Case Study Number 8: A Regional Firm revisits its partnership agreement prior to a merger

The Acquiring Firm

Firm A, a regional firm of $25,000,000 offering a diversified array of services. The firm has a significant amount of niches to cross sell services, especially to professionals so they elected to seek a merger of a firm they can help grow through the cross selling of these niches. They were told by their peers that in their experience, one of the most critical aspects the mergeree would want to see is the partnership agreement of the successor firm

The Consultative Process

Transition Advisors (TA) was hired by Firm A to review their current operating agreement as they are a LLC which works like a partnership agreement for partnerships. TA's review uncovered several aspects they recommended adjusting

Their buyout formula for retiring partners failed the TA litmus test. The litmus test is based on the following concepts: Just as we never told any clients; "buy this business, you will lose money for 7 years it is a great deal", we cannot tell that to our partners and motivate them to be our successors!

The litmus test:

Start with how much total compensation, including perks and benefits is the retiring partner making

Subtract from that total the anticipated cost of replacing that partner's labor.

Subtract from that new sum the annual buyout payments.

This final sum should be a strong enough positive number to motivate reasonable people. The key is while the retiring partners should be paid for their years of sweat equity, the remaining partners must make more money

The firm was recommended to switch to a compensation paid buyout which was settled at 2.5X the average of the prior 3 years compensation per partner, paid out over 10 years structured as a current deduction for the firm, plus capital over 4 years.

TA added a cap where in no one year could more than 5% of the firms gross collections be paid out in cumulative retirement payments to the retried partners to protect the cash flow of the firm since if the firm doesn't survive, no one gets paid off.

The firm believed their clients were brand loyal not partner loyal so they had no client retention aspect of buyout plan. TA recommended the addition of a 2 year notification period so that a retiring partner must provide 2 years notice prior to retiring so the firm has time to implement a strong remaining transition plan. Failure to give such notice enabled the firm the right to reduce a partner's buyout in the event more than a ten percent drop in fees came during the first two years following the partner's retirement without notice.

An additional adjustment TA implemented was that no two partners could retire within 1 year of each other without the remaining partners' approval. This was not due to financial reasons as the buyout passed the litmus test now, it was for professional reasons as how many partners can you replace in a short period of time?

Conclusion: the firm was able execute the merger they were seeking as the mergeree saw the revised operating agreement a home run for them since they were young and the terms of buying out the senior partners enabled them to make more money

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