WHEN GOOD PARTNERS GO BAD

BY KATIE KEIR, ASSISTANT EDITOR OF ADVISOR GROUP

DISCUSSING EXIT STRATEGIES EARLY WILL HELP YOU MANAGE A SPLIT

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THREE TYPES of PARTNERS

FINDER
The partner who locates prospects and brings in clients. He'll also meet with industry connections and attend events to keep tabs on trends.

MINDER
The main client-facing partner who works directly with major customers and develops their portfolios.

GRINDER
The partner who processes paperwork, and deals with the accounting and operational side of the business.

* Not their real names

IF YOU AND YOUR PARTNER HAVE A STANDARD BUSINESS AGREEMENT, GREAT—BUT IT WON'T PROTECT YOU IF THE PARTNERSHIP FALLS APART.

Standard agreements map out how to deal with the impacts of death, disability and bankruptcy. They're essential, but you're fooling yourself if you think they cover true worst-case scenarios.

Michael Vaughn*, a Vancouver-based advisor, found out the hard way.

Early in his career, he joined a senior colleague's new, independent business. Vaughn, who was brought on for his investment expertise, thought they had a solid partnership agreement. But the document only covered common exit scenarios and didn't protect him when things went sour.

Worse, some portions of the agreement were verbal—a major oversight.

Though he and his partner were compatible the first few years—both worked on "revolutionizing and growing the business," he concedes—their connection deteriorated.

We exited "the honeymoon phase and entered a nightmare scenario," he says. "My partner underwent a major personality shift. Whether that was due to greed, jealousy of my client relationships and expertise, or his natural disposition coming out, the relationship turned hostile."

The older partner started exploiting holes in their agreement by bending compensation rules, adding clauses and altering how Vaughn could access equity.

Realizing it was impossible to save the marred partnership, he cut his losses. And, in the aftermath, Vaughn's former partner used industry connections to attempt to ruin his career, forcing him to do damage control while getting back on his feet.

While a more detailed partnership agreement would have better protected his interests, it couldn't account for a vindictive partner.

The lesson? Properly evaluate your partner's personality, and then enact a complex, detailed agreement that protects your clients and your share of the business.

Test your compatibility

One major indicator of a prospective partner's value is her work history and reputation, says David Shlagbaum, partner at law firm Robins Appleby & Taub in Toronto. "Look at the existing liabilities and assets of your target partner, as you would an investment in a business," he says.

Find out her preferred compensation and fee structure, approach to risk, balance-sheet strength, and the content of her client reviews over the past five years. Look for red flags like high turnover rates and pending lawsuits. If your prospective partner won't cooperate with the discovery process, walk away.

And, it's not enough to have similar backgrounds and investing styles. You need to know whether your partner will be able to handle unanticipated challenges as your business evolves.

Vaughn recently started fresh with new partners; and, chastened by his breakup, proceeded with caution. Before sealing the deal, the new group met two-to-three ▶16

MYTHBUSTER

YOU NEED TO REPLACE PARTNERS *Not necessarily. Running a business alone means you'll keep all profits and maintain control. If you can't offer lost services, you can always refer clients to peers.*

John O'Connell
CEO of Davis Rea

> "THE INITIATOR will have plans ready long before the other party realizes what's going on."
>
> **Gregory Keele*, a Manitoba-based advisor**

ALL'S WELL THAT ENDS WELL

Partnerships most often dissolve in the face of changing priorities.

Take John O'Connell, CEO of Davis Rea in Toronto, who worked as an RBC portfolio manager for 25 years. Despite his success, he says he refined his goals, prompting him to leave in 2010.

He'd always wanted to own a money management company, so he decided to acquire one.

The bank had clear guidelines to deal with his departure—the key to keeping the breakup harmonious. O'Connell didn't have to hold difficult negotiations with his partners, which left their friendships intact and let him make a clean break.

To this day, he keeps contact with his former team. "Though we're not in a formal business partnership, they're great guys and I wouldn't hesitate sending clients to them," he says.

Peter Taylor, a Halifax-based advisor, agrees breakups don't have to be difficult. He and his two former partners had a strong working relationship and discussed their concerns regularly.*

When he announced he was leaving, they were disappointed, but understood his motivations. He gave three months' notice and continued to work there until the day his new business opened.

More importantly, they divided their business without needing legal help. His former colleagues have since hired a marketing specialist rather than a new partner, and Taylor has built the business he envisioned. His biggest success? Like O'Connell, he also preserved his connections, which is crucial in such a close-knit industry.

As O'Connell says, "Protecting your reputation should be your main focus in the midst of a business breakup." You should act professionally during and after all negotiations, since people in the industry will find out about your split and how it played out.

And, if a client were to call your former partners for a reference, you'd want them to speak highly of you—they're one of your best referral sources.

