Case Study Number 1: Using a Two Stage Deal, Seller Transitions His Practice Over Time

The Seller

The seller was a sole practitioner. He had one CPA, one non CPA professional, a per diem for tax season and a clerical and was generating approximately $750,000 in annual revenues. For purposes of the contract described below, the existing staff were the "*staffing base resources*". His practice was predominantly compilation and tax oriented. This seller was netting 40% of his revenues including salary, perks and benefits. He was investing approximately 2,200 hours annually, of which 60% was billable. He worked 6 days a week during tax season, 4 days per week during the Summer and 5 days per week the balance of the year while enjoying 4 weeks vacation annually.

This practitioner felt he had a strong staff, but no one who could be his replacement. His goal was to work three more years full time, several more years after that part time but he did not desire to reduce his income or control of the practice until he starting working part time. Over the next several years he was interested in remaining in the managing partner role as it relates to his clients. He feared becoming a "clock punching employee" of a successor firm and having to take a cut in pay. He knew the transition of his practice would be much more successful if he found his successor firm and started the process of introducing his clients to that firm now. However, if he sold his practice now under a traditional deal structure, any firm would likely ask him to take a cut in pay to justify the payments they would have to start making immediately. A traditional practice continuation agreement would not allow him to start the transition process immediately and held too much uncertainty regarding the state of the successor firm at the date it became effective.

The Buyer

The buyer was a three partner firm generating $2,500,000 in annual revenues. The firm was diversified in that it provided various types of business and financial consulting. The firm had additional capacity both on a staff level and space. The partner group's goal was to more fully utilize this capacity and create a growth situation that would enable them to make one or two current high level staff partners down the road without having to reduce their earnings.

Negotiation Process

After initial meetings, the seller narrowed the list to this one firm.. With our guidance, due diligence lists were exchanged, field reviews were performed, contracts were drafted, a transitional plan was prepared, and the deal was closed. From introduction to closing took 11 weeks.

Deal Terms

The key to a successful deal like this is to meet both sides' needs. The seller wanted to 1) get the successor in place in a much more significant way than a practice continuation agreement

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would, 2) maintain control and income while working full time, 3) create the best transition plan for the clients and staff, and 4) maximize the value of the practice.

The buyers wanted to 1) integrate the clients to their practice immediately, 2) immediately increase the size of their practice by almost one-third, 3) take advantage of the excess space and capacity they had, 4) have the seller around to help manage the transition over the next couple of years, and 5) be able to pay for the practice out of its profits to avoid investing a lot of their existing cash flow.

Therefore, we suggest the deal be structured as a Two Stage Deal. The buyers had the room thus the seller moved into the buyers' facility. All of the professional staff were retained and hired by the buyer firm except the clerical staff and per diem staff. The seller retained control over client service matters, his day-to-day activities, and his earnings until Stage Two. The buyers delayed the payment for the practice until the seller ceased working full time.

Stage One
In a Two Stage Deal, Stage One is the time from the onset of the affiliation until the seller substantially reduces their role (usually to no more than 60%). The seller's practice was treated as a part of the successor firm's practice. The seller continued to run his practice as he had run his firm before, coming and going as he saw fit. He billed his clients under the buyer's name as to the outside world this was viewed as a merger. The seller continued to receive the same 40% of gross revenues he was earning prior providing he did not need any additional labor support over and above *staffing base resources*. The seller retained his old entity so he could manage certain expenses and perks (such as car leases, insurance, and retirement plans) on his own terms. The 40% agreed upon profit was paid to his old firm as consulting fees. If based on his sole discretion, the seller elected to reduce his time commitment to the practice and or needed additional staff support, the seller would accept pro rata reductions in his income as a result.

Under the deal, Stage One would terminate and Stage Two would commence based on the first to occur of the following events:

- The death or permanent disability to the seller
- The date the seller reduced his time commitment to the practice below 60% of his past efforts
- The end of the third year

Stage Two
In a Two Stage Deal, Stage Two is the point that the sale is financially consummated. The purchase price, in this case, was 100% deferred during Stage One. The seller was paid 1.25X based on 25% of gross collections for the subsequent 5 years paid monthly, including fee increases, special projects and the like structured in a manner that provided the successor firm a current deduction. The seller received a $50,000 advance upon the onset of Stage Two, which was credited back to the buyers at a rate of $2,000 per month for the first 25 months.

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The seller was to remain on in a reduced role for the firm for additional compensation based on 33% of what he was billed out for on each mutually agreed upon tasks. He also received a new business incentive program that rewarded him 20% for 2 years on any new business he personally developed and brought to the buyer.

Benefits to both parties

During Stage One, the seller was able to remain "Master of his Domain", come and go as before while gradually getting his clients and successor acclimated to each other. The seller also received the effect of an "insurance policy" that protected his family and clients in the event of his death or disability during Stage One because either of those events immediately triggered the payments for the practice value. The seller also created a method of maximizing the value of his practice. This was because probability of retention of his clients was significantly enhanced because he was in charge of the transition over a three year period to a firm he had become a part of. Yet he also greatly reduced his liability and exposure as he was not an owner in the successor firm. In Stage Two he received strong compensation for his practice, his time and new business development skills.

The buyer received short term and long-term value. In the short run, since the firm had the space to absorb the practice and excess capacity to replace some staff, the buyer firm partners immediately created an additional $100,000 per year in overhead reductions by eliminating the seller's rent, some labor costs, software and other expenses. The successor firm was also guaranteed by the end of the third year to be in a position to take over a practice that had already been transitioned to them with maximum retention. The payments for the practice were timed to allow them to be made out of the cash flow created by the seller no longer being paid for his full time effort. Finally, by involving the near partner high level staff in the transition, the firm had a head start in developing practices which could lead to them becoming partners in the firm.

Certain facts and descriptions have been altered to protect the confidentiality of the parties involved in the above transaction.

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