Case Study Number 5: A Regional Firm Restructures Its Internal Succession Plan

The Firm

This firm generates $6,000,000 in annual fees, has six equity partners, one non-equity principal, and approximately 40 professional and clerical staff combined. It is a 25-year old practice with an excellent reputation in the region. It has consistently received unqualified peer reviews. The service mix is 20% audit, 25% reviews and compilations, 40% tax, with the balance from general consulting services. One client makes up 10% of annual revenues and no other client represents more than 5% of volume.

The Consultative Process

Transition Advisors recognizes that an internal succession plan must address not only the legal agreements between the owners and the firm, but also the business plan the firm has for dealing with the eventual transition of its owners. The firm has to be positioned properly to replace the resources that are lost when an owner leaves and to transition the relationships that are the responsibility of that owner.

After initially meeting as a group we asked each partner to provide us with a confidential description of the following:

1) Personal financial and professional goals
2) Plans for their career, especially the number of years they envision themselves continuing to work full time
3) Each partner's view of strengths and weaknesses in the firm's current position to manage owner transition
4) Issues they would like to see addressed better in the new agreements
5) Aspects of the existing agreements that they believe should be retained
6) The quality of their bench of near partner talent which was their pool of internal successors

We uncovered the following issues:

One of the biggest surprises for the partners was that each of them thought they had a good idea of the other partners' intentions and issues. As it turned out, there were some significant differences.

- Several partners indicated they were dissatisfied with the manner of distributing profits.
- One partner was currently reducing his time commitment to the firm as he neared retirement and the others believed he should be accepting pro rata reductions in his compensation as a result.
- One of the younger partners, who everyone was counting on being part of the long-term succession team, was actually seeking to leave in eight years to pursue an alternative career.
- Their agreement did not cover how to promote from within to make new partners; all previous partners were either founders or had been admitted through merger

TA's general philosophy for internal succession is a properly structured plan for buying out transitioning owners will:

- ensure that retiring partners are well paid for their years of commitment to the firm
- create adequate margin to acquire replacement resources
- anticipate there should be residual profit so that the remaining partners will benefit from increased earnings which motivates them to accept the risk this type of change creates

After reviewing the responses, our team met privately with each partner and also as a group. We facilitated a discussion of the issues identified and made recommendations for how to address them both in the business plan and the legal agreements.

New Agreements

We provided the partner group with a written assessment of their current agreement and recommendations for a new one. The assessment included:

- A valuation and payment formula that covered death, disability, and normal retirement
- Methodology for handling the termination of a partner other than through normal retirement
- A "look-back" financial analysis of the valuation formula that demonstrated the plan was self-funding
- Provisions covering a deferral in the payment of the retirement liability in the event of a severe short-term cash flow crunch or the loss of the one very large client
- Recommendation the agreement preclude two partners retiring within 12 months of each other
- Recommendations for handling pay out of capital accounts
- Tax treatment of all payments
- Restrictive covenants for terminated shareholders

One of the most important issues we addressed in the recommendations was the notice period required for retirement. The firm's prior agreement required only 90 days notice upon which the firm was obligated to fixed buyout payments for the subsequent 10 years. We pointed out to the partners, this left virtually no time for the firm to plan and implement a transition of a retiring partner's duties including client relationships. As a result the firm was at a significant risk the transition would not be successful and financially disastrous. We recommended a two year notice period which was accepted.

We also structured a financial methodology within the agreement for admitting new partners. The assessment of the firm's transition needs indicated that two new partners would need to be admitted internally from the bench within the next two years.

Because of the need for the new partner admissions (and to address the issues some of the current partners had with compensation) we also made recommendations for a partner compensation system. The new method adopted included a portion to be allocated based on equity, base salaries generally tied to 60% of historical compensation and significant administrative duties, a new business bonus system for partners, and the remaining profits allocated based on objective and subjective performance criteria such as productivity, profitability of managed books of business, and subjective performance attributes. The new plan also addressed how to pay partners that had already gone into a transitioning , part-time role.

Benefits of the Process to the Firm

The level of dissatisfaction that existed with regard to compensation was potentially disastrous. Getting this out on the table allowed the firm to address it and created a stronger and more motivated partner team.

The firm already knew it had not adequately addressed the need for long-term partner development. The younger partner's intention to transition earlier than originally thought caused the firm to identify an additional hole in their long-term succession team. The discussion assisted the firm in nailing down a specific plan for its two strong internal team members to be promoted to partner status. However, we also helped the partner team identify the need to look beyond the existing team for partner development to a greater extent than was previously thought necessary. The discussion led to insights into alternatives for building a stronger team. The firm now has a follow-up plan that includes acquiring additional talent through external merger and acquisition activity.

Even though the firm had a succession plan in place, it probably would not have worked as intended and would have left the firm in a weaker, nonviable position as owners transitioned out. By identifying issues the firm had with the business plan associated with succession and by addressing all aspects of the firm's agreements between the partners, the new plan created a strong foundation to manage transition.

All partners are now on the same page and a business plan for both short- term and long-term goals have been created. A new agreement was drafted and now dictates the firm's transition plan.

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