◀15 times per week for six months to discuss operational details and business planning, as well as each of their working styles, outlooks and experiences (see "Three types of partners," page 15).

Bryan Gelman, bankruptcy trustee and co-founder of Albert Gelman Inc. in Toronto, suggests asking how your partner would cover major personal debts, such as mortgages, if the practice has lean years. This will ensure you're not stuck with a disproportionate amount of operational costs or liabilities.

"Partners need to discuss their goals, as well as their projected revenues and expenses for at least the next five years," says Shlagbaum. "If any financing will be involved to get the business off the ground, each partner has to decide where it will come from—from another partner or a bank, for example."

Figure out who will be bringing in business and meeting with clients versus who'll manage the finances. Further, if one partner develops tax or insurance expertise along the way, all partners must discuss how this affects branding, workload division, and compensation.

For instance, even if only one partner can give tax advice, others can process tax returns or take on the firm's smaller clients.

Most importantly, those new divisions of labour must be codified in a revised partnership agreement and supporting documents.

Making it official

But partnership agreements don't cover all relevant areas.

To fill in the blanks, draft a separate partnership charter that outlines each partner's goals, expectations, responsibilities, and views on money and investing.

Though the charter takes considerable effort to create, he says, you'll reference it repeatedly to resolve conflicts and reaffirm business goals and expectations.

Formally review the agreement and charter quarterly, says John O'Connell, CEO of Davis Rea in Toronto, and address shifting priorities, unmet expectations and the last three months' successes and challenges.

"It doesn't have to be a negative experience, and all members should be open about their feedback. Setting regular reviews in advance helps each partner consider any crucial business issues prior to the meeting," he says (Read his successful breakup story on page 16).

Re-examine the documents sooner if a partner's situation changes. This will prevent having to make modifications during stressful times (see "Hidden challenges," this page).

Each year, determine a fair market value for the company, "which can be used in the event of breakdown between partners," says Gelman. Then, address compensation and insurance requirements based on that valuation.

Standard agreements make business division seem cut and dried, but breakups are always difficult even if they're amicable.

Take Halifax advisor Peter Taylor*. When he realized he and his two partners didn't see eye-to-eye on marketing strategies, he left to start his own firm. Though the split was harmonious, he had to start over. Plus his former partners lost significant revenue, and almost half their clients due to his departure.

But since they'd discussed expectations at the outset, they minimized their stress and financial loss. What's more, they're on good terms and still share one client.

No agreement?

If you don't have an agreement before your breakup, you're in for a major challenge. Whether you plan to keep, leave or close the business, you'll need to value and divide it. Doing this from scratch will eat time and money—and reduce your eventual payout.

"The initiator [or someone who has prepared well for a breakup] has the upper hand, especially if she has thought about moving on and covering costs. She'll have plans ready long before the other party realizes what's going on," says Gregory Keele*, a Manitoba-based advisor who's suffered through a few business breakups.

He didn't initiate his most recent split. And though they had an agreement, he wasn't aware of his partner's discontent, and was caught off guard.

That kind of pressure can compromise the negotiation process; more so if partners had been scraping to meet their bottom lines. When businesses are profitable, partners focus on shared successes, not compensation disparities. But when revenue's low, "partners become more selfish. [Financial strain] also changes people's perceptions of the rules," says Shlagbaum.

This leads to partners renegotiating their agreements. Though you may have informally discussed how to divide property and split profits, greed may warp each partner's expectations.

Partners buying each other out will often offer less for assets they want, demand more for items they're forced to sell, and withhold crucial data out of spite.

So, people should seek advice separately, and move to arbitration if they ▶18

HIDDEN CHALLENGES

Aside from obvious stress points like divorce, death and illness, consider these potential issues when striking a business deal or evaluating your current partnership:

DISABLED PARTNER STAYS INVOLVED

A disabled partner is usually compensated for a set period of time until his disability coverage commences, says insolvency specialist Bryan Gelman. But what if he wants to remain active in the business? Build a solution to this scenario into your agreement.

