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CPA Firm Partner Agreement Essentials

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CPA FIRM PARTNER AGREEMENT ESSENTIALS

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Introduction

Buying a family home is one of the the biggest investment most people make in their lives. And because most of us are not real estate experts, we protect ourselves by engaging an attorney to ensure that the purchase is handled correctly. We don't hesitate for a moment to invest a few thousand dollars of attorney fees to hire an expert.

Protecting Your Business

Being a partner in a CPA firm should be no different. Think about it. Based on data from the 2016 Rosenberg MAP Survey, here is a rough idea of the value of a partner's ownership in a $10M firm:

30-year income stream at $400,000 per year	$12,000,000
Goodwill retirement buyout @ 3 times comp	1,200,000
Capital retirement buyout @ 25% of goodwill	300,000
TOTAL CASH FLOW	$13,500,000

If ever there were a no-brainer, it would be to spend a few dollars to protect your $13.5M investment by seeking the expert advice of an attorney and a consultant to create a partner agreement for your firm.

Yet, according to the 2016 AICPA PCPS Survey, 37%--more than one-third!—of multipartner firms *do not* have partnership agreements. (We will use the generic term "partner agreement" to describe the agreement among a CPA firm's owners for governing the firm, regardless of whether the legal entity is a partnership, LLC, LLP, corporation, etc.) Based on our experience consulting with CPA firms, I'm certain this 37% figure declines as firm size increases, but it's still in the 20-25% range for all substantial firms--still inexcusable.

Many of you reading this are sitting smug and satisfied because your firm *has* a partner agreement. But merely having an agreement should not make you feel content. The key question is this: Is the agreement properly written and consistent with CPA industry best practices?

I have read hundreds of agreements in my career, and I must tell you that *50-75% are so poorly written* they fail to address a dozen or more critically important issues. We will detail these omissions throughout the book.

What Is a Partner Agreement?

According to nolo.com:

"A partner agreement spells out the rights and responsibilities of the firm's owners. Without one, firms will be ill-equipped to settle or avoid conflicts because if certain key passages are missing or written improperly, the courts will intervene in ways that the partners may not like. A partner agreement allows the firm's partners to structure their business relationships with each other in ways that suit their desires, needs, and preferences."

Any book on partner agreements will have an obligatory paragraph like the one above. But most readers probably knew this definition, so it might not be very illuminating. Let's try this one.

A partner agreement is a legally binding document that stipulates how the firm will be governed. By signing this agreement, all the

partners agree to abide by the document's terms. This helps the firm minimize problems and disputes such as these:

1. In the absence of a signed agreement, state laws, which vary by state, will be used to settle partner disputes. By necessity these state laws are one-size-fits-all rules. It's much better to have an agreement in which the firm's partners state the rules for their firm *on their own terms*. Examples:

    a. A CPA firm decides *not* to provide for payment of goodwill-based retirement benefits. Without a partner agreement, state law could require the firm to pay these benefits if the departed partner sues the firm for them.

    b. If the founder or power partner dies or becomes permanently disabled, the other partners may be legally entitled to a much larger share of the firm than they deserve.

2. Voting. Great example: A four-partner firm asked me to help them with their first-ever partner agreement. The firm was dominated by its founder. He brought in most of the firm's clients, managed the firm and was the primary driver of virtually everything in the firm, including its success and profits. Without a written agreement, the founder was susceptible to the three other partners essentially throwing him out of the firm, with or without valid cause.

3. Other critical issues partner agreements need to address:
    - Admitting new partners.
    - Expelling partners.
    - Duties of partners.
    - Management duties.

4. Allocating firm income. Most firms allocate partner income based on partner performance, as opposed to non-performance methods such as ownership percentage, pay equal or seniority. Although many firms may factor this into the allocation system, in the absence of a written agreement, in the case of a dispute,

it's possible a court could force the income to be allocated on ownership percentage rather than performance.

5. Specify circumstances that allow the firm to expel a partner. Without this, firms may be greatly limited in terminating partners, even for egregious acts.

6. When duties and rules of conduct are documented in a partner agreement and signed by all partners, they are more likely to adhere to these rules than if there is nothing in writing.

The Partner Agreement's Role in Overall Firm Management

A partner agreement is essentially a *contract* among the partners, setting out their duties, obligations and entitlements. Here is how the partner agreement serves as a starting point for firm governance:

1. It establishes rules for how decisions are made, whether by managing partner, executive committee or votes of the partner group as a whole.

2. It prescribes how the firm expects its partners to conduct themselves and to what extent violations of these guidelines are grounds for expulsion. This enables a firm to terminate a partner who impairs the firm.

3. It prevents a departing partner from taking the firm's clients and staff. At a minimum, if this occurs the agreement specifies the liquidated damages for doing so. Without this clause, it is likely that a court will set the damages considerably below what the firm would otherwise have been entitled to.

4. It provides rules for how long partners may work at the firm and in what capacity. This is critically important for the firm's succession planning. When partners have the right to work "forever" and perpetually work on their terms instead of the

firm's, the firm's general management and efforts to bring in new partners are greatly hindered.

5. Not having a partner agreement becomes a huge problem when new partners are admitted or when the firm merges with another firm. In both cases, the prospective new owners will want to see and sign a partner agreement. Failure to have an agreement could prevent these potential partners from joining your firm.

