback from these candidates as to what they're willing to do as part of the agreement. Big firms may admit a group of new partners every year, so they generally have a mechanism in place that they know works. But smaller firms don't always admit new partners on a regular basis, so they might discover that they don't really know how to do it right – what they were doing five or six years ago might not be acceptable to a new batch of partners today. They may need to step back and think about what they need to do to make themselves a more attractive opportunity for the next generation.

THE RISKS OF LETTING AN AGREEMENT LANGUISH

SHAPIRO: I was working with a firm last year that failed to update a retirement provision and a partner was not pulling his weight for a long period of time. They thought they were going to pay him less at retirement than the partnership agreement dictated because everyone knew that he overstayed and underperformed. But when we looked back at the partnership agreement, he was entitled to a lot more money than they thought he should be. This is a good example of why firms must look at the agreement on a regular basis to see if it still works for the business.

PUTNEY: An agreement that is out of step with how the firm operates or how the marketplace has changed could force the firm to do things that it might not want to do, or to miss out on opportunities it might otherwise have pursued, such as admitting a new partner or doing a merger.



THE IMPACT OF PRIVATE EQUITY

SHAPIRO: There are a lot of changes going on in the marketplace right now in terms of how firms are being bought and sold, especially with private equity coming into the profession. [Private equity firms'] valuation models are different than those historically used by accounting firms, so it's worth looking at the partnership agreements to verify whether the existing retirement formulas still make sense. Should the value of the firm in these agreements be adjusted based on the increase in value that's happening throughout the profession?

PUTNEY: One of the things that private equity is saying is that firms have been undervaluing themselves. Valuations have gotten pretty high, so firms are reevaluating what their value is and how they pay their partners to get more in line with what private equity is telling them. And so, there's been an impact on partner agreements – not in a great many firms, but there's definitely a trend in that direction and it's something that we're probably going to see more of going forward.

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Notes
From the Field

What do partner agreement updates look like in practice? Two MPs – **Gary Wallace** of Glen Allen, Va.-based IPA 200 firm **Keiter CPAs** (20 partners, FY21 net revenue of $33.1 million) and **Aaron Swiggum** of Maumee, Ohio-based IPA 300 firm **William Vaughan Company** (15 partners, FY21 net revenue of $17.5 million) – shared their thoughts on how the process has played out in their firms.

When was your last partner agreement update? What was the impetus for the change?

GARY WALLACE: Our last amendment was in 2019, and prior to that it was 2015. Both were primarily focused on compensation issues.

AARON SWIGGUM: Our last update occurred with the merger between William Vaughan Company and Davenport Hanf & Company (DHC) in 2018.

Are your changes to the partner agreement generally proactive or reactive?

WALLACE: In most cases, it's proactive – it's something our partner group has discussed and come to a conclusion on. But some of the legal tweaks here and there have been more reactive. We make changes as needed – my COO and I are regularly reviewing the documents to see if there's anything that needs to be addressed.

SWIGGUM: It's not a regular exercise. Changes are generally based on significant events, such as partner retirements, partner admissions or mergers. Our main goal is to maintain easy-in/easy-out provisions for partner admissions and retirements.

What challenges have you faced in making updates to your partner agreement?

WALLACE: Any time you're making changes, you're going to have a group that's totally in agreement with the change and a group that has questions or reservations about the change. That's the joy of being a closely held business with a lot of owners. You can make changes, but it does take time and discussion. Formal changes do require a majority or supermajority of votes, but you always have to deal with the different personalities and where people come down on different issues. Fortunately, we've always been able to work through any issues and get to consensus.

SWIGGUM: Thanks to the fact that our partners are in alignment about the overall approach to admissions/retirements and a commitment to remaining fiercely independent, our challenges have been minimal.

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