Industry Trends

Protecting the Firm

Whose rights come first—the firm's or the partner's?

By Allan D. Koltin

Q: When you talk about protecting the firm through a well-written partnership agreement, what specific areas are you typically referring to?

A: Although I am not an attorney, I have reviewed numerous partnership agreements and, unfortunately, have had to review them when there is a negative issue involving a partner. More times than not, partnership agreements are either dated as it relates to current case law, or have had so many addenda inserted along the way that the original protection that the firm sought is no longer consistently applied throughout the addenda. My number-one recommendation for firms is to have an annual review of all of their agreements by an attorney who specializes in working with CPA firms and professional services firms.

Q: What areas typically result in the most exposure or liability to the firm?

A: That question is an easy one. Too often there are soft provisions in terms of an exiting partner being able to take clients and staff. When I ask firms why these protections were soft, they typically respond that while they may have been soft, this also provided a benefit to partners should they want to leave and would make it easy for them to set up a new firm. I know this sounds strange, but how can you build a firm long-term when you make it so easy for partners to leave and take business and staff?

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Q: Let's talk first about taking clients when a partner leaves.

A: Unlike the legal profession, which states that it is unethical to *not* let partners take clients with them, most well-written partnership agreements within the accounting profession have a clause that essentially states if you take clients with you, you will, at a minimum, pay one times the prior year's fees. Having said that, some firms ask for as much as two times the prior year's fees and have been able to enforce these provisions in courts. I think the courts have come to realize that an accounting firm is in fact a real business, and asking a departing partner to pay for the clients he or she is taking is a logical outcome. When this often gets tricky is when a partner says he or she is leaving and doesn't have any plans to take clients, but over a period of time clients indirectly "catch up" with the departing partner. That is why I think it is critical to state in your agreement that whether a client departs with a partner directly or indirectly, the departing partner should have to pay the firm for the business that is taken.

Q: How do you handle a situation in which it is nonrecurring work, such as litigation support, where the actual client is the law firm and it typically is referred by a specific attorney?

A: In this specific situation, I have seen very precise wording that will name the law firm as the client and/or will name specific lawyers within a law firm, provided those are the ones who typically refer business. Again, I think we should stress that often these agreements are telling the departing partner, "You have the right to go and take business, but you do need to pay for the business that you are taking."

Q: Are there times when agreements are written and provide other types of restrictions where the partners are not able to take clients with them?

A: Yes. Sometimes I will see geographic restrictions

indicating that a partner cannot practice public accounting within a specific geographic area for a defined timeframe. Sometimes I will also see a defined timeframe in which they can't practice public accounting, with or without geographical restrictions. Clearly, the courts do not like to see agreements in which one can't practice his or her trade, but they do understand the concept of protecting the firm and its key assets.

Q: You also mentioned protecting the firm as it relates to taking staff. Could you shed some light on this?

A: Today, most agreements provide for a stiff penalty should a departing partner take any staff (whether that be client service or administrative staff). I am seeing more provisions written into agreements that suggest a penalty as much as one times the annual compensation package of the associate that the departing partner is taking. When you think about it, the firm has to go out and find a new associate and frequently is going to pay 30 percent to 35 percent of the new associate's compensation to a search firm. Additionally, there are lost productivity issues, training issues, morale issues, and, quite candidly, asking someone for one times the annual compensation package of a departing associate is not an unrealistic demand.

Q: Who in the firm should sign employment agreements that define these terms and conditions for penalties for taking clients or staff?

A: I am a big proponent that this is not a partner-only thing and that every associate in the firm, whether it be the receptionist or first-year associate, all the way up to the most senior partner, should sign this type of agreement. The firm is not only advancing payroll to these individuals, it is also providing training, technology, and career enhancement skills along the way. My belief is that everybody should be bound by some type of employment agreement. That is not to say that the one signed by the first-year associates should be the same as that of an equity partner. However, there clearly should be protections in all of the agreements.

Q: Are there any other restrictions that partners or associates should have when it comes to taking clients or people?

A: Recently, I have seen more agreements written that also, for some period of time (call it one to two years), prohibit partners and associates from working together and forming a competing firm. I think this goes a long way to, again, protect the firm and make it that much more difficult for individuals to begin "planning together" their departure while they are enjoying the benefits of receiving a paycheck from their current firm.

Q: Are there any other provisions of the partnership agreement that are getting a lot of discussion presently?

A: I would be remiss if I didn't talk about mandatory retirement and the rights and obligations of the retiring partner. My personal preference is to have mandatory retirement at age 65. However, I still see a decent number of firms having one at age 62 and there are still others that have no mandatory retirement age at all. I think the key issue is, once again, to protect the firm and not have a situation in which an older, nonproductive partner has the right to stay on with the firm. Productivity should never be defined by age, but rather should be defined by performance. Having said that, I believe the best thing for a firm to do is to have a mandatory retirement at age 65 when the partner's stock or equity is turned over to the firm, but to have provisions in place which, on a case-by-case basis, allow partners to request some type of continued employment with the firm. This mechanism allows the firm to decide with whom it specifically wants to continue a working relationship. Most important, this is on the firm's terms, not the retiring partner's terms.

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Q: Sometimes I will hear firms mention that each partner has the same vote, and other times I will hear that votes are based on equity. Is there a right or wrong approach?

A: This is a tough question to answer, but I believe the major issues of the firm should be voted on based on equity/ownership. These issues involve the admission of a new equity partner, the termination of an equity partner, the decision to merge with an equal or larger firm, or a major capital expenditure. I am fine with a lot of the other business decisions being one partner–one vote, but all too often I see firms get into trouble because the percentage vote to approve a major decision

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is simply too high, and all it takes is a handful of partners to vote something down. I recently worked with a firm of 14 partners where 11 wanted to merge upstream and three were against the merger. Unfortunately, the firm needed an 80-percent vote to approve the merger, and it was voted down. The reality is that two of the three partners who voted against the merger were the two most underperforming partners in the firm. They realized that they had a much better deal with their present firm than the deal they would have gotten with the larger firm (they would have come along for the merger, but probably would not have survived). It is situations like this where I believe that an 80-percent majority vote makes no sense and percentage votes to approve major decisions should be somewhere between 67 percent and 75 percent, but no more than 75 percent.

Q: Are there any issues relative to departing partners getting their capital or deferred compensation out of the firm should they leave and start a competing firm?

A: This is an easy one. The agreement should be written so that if a partner violates the agreement in any way, the firm has the right to hold onto that partner's capital and deferred compensation. There is something fundamentally wrong with a partner breaching a major provision of the agreement and still receiving checks from the firm. Recently, I worked with a firm where a partner resigned on the spot, as opposed to giving the proper 180-days' notice and, in doing so, that partner waived all rights to capital and deferred compensation. This might sound heavy handed, but partnerships need to be protected and partners need to play by the rules. The best long-term place for a partner who can't play by the rules and best practices of a well-protected firm is something called "sole practitioner." I just hope that type of partner figures it out early in his or her career and doesn't get stuck in a bad situation.

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Q: Is there anything else you would like to add or mention?

A: I am personally involved in the mediation and arbitration of these issues with firms. My comment to them is that I (or any other consultant) will cost about 1/100th of what the lawyers would get once the case gets into their hands. I think lawyers are very valuable and I highly recommend them. Unfortunately, I have seen the cost of litigating these matters go through the roof—and when this happens—everyone loses (except the lawyers, of course!).

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