Accounting Firm Partnership Agreements

By Russell Shapiro

A partnership agreement is the cornerstone of the relationship among the partners of an accounting firm. It contains provisions regulating the overall governance of the firm, the relationship among the partners and the rights and obligations of the partners, including retirement benefits. A partnership agreement should not be static. Rather, it should be periodically reviewed and modified to meet the firm's and the partners' changing needs. This article provides an overview of the fundamental issues and provisions that should be considered and addressed during the review process.

Note that while the terms "partnership agreement" and "partners" are used throughout this article, accounting firms may be organized as limited liability companies, professional or regular corporations or limited liability partnerships. The issues and principles addressed by this article apply to accounting firms in whatever form they are organized, albeit with some variation in how the agreements are structured.

Firm management

Managing partner. The managing partner (or chairman) is responsible and has authority for the day-to-day decisions of the firm. In firms with an executive committee (described later in this article), the managing partner is almost always an *ex officio* member of that committee. The managing partner may be selected by the executive committee or the partnership at large.

A four-year term is typical, though not universal, and the partnership agreement may provide for term limits, subject to supermajority override. The managing partner may be removed by either a vote of a majority of the executive committee or a supermajority vote of the partners. Generally, there does not have to be a specified reason to remove the managing partner. It is enough that the confidence in the managing partner's leadership has been lost.

Governance. Generally, larger accounting firms (which for purposes of this article are firms with 10 or more partners) are governed by an executive committee (also called a management committee, policy and planning committee or board of directors). The executive committee and its powers may evolve as the firm grows and partners give up their individual autonomy for more centralized and efficient decision-making. This committee typically makes all decisions on behalf of the partnership, other than those specifically reserved to a vote of the partners. In most instances, all partners retain their right to vote on strategic issues affecting the firm, such as mergers and acquisitions.

To allow for continuity, executive committee members may be elected in staggered terms. Terms are generally three or four years, and some partnership agreements limit the number of terms, subject to a supermajority override. A supermajority of 60 percent or 66-2/3 percent is recommended, as any higher number may give too much power to too few partners. Some firms use nominating committees to determine who should stand for election to the executive committee. Executive committee members may be subject to removal by a vote of a majority of the executive committee or by a supermajority of the partners, without a reason being specified. Executive Committees typically consist of between four and seven members.

Partner Voting. Certain fundamental decisions are retained by the partners, including merger, dissolution, partner admission, partner termination, amendments to the partnership agreement, substantial debt and lease obligations and possibly other major commercial decisions. The most important decisions may be subject to a supermajority vote. Keep in mind that by its nature, a supermajority vote requirement may result in the will of the majority being thwarted. Generally, voting is by percentage interest, but some firms allow for *per capita* voting.

Other committees and appointments. A partnership agreement may provide for a compensation committee to determine each partner's annual draw or salary amount and annual bonus. Oftentimes, the compensation committee's deci-

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sions must be approved by the executive committee.

Additional committees and appointments may develop as firms grow. The partnership agreement may provide for how members of these committees and the department heads are selected, with the executive committee typically making selection decisions. There may be a partnership-wide nomination and voting process for the most important committees, like the compensation committee.

Capital accounts

Firm capital. Generally, becoming a partner means making a capital contribution. Typically, the capital covers the firm's working capital needs. The capital contribution may be a one-time fixed amount or related to the percentage interest acquired or the partner's expected compensation. The partnership agreement may allow the executive committee to call additional capital; however, capital calls are rare, as most firms opt to withhold distributions rather than call capital.

A partner's capital account consists of the initial capital contribution plus that partner's allocable share of any profits retained in the business. Over time, due to profits being retained in some years and not others and percentage interest changes, disparities can arise between a partner's capital account and percentage interest, which may cause some partners to feel they have more at stake than others. To address this, periodically (*e.g.*, every five years), capital accounts may need to be brought into line with percentage interests, a fixed number or compensation. This will allow over-contributed partners to withdraw capital and require under-contributed partners to put more in (usually over a period of time).

Interest is commonly paid on capital accounts and helps address the disparity among capital accounts. Interest may be a fixed percentage (*e.g.*, prime plus three percent).

