Admitting New Partners – Succession Best Practices

By Gary Adamson, CPA

As we work through the succession and retirement of senior partners in our firms, a lot of us are also reviewing and updating our internal documents and agreements. A key part of the update should be focused around how we bring new partners into the firm to replace the "old guys". There have been changes in valuations and process that we really need to be aware of. Following are some of the best practices.

How Many do you Really Need?

More often than not firms are supporting too many partners based on the firm's revenue. That also usually means that the partners are doing a lot of work that could be done by staff. Take a look at the Rosenberg or IPA surveys for average revenue per partner and you will see that the trend is to push more leverage of the work and to get more done with fewer partners.

On top of that, the demographics in our firms today tell us that fewer people than ever want to be an equity partner based on the traditional definition. Although our initial reaction to that reality is "we just don't have enough of the right people to replace us", maybe it's not such a bad thing. With the retirement of some of our senior people, we have an opportunity to look for ways to improve the leverage. Said a little differently, we should be challenging the pyramids in our firms by asking "is there a different way to serve our clients and get the work done" and "do we really need all of these partners"? Too often we're on auto pilot worrying only about how to fill the holes the way that we have always done it. Now is the time to step back and challenge it.

Do you have a PIT program?

Many firms have developed a partner - in - training (PIT) process that they use to evaluate and develop their new partner candidates. It generally runs for a year or two. The candidate is invited to attend partner meetings and other partner interactions, is given goals specific to the program, is exposed to firm financial and other partner level information, is provided leadership and other education and is mentored through the process by a partner. The purpose is to give both sides the opportunity to observe the other and to make sure that there is a good fit.

Non Equity or Low Equity Partners

One of the ways that some firms are addressing the "how many" question is by using the Non Equity or Low Equity partner position. It is a spot on the organizational chart that carries with it significant client responsibility and recognition inside and outside the firm as a partner. It stops short of the commitment and compensation of a full equity partner. Some firms will use the position as a stepping stone to the full equity spot. Others will allow an individual to stay in the role indefinitely. There are probably people in your firm right now that fit that spot and would actually be more comfortable there. It opens up other choices and possibilities on the decisions you have to make on equity partners.

Buying In

Not too many years ago it wasn't unusual for new partners to buy in at valuations that included a large goodwill factor on top of a capital account amount. The large numbers really weren't affordable and firms figured out creative ways to internally finance them (borrow from Peter to pay Paul). Another common practice was purchases of partnership interests outside the firm between partners which produced a lot of wheeling and dealing and inconsistencies. The good news is that both of these practices are almost gone.

The normal today is that capital transactions for both new and exiting partners are with the firm and controlled by the firm's partner agreements. Values for buying in are usually based on the firm's accrual basis balance sheet and the new partner starts out buying only a piece of that. The goodwill value is earned over time by the incoming partner through a vesting process that is often based on years of service and the firm's normal retirement date.

How Much Capital?

"It depends" is not a good answer but there is really not a rule of thumb for the percentage of equity that the firm sells to the new partner. It depends on the firm and how it approaches a number of things including partner compensation and retirement. We can however give you a few numbers and thoughts. First, the average buy-in for a new partner based on 331 firms in the 2012 Rosenberg survey was $137,000.

Second, the trend in the profession is that ownership percentages are having less and less to do with what a partner's compensation and retirement payouts will be. It is more about your performance and relative contribution among your partners.

Capital is becoming more about voting rights and supporting a potion of the firm's balance sheet. The author is seeing the profession move to capital accounts that

are similar for all partners except for new partners where they may start out at some smaller level and move up to “full equity” status over time.

Financing the Buy - In

Recognizing that most of our younger associates are not able to write the check above for $137,000, firms must figure out a way to assist with financing it for the new partner. The normal route is that the firm will withhold the amount over some period of time from future profit distributions to the new partner.

There is another approach used by some firms that I happen to like a lot. It is using outside financing rather than inside. Basically the firm guarantees a loan for the new partner at a bank. Normally the firm can help the new partner receive attractive terms. The new partner borrows the $137,000 and contributes it to the firm in exchange for the partnership interest. The firm will make sure that the new partner receives a compensation increase that is at least enough to cover the new debt service.

Here is why I like it. The firm gets the new capital dollars which most firms can certainly use. Yes it comes with a guarantee but it is off - balance sheet debt. More important, there is something very personal about the new partner borrowing that $137,000 from a bank. It is pretty sobering and it brings a certain level of seriousness to the transaction that you won’t get otherwise.

On a personal note, I will never forget when I borrowed the money to make my first capital contribution as a new partner. It was a huge deal to me. Some of you may remember when the prime rate was 22% back in the 1980’s, which made it even more interesting!

Regardless of whether you change anything or not, the Baby Boomer succession wave presents an opportunity to review and challenge how we bring new partners into our firms.

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