Throughout this book, we will suggest hundreds of provisions that should be in a CPA firm partner agreement, not because some lawyer says you need them but because the partners sit down and decide *exactly* how they want their firm managed and how decisions will be made. Without a binding agreement, the owners may be denied the opportunity to manage their firm *the way they want to.*

Why Some Firms Don't Have a Partner Agreement

I see these excuses all the time. Many are interrelated:

1. Topping the list is "We just haven't had the time." In my experience, these are code words for "We know we will never agree on key, sensitive terms and we want to avoid fighting over them for fear it will break up the firm." Common issues of potential dispute include partner retirement benefits, managing partner duties and non-compete covenants.

   So, they reason, "Why bother creating an agreement if we know we will never agree on the terms?"

2. Unwarranted confidence by dominating partners (usually founders) that they don't need a partner agreement to control and manage the firm. In these situations, there is a huge gap between these power partners and the other partners in terms of rainmaking, reputation, age, technical knowledge, leadership, compensation and other traits. They feel they can operate the firm as if it's *their* firm despite having several partners and can

do whatever they want because there is zero chance of an uprising.

3. True procrastination. Many people are truly disorganized or have difficulty focusing on doing first things first (borrowed from Stephen Covey's *Seven Habits* literature). They know that putting together a partner agreement will be a long, arduous, boring and expensive task and they simply can't find the time to get it done, even if they may be able to agree on the terms.

4. Ignorance is bliss. Some owners may be brilliant at accounting and tax but are blissfully unaware of the dire consequences of not having a partner agreement.

5. Penny wise and pound foolish. The partners know that they should have a partner agreement, but they aren't willing to pay the money to hire a lawyer and/or a consultant to get it done.

6. Merger plans. Some firms question why they should make the effort to create a partner agreement when their exit strategy is to sell the firm instead of bringing in new partners. OK, that addresses the partner retirement part of the agreement. But there are dozens of other critical issues the partner agreement needs to address, such as voting, duties of the managing partner, partner duties and prohibitions.

One final note. It's incredible how many agreements I have read that are older than dirt, written 10 or even 20 years ago. Few things in life remain the same. There have been many changes in partner governance methods and agreements at CPA firms over the years. Here are a few examples:

- Many agreements require retiring partners to transition clients as a condition of receiving their full benefits.
- Notice of intent to retire is a lot farther out than it used to be.
- New partner buy-ins are much smaller than in the past.
- The role and impact of a partner's ownership percentage have greatly diminished.
- Non-compete and non-solicitation covenants have changed.
- Decision-making authority has shifted from the partners-as-a-whole to the managing partner and the executive committee to parallel a shift at firms from a partnership governance philosophy to a corporate structure.

If your firm has a well-written agreement, make sure you have a consultant and/or attorney look it over every two or three years to make sure it is current.

THIS BOOK IS NOT A TEMPLATE FOR READERS TO PREPARE THEIR OWN PARTNER AGREEMENT

This book *is* for people who want to understand what *must* be in their partner agreements and why. It's for understanding the *concepts* of how to use a partner agreement to help govern the firm.

I have assisted dozens of CPA firms in creating or modifying their partner agreements. My advice to them is based on reading hundreds of partner agreements.

I've seen a lot of lousy agreements, but I've also seen many that are very good. In writing this book, I have extracted the very best practices I have seen in well-written partner agreements to share with my readers.

This book *is not* for people intent on writing their own agreement and looking to me for precise language to incorporate into the document.

I have never once actually written an agreement and I never will. This is a job for attorneys, preferably those experienced in writing CPA firm partner agreements and familiar with the laws of the state in which the firm resides.

No Boilerplate

Sick of my telling you what is *not* in this book? Sorry. Here is one more.

This book does *not* address the boilerplate legalese commonly found at the end of partner agreements. Examples: indemnification, dissolution, maintaining books and records, successors and assigns, and severability. The omission of these provisions does not mean that they are unimportant. Instead, it means that we have limited this book to the major aspects of accounting firm governance that firms deal with on a day-to-day basis.

Experts in CPA firm partner agreements who we rely on

Throughout this book, we will be citing information provided to us by three attorneys experienced in CPA firm partner agreements.

- ***Peter Fontaine is the founder and managing partner of NewGate Law. Before launching NewGate in 2012, he was the general counsel at McGladrey and assistant general counsel at Arthur Andersen. Peter works exclusively with CPA firms. www.newgatgelaw.com He can be reached at pfontaine@newgatelaw.com and at (617) 513-2440.***

- ***Russell Shapiro is a partner in the Chicago law firm of Levenfeld Pearlstein.* Accounting Today *named him one of the Top 100 Most Influential People in Accounting. Russell works extensively with CPA firms, especially in mergers and partner agreement issues. He can be reached at Russell Shapiro rshapiro@lplegal.com and at (312) 476-7560.***

- ***Frank Saibert is a partner in the Chicago law firm of Nixon Peabody. He focuses on labor law, which includes the area of non-compete agreements. Frank is a long time presenter at our Chicago area roundtable groups. He can be reached at fjsaibert@nixonpeabody.com and at (312) 977-4154.***