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Partnership Agreements for Accountants

Background

Are you starting to think about retirement? Perhaps you're not enjoying working in the practice as much as you used to. The fact is, sooner or later you will either want to, or perhaps be forced to, leave your accounting practice.

You may be a sole practitioner or perhaps have a partner or two. Do you have an exit plan? Or is that something you will get around to one day? With a 'baby boomer prompted' surge in people retiring in the next decade or so, perhaps you should start thinking about it now. Similarly you never know when tragedy may strike and you are forced to stop work due to illness or even worse - death.

We have worked with a number of accounting practices over the years to put their exit strategies into effect via legal agreements. In this edition we will share some of those strategies with you to help you consider your own position. We have found that accounting practices' agreements tend to be quite different from the norm.

One - The Equity Sell-Down Strategy

Some accountants have identified younger staff members who they believe have partner potential. A common strategy is to sell down equity to a younger accountant over time. It may start with 5% or 10% and build up over a number of years.

Some advantages of this approach include: providing an incentive for an employee to stay with the practice, they have time to fund their buy-in, you can introduce your clients to the new partner over time making the eventual full hand-over much smoother and you have time to gradually "untie" yourself from the business.

Issues such as the timing of capital gains tax obligations need to be taken care of in the agreement as do performance issues, which we discuss later.

Two - The Voluntary Exit Scenarios

Retirement or 'sea change' scenarios should also be considered. Sooner or later one partner will want to leave. Again, negotiating an 'out clause' is much easier when the playing field is level.

Standard partnership or shareholder agreements usually have a 'first right of refusal' clause ie if you want to sell you must offer your share to the remaining partners first. However with these types of agreements they don't have to buy that share so you may need to find an alternative buyer - not easy when you don't own 100%.

With a Exit Agreement you can choose to include a compulsory purchase condition, which the majority of our accounting clients have chosen to include.

Again the agreement must address the valuation and payment terms and usually include a discount to valuation and terms consistent with payments being made according to the available cashflow.

Three - The Forced Exit scenarios

What if one of your partners is suddenly not "pulling his weight"? Perhaps they have lost their focus or are not quite as good at bringing in the business as they were. Worse still, if they commit a fraud. Would you be happy to keep working with them? Will your investment in the practice be at risk?

Confronting these issues will be much more difficult if you haven't formalised the ground rules while everything is going well.

We have prepared a number of forced exit agreements for accounting practices recently and have found their requirements to be quite different from the usual agreements between business partners.

Here are some of the conditions we have been briefed to include in exit agreements under which a partner can be forced out.

Fraud - a conviction for fraud committed by a partner (particularly critical in the accounting environment).

Bankruptcy - as defined in the Bankruptcy Act 1966.

Non-Performance - the parameters for performance standards must be defined and agreed by the partners. The agreement can be flexible enough to allow these to be changed over time with perhaps the safety net of a unanimous decision by all partners being required before they are binding.

Mental Incapacity - if a partner is mentally incapacitated to the extent that it stops them fulfilling their job function for a period of time eg for 6 or 12 months.

And the terms ...?

The agreement must also address what the departing partner is paid for their equity with options including a discount to value in the event of a fraud to full value in the case of mental incapacity.

Four - The Worst Case Scenario Risk Management Strategy

What would you do if your partner was injured in a car accident and could no longer work? What if they got cancer and needed extended time off work to recover? Have you agreed how to value the business and how you would pay for it? How would you feel if their spouse refuses to sell? After all, they will probably end up owning the shares in the business.

Insurance can provide a funding solution to these scenarios and advice should be obtained from a Financial Planner or Risk Writer specialising in business insurance.

Having the legal agreement prepared in conjunction will also ensure the equity changes hands at the time. We've often heard the 'gentleman's agreement' argument but things can get awkward when one of the parties is no longer around. Getting an agreement done will also prompt you to consider the rights and obligations you want enforced. For example, the consequences of a critical illness should be considered as it's not always clear what the outcome will be - you may need to agree for how long you are prepared to support someone before you want the option of being able to force them out of the business, if at all.

Other issues such as insurance ownership and tax consequences, paying off internal debts, dealing with personal guarantees attached to business loans etc also need to be considered.

Dealing with your estate assets via a comprehensive estate plan is also critical but if you are a sole practitioner it's even more imperative as your spouse may be left to deal with an accounting practice in which they have no experience. Documenting what you want to happen will help make things easier for your spouse.

You may also want to consider whether insurance will help fund a value gap that may occur if a 'fire sale' has to take place with a sole practitioner business.

Irongroup Lawyers can help..

If you would like a copy of the Irongroup Insights on Exit Agreements or Buy Sell Agreements please send an email to info@irongroup.com

Or for more information on Irongroup's Business Succession Planning strategies please call us on 03 8621 9000.