Partner obligations, rights and benefits

Restrictive covenants. Restrictive covenants, which include noncompetition, client nonsolicitation and employee nonsolicitation agreements, are a cornerstone of most partnership agreements and provide a significant component of a firm's goodwill value. Restrictive covenants run both during, and for a period of time after, a partner's association with the firm. Restrictive covenants must be narrowly tailored to the specific purpose of the provision in order to be enforceable under state law. Most, if not all, states recognize appropriate nonsolicitation covenants in order to protect the accounting firm business. Noncompetition covenants may be more difficult to enforce depending on the facts and state law. Partners who have retired or who are otherwise eligible to receive benefits or payments from the firm must comply with all restrictive covenants in order to remain eligible for such benefits and payments.

Consequences of a violation of a restrictive covenant may include injunctive relief (*i.e.*, to restrict the departing partner from continuing to violate the restrictive covenant), return of past retirement benefits, forfeiture of future retirement benefits, set-offs against unreturned capital and/or stipulated damages. While the amounts and enforceability of specific damages provisions vary from state to state, damages commonly range between 100 percent to 150 percent of the annualized fee generated by an improperly solicited client and 50 percent to 100 percent of an improperly solicited employee's annual compensation. Many partnership agreements allow a partner to "buy" his or her clients from the partnership for a specified amount.

Mandatory retirement. Many firms set a mandatory retirement age, typically between 62 and 67. However, with the current downturn and, because some partners continue to be high-value contributors, some firms are revisiting their agreements and extending this age to 70 and beyond. Benefits of mandatory retirement include a framework to smoothly transition clients and other firm responsibilities. Generally, mandatory retirement for equity partners is permissible.

However, partners with no voting rights or risk of loss in the enterprise may claim that they are tantamount to employees and, therefore, have the benefit of the Age Discrimination in Employment Act of 1967, which prohibits termination on the basis of age. This area of the law is under development.

Early retirement. Many firms allow for early retirement, starting at around 55, but executive committee approval may be required. Early retiring partners

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are often required to give a long notice prior to retirement (*e.g.*, 12 or 24 months). This gives the firm the ability to plan for a smooth transition. Failure to give the required notice may affect the amount or timing of the retirement payments.

Retirement benefits and payments. A retiring or withdrawing partner's capital account is typically paid out to that partner over two to five years, with interest at a designated rate. The partnership may set-off against the capital account any amounts that the partner owes to the partnership, including damages resulting from a violation of a restrictive covenant. Additionally, a portion of the capital may be held back to cover contingent liabilities existing at the time of retirement or withdrawal.

Retirement benefits typically vest over a long period (*e.g.*, 10 years) and may not begin to vest until the partner has been a partner for a substantial period. In merger transactions, service to the prior firm is typically credited to merged-in partners.

There are a few different approaches to determining the amount of retirement compensation. The retained-business approach pays a partner for his or her originated business that continues with the firm after retirement. For example, a retired partner may receive 20 percent of the business generated by that partner's originated clients for five years after retirement. This way, payments are roughly matched against receipts. This arrangement is usually seen in younger firms with less institutionalized clients and provides incentive to the retiring partner to aid with a smooth transition of the client relationships.

Another common approach uses a multiple of historic compensation. For example, a partner may receive the average of the last five years' compensation multiplied by three. Firms may migrate to this methodology as clients become more institutionalized.

Redemption of a partner's partnership interest is another approach. The amount paid is the percentage interest redeemed, multiplied by the value of the firm, which is typically determined according to a formula stated in the partnership agreement. This may result in capital gains treatment to the partner, but does not allow an expense deduction to the firm.

Depending on the method used, some partnership agreements have an adjustment mechanism that reduces a partner's retirement compensation in the event of a significant loss of firm business. In most instances, there is a limitation on the percentage of partnership net income that may be paid to retired partners, generally in the 10-12-percent range. Missed payments are carried into future years.

Retired partners may be provided security in the form of second liens on the partnership's assets or personal recourse against remaining partners. To help protect the retirement benefits, a minority of partnership agreements allow retired partners to vote on mergers or other major events.

Work after retirement. Generally, there is no right to continue to work after retirement. However, some firms find utility to partners continuing on as employees after retirement. In such cases, the former partner should sign an agreement extending the restrictive covenants through a period after employment ends.