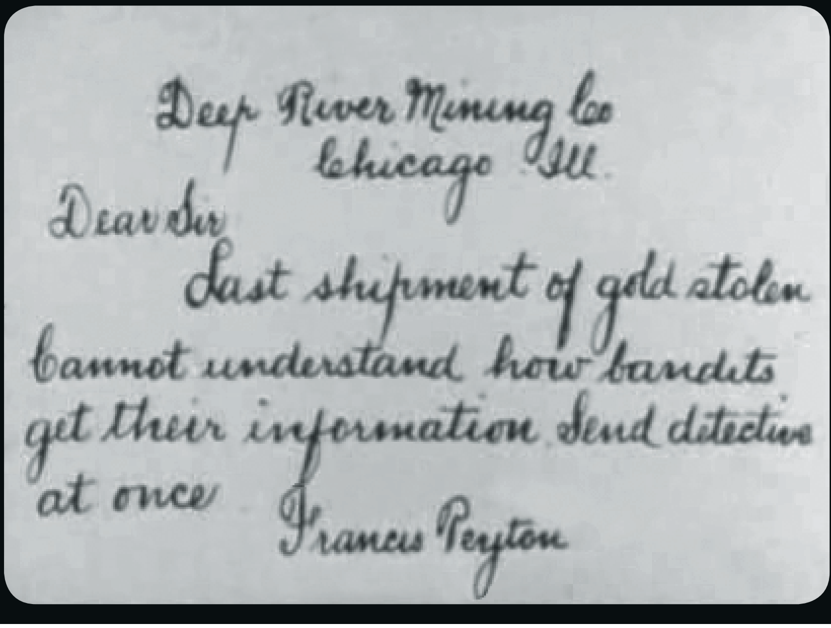
WORKLOAD FLUCTUATES

Say your partner brings in a major client, or you make a connection that boosts your practice's reputation. Is a raise in order? Assign a value to such improvements. And remember, compensation and salary drive behaviour, so track each partner's goals and expectations.

LIFE INSURANCE ON A PARTNER

This protects your business if a partner dies, because it may take a while to find someone to make up the lost income. ▶18

JAIME HOGGE, PUBLICDOMAIN.ARCHIVE.ORG


Deep River Mining Co
Chicago Ill
Dear Sir
Last shipment of gold stolen
Cannot understand how bandits
get their information Send detective
at once
Francis Peyton

◀17 can't negotiate the split themselves. Each advisor would then value the business independently, and a judge would decide on an appropriate amount.

He warns pendulum-style arbitration, when the judge chooses one partner's valuation over the other, is becoming more common. "Partners are pushed toward a more accurate, fair assessment since they know only one value will be chosen," says Gelman.

If a death sparks the business division, surviving partners could find themselves dealing with an insurance rep or spouse instead. They'll often demand payout for their full share of the business immediately.

If the survivors don't have enough cash, they'll either pay out their share over a few years, or get a loan. By stipulating payout terms to family members or taking out life insurance on your partner, you can avoid this hassle.

IF YOU HANDLE THE BREAKUP BADLY, NEWS WILL SPREAD FAST IN THIS INDUSTRY.

In Keele's new multi-firm partnership, the ages of the parties range from 35-to-60. Their agreement accounts for the differing retirement horizons and financial goals, and the possibility of a partner's death. It's designed to prevent surprise departures.

Breaking the news

Write into the partnership charter how you'll tell and handle clients in the event of breakup. After all, bitter splits can cause advisors to fight over each file.

Keele says, "In my case, the books of business were always kept separate, and that's much simpler. It's ultimately the client's decision, though, and most want to stay with the person they're currently dealing with."

Larger firms sometimes use a third party to break the news, says Gelman. But personal meetings are preferable, and you'll have a better chance of retaining clients if they feel well informed.

Shlagbaum says to assure them they'll receive the same level of service by staying with you. If you're merging with another partner or firm, highlight the new services they'll receive. He notes they'll also be concerned about fees and rates.

Don't deliver the news until you've confirmed the breakup and all the partners have agreed on what to tell clients. Everyone should receive the same information at once.

Taylor gave his clients a month to decide whether to come with him or stay with his former colleagues. Though most stuck with him, a few re-interviewed him and his partners to assess which was the better option.

But if you're part of a large firm, you won't have rights to client files. In O'Connell's case, RBC was legally entitled to all client data. These institutions will also have non-compete and non-solicitation agreements that determine if and when departing partners can start a new business. These often include geographical limitations, and will severely limit your options once you make an exit.

And if an old client approaches, you may have to decline. Or, if you decide to work with him, retain documentation that proves he initiated contact. AE

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ADDING NEW PARTNERS

When bringing in a new partner, lawyer David Shlagbaum suggests collaborating on a trial basis for at least six months. Create a cost-and fee-sharing structure until you're ready to formalize the relationship.

"Offering conditional employment is unfair," adds advisor Peter Taylor*. "It's important to maintain the identity and structure of your firm, so perform due diligence and discuss how a partner plans to do business."

He says another option is to hire the person as an employee and evaluate your working relationship.

And if you decide to name her a partner, Shlagbaum says it's usually a good idea to create a new agreement.

◀17

"If the business pays for premiums and deducts them for tax purposes, any payouts under the policy may be treated as taxable income," says Gelman. So consider having partners pay out of pocket. But premiums will inevitably differ among partners—one partner's policy may cost more because she smokes, for instance—and this can cause resentment.

YOU HIRE FORMER EMPLOYEES

Consult labour laws when rehiring or terminating former employees. By law, you could be responsible for severance payments and other benefits dating back to the employee's start date at the predecessor company.