

YOUR MONEY:

How To Add An Equity Partner, Part II

March 2007, By Guy McPhail

(In the first installment of this two-part series, Financial Advisor Guy McPhail laid out the reasons for bringing in a new equity partner or putting employees on a path to equity participation. In the second installment, he provides a step-by-step guideline on how to do this correctly.)

1. Partnership or stockholder agreements

A partnership or stockholder agreement spells out the exact terms and conditions of the partnership, including who owns what. Make sure your agreement document is up-to-date and reflects the structure of your business (e.g., S-Corp, LLC, etc.). Keep records when establishing or modifying partnership or stockholder agreements.

2. A buy-sell agreement

Buy-sell agreements are like prenuptial agreements among owners, which stipulate when owners can sell their interests, to whom and at what price. They are used when an owner retires, goes bankrupt, becomes disabled, gets divorced or dies, to provide the orderly transfer of his or her shares to other owners. Without a proper agreement, a firm can be forced to liquidate to buy out an owner's heirs, so execute a buy-sell agreement immediately when adding a new partner. Also, hire a qualified business appraiser to periodically update the valuation of the business. (For more on buy-sell agreements, please see these stories on Small Business Review).

3. Formal owner compensation and incentive plans

I recommend that each owner has his own annual compensation and incentive plan, and that it is agreed to by his partner or partners. The plan spells out what each owner is accountable for and what they can expect in cash flow from the business. Your annual budgeting process should include review of these plans.

The Eight-Point Checklist

1. Partnership or stockholder agreements
2. Buy – Sell Agreement
3. Owner compensation and incentive plans
4. Establish guidelines for contributions to revenue and division of income
5. Update the financial plan for your business
6. Review staff employment agreements
7. Create annual game plan, with quarterly reviews
8. Add annual owners' retreat

4. Establish guidelines for contributions to revenue and division of income

I often see businesses in which one partner has more administrative or managerial duties while the other has more billable hours or is responsible for new business development. If one law firm partner bills \$1 million annually and the other bills \$750,000, but also acts as managing partner, they may wind up with equal salaries. If both partners have similar administrative responsibilities, the \$1 million producer needs to get a higher proportion of the income. On the other hand, if the lower producer owns 80% of the equity, he is also entitled to a greater share of the profits. All these considerations should be spelled out in the compensation agreements.

The compensation plan must also take into account the tax implications of how monies are distributed — how much will be salary, how much will be profit distribution and so on. To make sure you handle these critical financial issues correctly, find yourself a great CPA and financial advisor.

Could your business production income expectations for each partner be too high or low? Research this in your industry's trade magazines; they may provide some useful perspective. For my business I keep up with financial planning magazines and industry surveys to track where our firm is and how much other professionals are producing.

5. Update the financial plan for your business

Once you add a new partner to your business, your company's financial plan needs to be updated to reflect the firm's new expectations. It also is a good time to update your personal financial plan, which will be affected also.

The financial plan for your business should act as a road map, depicting where your business stands and where it is headed financially. Each owner needs to understand and agree to the financial milestones in the plan. (These should be achievable and realistic, but should represent a challenge to for each owner.

When working with a small business owner on a financial plan, here are just some of the many questions we ask:

- Is your actual revenue in line with your targeted revenue?
- Are your profits and distributions to owners where you have it targeted?
- Are contributions for the owners to retirement plans being made as expected?
- Is your pension plan portfolio on track?

Having a current financial plan for your business will give you a benchmark and guide for making more educated decisions about what action steps you may need to take next for achieving your financial goals for your business.

6. Employment agreements for staff

When adding a new partner, it's a good time to think about your employees, too. Employment agreements, which can stipulate, for example, that employees abide by relevant government regulations, can save a small business a great deal of trouble. An employment agreement may be an explicit or implied contract; most employees work under employment contracts, whether they realize it or not. For example, if during orientation a new employee signs a promise to abide by company policy, it likely constitutes an employment contract. An employment contract can also include noncompete agreements, protecting the firm when a key employee leaves.

Remember: These contracts work both ways. A violation of terms in an employment contract by either an employee or employer can result in breach of contract.

7. Annual plans with quarterly reviews

Too often, I see partnerships in which one owner is wondering exactly what the others are doing with their time and how they are pulling their weight. What can you do so that this doesn't occur at your business? The owners must acknowledge that each of them has certain talents and areas of expertise—marketing, manufacturing, management, etc. Each owner's areas of responsibility should be clearly defined, with expectations of how those responsibilities are to be carried out enshrined in the financial plan. (See how my checklist of points interconnect?)

Holding quarterly review meetings is a good means of assuring that the right hand knows what the left hand is doing. Owner/managers get an opportunity to review each other's activities and exchange ideas and feedback that can help ensure the company is on track. These sessions also provide an opportunity for senior partners to train or coach junior partners on skills they may have yet to master.

8. Annual firm retreat

My firm benefits enormously from an annual retreat. We use it for brainstorming, relaxation and as a reward for another year in business. These events, which usually last two to three days, give us an opportunity to leave the ringing phones and email behind and take the time to discuss business-management issues that keep getting pushed to the back burner. Topics that are always on my firm's agenda include new business development and how we can fine-tune our client service process.

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