Pre-retirement withdrawal or involuntary termination. If a partner leaves the firm prior to the early-retirement age, retirement benefits may still be provided to the extent that they are vested, but payments may not begin until the early retirement age is reached. The partner may lose all retirement benefits in the event of a "for cause" involuntary termination.

Death and life insurance. Many firms have life insurance on their partners, which buys the firm time as a death may occur suddenly, without an opportunity to transition clients and other responsibilities. All or a portion of the insurance proceeds may be paid to the deceased partner's estate immediately after death to the extent of the capital account and, in some cases, the retirement benefits. Upon retirement, partners are usually allowed to take over the insurance policy.

Compensation. Compensation is usually determined by a compensation committee, rather than being directly addressed in the partnership agreement. How the compensation committee is chosen, terms of office and so forth may be provided in the partnership agreement. The compensation committee may develop a compensation policy, but the committee must make clear that the policy is not part of the partnership agreement. This is to avoid a claim by a partner that a certain for-

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mula or process is somehow part of the partnership agreement, rather than merely current policy guidelines. I have not seen a partnership agreement that addresses whether the compensation system will be opened or closed, probably because this is left as a management decision.

Partner removal. Removing a partner often requires a supermajority vote, although in some firms the executive committee has this authority. The executive committee should always have the ability to remove a partner for violations of law, regulations, ethics codes or professional requirements.

Income partners

It is important to clearly define the legal relationship of income partners to the firm. The best practice is to have separate agreements with income partners that make clear that they are at-will employees and that they are bound by restrictive covenants. The separate agreement would also contain any other terms of the relationship. Typically, income partners do not make capital contributions and have no voting rights. Income partners are considered employees of the partnership, and, as employees, they have all the rights of employees, including protection against age discrimination. Therefore, mandatory retirement provisions generally should not apply to income partners.

Some firms choose to include income partners in their partnership agreement and have designated sections that deal with the rights of income partners. It is important to make sure that income partners are subject to the restrictive covenants. In some cases, partnership agreements will provide certain severance benefits to income partners (but not the same benefits available to equity partners).

Generally, the better practice is to not have income partners be signatories to the partnership agreement. There may be provisions of the agreement that are confidential. Further, in practice, it is difficult to avoid all ambiguity as to whether a particular section in an agreement applies to income partners.

The nuts and bolts of the agreement

Following are "nuts and bolts" provisions of the partnership agreement:

- *Full time*. It is important to require each partner to devote his or her full-time professional attention to the partnership's business. Side businesses can be very distracting, cause resentment among the other partners and may involve the partnership in lawsuits involving the other business activity. The partnership agreement should make clear that proceeds of all work belong to the partnership, including all books, computer programs, speaking fees, board fees, trustee and executor fees.
- *Amendments*. It is important to carefully address how the partnership agreement can be amended. The partnership must be flexible enough so that a majority or supermajority can amend the agreement, rather than requiring unanimity. Most amendment provisions provide protections against changes that single out any one particular partner. Some agreements provide that if an amendment changes retirement benefits, the changes only apply to partners under a specified age, with partners close to retirement being grandfathered.
- *Contribution right*. A partnership agreement should provide a right of contribution among the partners. So, for example, if one or more of the partners guaranteed a bank loan and is called upon to make good on that loan, then all partners contribute in proportion to their percentage interests or on an equal basis.
- *Standards and reputation*. The partners should agree to adhere to all laws, regulations, professional standards and codes, and such adherence should be necessary to maintain partner status. As it is important that the firm maintain its reputation in the community, many partnership agreements contain provisions where partners agree to file their tax returns and to pay their taxes and debts.
- *Arbitration*. Many partners believe that arbitration or mediation are preferable in lieu of or prior to court proceedings. However, this should not apply to the right of the partnership to seek injunctive relief in a court in the event of a breach of a restrictive covenant.
- *Indemnification*. Most partnerships will indemnify partners for action taken in the line of work as long as it does not involve gross negligence or willful misconduct. The corollary to this is that many partnership agreements will require indemnification by

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partners relating to acts committed by them of gross negligence or willful misconduct.

- *Confidentiality.* Partners should be required to keep firm and client information confidential.

In conclusion, the partnership agreement is a fundamental part of managing an accounting firm and the relationship among the partners. Careful attention must be paid to it and it should be revisited periodically.

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